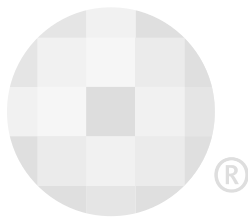
Planning Lump Sum Distributions of Employer Stock from Stock Bonus Plans and ESOPs

By Vorris J. Blankenship

Vorris J. Blankenship examines planning lump sum distributions from stock bonus plans and employee stock ownership plans.



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Stock bonus plans and employee stock ownership plans (ESOPs) must generally honor a participant's demand to distribute the participant's benefits in employer securities rather than cash.[1] The primary benefits of such a distribution are the participant's ability (1) to defer tax on some or all of the net unrealized appreciation (NUA) in the employer securities, and (2) to convert the NUA from ordinary income to capital gain.[2]

NUA is the excess of the value of the employer securities when distributed over the amount the plan paid for the securities.[3] For this purpose, employer securities generally include stock of the employer establishing the plan, and bonds or debentures of the employer if they are in registered form or have interest coupons attached. Employer securities also generally include the same types of stocks, bonds or debentures of the employer's parent corporation and subsidiaries.[4]

A plan participant may exclude from gross income all the NUA included in a "lump sum distribution."[5] A lump sum distribution is generally a distribution, within one tax year, of the full amount credited to the participant by all similar or related plans maintained by the same employer.[6] The participant must also receive the lump sum after attaining age 59 1/2, or on account of the participant's death or separation from service.[7]

The total amount credited to the participant (*i.e.*, the lump sum) is determined as of the date of the *first distribution* occurring after the most recent triggering event (*i.e.*, the first distribution after the most recent to occur of the participant's death, separation from service or attainment of age 59 1/2). That amount may be distributed

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in more than one distribution as long as all the distributions occur in the year of the first distribution. Distributions before the most recent triggering event are irrelevant.[8]

The NUA in a lump sum distribution is not immediately taxable. Instead, the NUA is generally taxable at long-term capital gain rates when the stock is sold,[9] without regard to the stock's holding period.[10]

The Potentially Optimum Result for a Lump Sum Distribution

A plan participant should be able to defer all the tax on a lump sum distribution consisting entirely of employer securities by rolling over securities with a value equal to the otherwise taxable portion of the distribution and personally retaining the remainder of the securities.[11] This result appears to follow from application of the following rules:

1. NUA is excluded from gross income and thus is excluded from the taxable portion of a lump sum distribution.[12]
2. A participant can limit a tax-free partial rollover from the distribution to an amount equal to the otherwise taxable portion of the distribution (from which NUA has already been excluded).[13]
3. The NUA and after-tax investment retained by the participant are not taxable.[14]

The following example illustrates the favorable tax consequences that should result from application of these rules:

Example 1. Assume a plan participant receives a lump sum distribution of $1 million that consists entirely of employer stock. The plan purchased the stock for $240,000, using employer contributions of $90,000 and participant contributions of $150,000.[15] Thus, NUA in the stock equals $760,000 ($1 million of stock less its total cost of $240,000). The taxable portion of the distribution is $90,000 ($1 million of stock less $150,000 investment and less $760,000 of NUA).

The participant should be able to eliminate the taxable portion of the distribution by rolling over stock with a value of $90,000 to an IRA. The participant should then be able to retain tax-free an amount of stock with a value of $910,000 (equal to the sum of the $760,000 of NUA and the $150,000 return of investment). Thus, no portion of the distribution should be immediately taxable. The NUA, of course, will become taxable at long-term capital gain rates to the extent it is realized when the participant sells the retained stock. The distribution and rollover is illustrated in Table 1.

In LTR 8538062, the IRS appeared to agree with the result in Example 1. In the ruling, the IRS allowed a plan participant to offset the otherwise taxable amount of a distribution by the full fair market value of stock rolled over. Thus, the NUA associated with the rolled-over stock appeared to remain with the stock not rolled over. In a more recent ruling with similar facts, the IRS had an opportunity to comment negatively on a participant's assignment of all of a distribution's NUA to retained stock (and none to stock rolled over), but did not do so. In fact, the IRS seemed to tacitly endorse the participant's NUA allocation, by granting a waiver of the 60-day rollover period expressly designed to facilitate it.[16]

Note that the plan participant in Example 1 personally retained his after-tax investment of $150,000. Thus, the investment remained imbedded in the participant's retained stock along with the NUA (perhaps for a very long time if the participant intended to defer the gain on the stock indefinitely). Consequently, the participant might also want to roll over the investment into the IRA by increasing the amount of the rollover by another $150,000 of stock. Unfortunately, the participant is unlikely to succeed in that effort.

TABLE 1.

	Pre-Rollover Distribution	Rolled-Over Portion	Retained Portion
Participant contributions (investment)	150,000	0	150,000
NUA retained	760,000	0	760,000
Taxable portion rolled over tax-free	90,000	90,000	0
Total value of distributed stock	1,000,000	90,000	910,000

TABLE 2.

	Pre-Rollover Distribution	Rolled-Over Portion	Retained Portion
Participant contributions (investment)	150,000	150,000	0
NUA retained	760,000	0	760,000
Taxable portion rolled over tax-free	90,000	90,000	0
Total value of distributed stock	1,000,000	240,000	760,000

Example 2. (a) Assume the same facts as in Example 1 above, except that the plan participant rolls over stock with a

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value of $240,000 to an IRA. The first $90,000 of the rollover consists of the otherwise taxable amount of the distribution. The participant then hopes that the remaining $150,000 of the rollover will consist of the participant's recovery of after-tax investment. The desired result is illustrated in Table 2.

(b) Unfortunately, the $150,000 rollover characterized as participant investment in the above schedule is most probably a combination of NUA and participant investment. The relevant statutory language specifies only that the rollover consists first of the otherwise taxable income of $90,000. The statute does not specifically characterize the rollover to the extent it exceeds that taxable amount.[17] If the IRS characterized the excess as investment and NUA in the same proportions as in the original distribution, the result would be as illustrated in Table 3.

The rollover in Table 3 still eliminates taxable income. However, the proportionate allocation of investment and NUA to the rollover leaves most of the investment with the participant. It also effectively destroys NUA of $125,275, since the participant may not characterize as NUA any subsequent IRA distributions of the rolled-over stock.[18]

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The IRS might even contend that NUA must be rolled over (and eliminated) in its entirety before any portion of the investment can be rolled over. In LTR 9043056,[19] a plan participant rolled over to an IRA all the employer stock distributed to him except an amount of stock equal in value to his investment. The IRS concluded that the participant had retained only his investment in the plan, thus implying the participant had rolled over all the NUA in the distributed stock (including the NUA in retained stock).

However, the tax law was quite different when the IRS issued this ruling. Then, the maximum amount a participant could roll over was the excess of the lump sum distribution over the "employee contributions" to the plan.[20] Employee contributions did not include NUA,[21] so the participant's retention of only the contributions indicated that the participant had rolled over all the NUA in the stock, while retaining the investment. By contrast, the current statutory language specifies only that the rollover consists first of the otherwise taxable income in the lump sum distribution. The statute does not specify the character of the rollover to the extent it exceeds that taxable amount.[22]

The IRS May Attempt to Identify NUA with Specific Stock Rolled Over

Despite the logic of Examples 1 and 2(b) above, the IRS may insist that NUA is identified only with the specific stock that generated it. Under this theory, rolled-over stock would carry with it the NUA associated with that stock, and the retained stock would not contain any of the NUA generated by the rolled-over stock.

For example, in at least three private letter rulings, the IRS expressed agreement with a plan participant's stated intention to treat as NUA only the NUA in employer stock not rolled over (thus forgoing the benefit of NUA in stock rolled over).[23] Of course, it is possible the IRS was simply reluctant to grant a ruling broader than that requested by the participant. However, as long ago as the year 2000, staff of the Treasury and the IRS indicated informally to an American Bar Association committee that LTR 8538062, discussed above, was issued in error and that NUA "follows the stock."[24]

The problem with such a contention is that the statute very clearly provides that NUA is excluded from the taxable portion of a distribution, determined before any rollover.[25] The statute then provides that the taxable portion of the distribution so diminished is rolled over before any nontaxable amounts.[26] The rollover, then, is characterized first by reference to the taxable portion of the distribution and second by reference to the nontaxable portions (investment and NUA) and not by the type of property rolled over. Thus, the tax effect of the rollover should be the same whether the participant rolls over cash, employer securities, or some other type of property.

Furthermore, NUA is by definition the total appreciation in value of stock distributed during the tax year offset by the total decline in value of other stock distributed during the tax year.[27] Because of the offset of appreciation and depreciation, NUA loses its connection to the specific shares of stock that generated it. In fact, the IRS requires a participant to allocate NUA *equally* to each share

TABLE 3.

	Pre-Rollover Distribution	Rolled-Over Portion	Retained Portion
Participant contributions (investment)	150,000	24,725	125,275
NUA before/after rollover	760,000	125,275	634,725
Taxable portion rolled over tax-free	90,000	90,000	0
Total value of distributed stock	1,000,000	240,000	760,000

of retained employer stock to determine the basis of the stock for future sale (regardless of the NUA actually generated by each such share).[28] Thus, the NUA component of a distribution has almost the same kind of amorphous disconnect from specific property distributed as do the investment and taxable components of the distribution.

Nevertheless, if the IRS did successfully assert in Example 1 above that the participant must allocate some of the distributed NUA to stock rolled over, that portion of the NUA might be effectively eliminated and some of the retained portion of the distribution might become taxable.

Example 3. Assume the same facts as in Example 1, except that the IRS is successful in allocating a proportionate amount of the NUA to the stock rolled over. Note that NUA in Example 1 represents 76 percent of the value of the distributed stock ($760,000 of NUA divided by $1 million of stock). Thus, with a proportionate allocation of NUA, the $90,000 rollover amount would contain $68,400 of NUA (76 percent of the $90,000 rollover amount). The remaining $21,600 portion of the rollover would represent some of the otherwise taxable amount in the distribution.

Thus, the plan participant would retain and be taxable on $68,400 of the distribution ($90,000 taxable amount before rollover less $21,600 rolled over). The participant would also retain tax-free $691,600 of the original NUA ($760,000 of original NUA less $68,400 of rolled-over NUA). Finally, the participant would retain tax-free the $150,000 investment portion of the distribution. The final result is summarized in Table 4.

Thus, an IRS allocation of NUA to rolled-over stock would reduce retained NUA by $68,400 and would increase retained taxable income by an equal amount. Consequently, the participant would fail to make the distribution and rollover nontaxable. Furthermore, the rolled-over NUA could no longer be characterized as NUA.[29] Note again, though, that this potential IRS position seemingly violates the requirement that the taxable component of a distribution must be rolled over before a nontaxable component (the NUA).

Nevertheless, to ensure that the distribution and rollover in the above example are nontaxable, the participant might want to anticipate the IRS's contention that rolled-over stock contains NUA. The participant could do so by iteratively determining an optimum rollover amount that would assure that the distribution and rollover are nontaxable, while minimizing elimination of NUA.[30]

Example 4. Assume the same facts as in Example 3, except that the plan participant rolls over tax-free an amount of stock with an iteratively determined value of $375,000.[31] Then, the rollover consists of $285,000 of NUA (76 percent of the $375,000 rollover amount) and the $90,000 portion of the distribution that is otherwise taxable. The participant retains tax-free the $150,000 investment portion of the distribution and $475,000 of the original NUA ($760,000 of original NUA less $285,000 of rolled-over NUA). Thus, the distribution and rollover would be totally tax-free (even under the IRS's most unfavorable potential position). The result is summarized in Table 5.

Thus, by rolling over $285,000 more than in Example 3, the participant eliminated the entire $90,000 of otherwise taxable income. The offset is that the participant irrevocably lost $285,000 of NUA through the rollover (under the IRS's most unfavorable potential position).

The above examples assume that all participant contributions are used to purchase employer stock and that the lump sum distribution consists entirely of employer

TABLE 4.

	Pre-Rollover Distribution	Rolled-Over Portion	Retained Portion
Participant contributions (investment)	150,000	0	150,000
NUA before/after rollover	760,000	68,400	691,600
Taxable portion before/after rollover	90,000	21,600	68,400
Total value of distributed stock	1,000,000	90,000	910,000

TABLE 5.

	Pre-Rollover Distribution	Rolled-Over Portion	Retained Portion
Participant contributions (investment)	150,000	0	150,000
NUA before/after rollover	760,000	285,000	475,000
Taxable portion rolled over tax-free	90,000	90,000	0
Total value of distributed stock	1,000,000	375,000	625,000

stock. If instead the participant has made some after-tax contributions that were not used to purchase employer stock, the participant might be able to eliminate or diminish taxable income without wasting NUA. That is, previous participant contributions not used to purchase employer stock may have given the plan sufficient cash and investment to eliminate or diminish otherwise taxable income without rolling over employer stock containing NUA.

Example 5. Assume the facts are the same as in Example 4, except as follows. In addition to the participant's contributions of $150,000 to purchase employer stock, the participant has over the years made after-tax contributions of $60,000 to the plan that were not used to purchase employer stock. Because of the additional contributions (and earnings thereon), the plan held $70,000 cash, in addition to the $1 million of employer stock. In that case, the taxable portion of the distribution is $100,000 (the $1,070,000 distribution less NUA of $760,000 and less participant investment of $210,000).

Assume the participant rolls over the $70,000 cash distribution to an IRA and retains the $1 million of employer stock. Then, the taxable portion of the distribution is reduced from $100,000 to $30,000. The participant retains tax-free the $210,000 investment portion of the distribution and the entire NUA of $760,000.

Mathematically, the $30,000 of taxable income left after the rollover is attributable to the $90,000 of employer contributions offset by the $60,000 of participant contributions not used to purchase stock. The participant could have reduced the taxable income to zero if over the years she had made another $30,000 of contributions not used to purchase stock and then rolled over the extra $30,000 to the IRA.

However, a participant would be ill-advised to make such a contribution immediately before the lump sum distribution of all funds. The IRS and the courts would almost certainly apply the step transaction doctrine or some other substance-over-form doctrine to disregard a last minute contribution that is immediately distributed and rolled over.[32] They would instead treat that part of the rollover as a direct contribution to the IRA (most likely an excess contribution subject to penalty).

Diminished Deferral for Non-Readily Tradable Stock

The tax deferral afforded by NUA is generally greater for readily tradable stock than it is for stock that is not readily tradable. For stock that is readily tradable, a plan participant may defer some or all of the tax on NUA indefinitely simply by continuing to hold some or all of the stock.

On the other hand, a participant must, as a practical matter, exercise his or her option to sell non-readily tradable stock to the employer within a relatively short period after receiving the stock, or risk "getting stuck" with unmarketable stock.[33] More specifically, if a stock bonus plan or ESOP distributes employer stock that is not readily tradable, the participant may require the employer to repurchase the stock under a fair valuation formula.[34] A participant may generally exercise this repurchase option (or "put") during the 60-day period immediately following the distribution of employer stock, or during a designated 60-day period in the following plan year.[35]

For employer stock included in a "total distribution," the employer generally must repurchase the stock after exercise of the put option by making substantially equal purchase payments (annually or more frequently) over a prescribed period of five years or less. The payments must begin within 30 days after the participant's exercise of the repurchase option, and the employer must provide adequate security and reasonable interest on unpaid amounts.[36] Fortunately, the IRS will not treat a distribution and immediate repurchase of the stock as if it were a cash distribution, even if the participant provides instructions for the repurchase in advance of the distribution.[37]

Thus, the participant may exclude NUA from the otherwise taxable portion of the distribution, and may report any gain on the employer's repurchase of the stock as long-term capital gain, at least to the extent of the NUA.[38] Obviously though, deferral of the NUA ends with the sale of the stock.

As an alternative, the participant might defer all the income on the distribution by rolling over all the stock or its

TABLE 6.

	Pre-Rollover Distribution	Rolled-Over Portion	Retained Portion
Participant contributions (investment)	210,000	0	210,000
NUA retained	760,000	0	760,000
Taxable portion before/after rollover	100,000	70,000	30,000
Total value distributed stock and cash	1,070,000	70,000	1,000,000

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proceeds to an IRA. However, in that case, the participant would forfeit capital gain treatment for the NUA. The rollover decision should of course take into account the more complete tax deferral advantage of an IRA rollover versus the higher ordinary income tax rates applicable to eventual IRA distributions. The shorter the deferral period in the IRA, the relatively less desirable a total rollover.

If a plan participant intends to sell employer stock and ultimately leave the proceeds to charity, the participant may be able to extend deferral of capital gain on the stock well beyond the date of its sale. That is, the participant may form a charitable remainder trust (CRT)[39] and contribute the stock to the CRT. The participant will generally receive an income and gift tax charitable deduction for the contribution equal to the present value of the charitable remainder.[40] Subsequent sale of the stock by the CRT will normally not be taxable to the CRT or the participant.[41] Rather, capital gain on the sale will be taxable to the participant gradually over future years as he or she receives distributions from the CRT.[42]

ENDNOTES

1. Code Sec. 409(h)(1)(A).
2. Code Sec. 402(e)(4)(E).
3. Reg. §1.402(a)-1(b)(2)(i). A plan participant must net appreciation and depreciation in distributed employer securities, and must treat two or more distributions of securities in a tax year as a single distribution. *Id*.
4. Code Sec. 402(e)(4)(E). For ESOPs, employer securities are generally limited to common stock and certain convertible preferred stock. Code Sec. 409(*l*).
5. Code Sec. 402(e)(4)(B). Note, though, that even though excluded from gross income, NUA counts toward satisfaction of any applicable minimum distribution requirements. Reg. §1.401(a)(9)-5, Q&A 9(a). Note also that the tax law applies the NUA rules without regard to state community property laws. Code Sec. 402(e)(4)(D)(iii).
6. Code Sec. 402(e)(4)(D).
7. Code Sec. 402(e)(4)(D)(i).
8. Notice 89-25, Q&A 6, 1989-1 CB 662; Proposed Reg. §1.402(e)-2(d)(1)(ii); LTR 201241019 (July 20, 2012).
9. Code Sec. 1222(3); Reg. §1.402(a)-1(b)(1)(i); Notice 98-24, 1998-1 CB 929. Note that NUA is "income in respect of a decedent" for which a beneficiary does not get a step-up in basis for income tax purposes. Rev. Rul. 75-125, 1975-1 CB 254; Rev. Rul. 69-297, 1969-1 CB 131.
10. Code Sec. 1222(3); Reg. §1.402(a)-1(b)(1)(i); Notice 98-24, 1998-1 CB 929.
11. LTR 8538062 (June 25, 1985); LTR 201144040 (Aug. 12, 2011). A distribution will not fail to qualify as a lump sum distribution merely because the plan participant transfers some portion of the distribution tax-free to an IRA or another qualified retirement plan in a trustee-to-trustee transfer or an indirect rollover. LTR 200003058 (Oct. 29, 1999); LTR 200038057 (June 28, 2000); LTR 200038052 (June 27, 2000).
12. Code Sec. 402(e)(4)(B).
13. Code Sec. 402(c)(2).
14. Code Secs. 72, 402(a), 402(e)(4)(B).
15. For simplicity, assume the employer corporation does not pay dividends on its stock.
16. LTR 201144040 (Aug. 12, 2011).
17. Code Sec. 402(c)(2).
18. The favorable tax treatment of NUA is limited to distributions from qualified plans. It is not available for distributions from IRAs. Code Sec. 402(e)(4). For a rollover to another qualified plan, past NUA is lost but it will begin to accumulate again to the extent of appreciation in employer securities occurring after the rollover. LTR 9424067 (Mar. 23, 1994).
19. LTR 9043056 (Aug. 1, 1990).
20. Code Sec. 402(a)(5)(B) (1986).
21. The IRS specifically held in LTR 8538062 (June 25, 1985) that "employee contributions" did not include NUA.
22. Code Sec. 402(c)(2). In Notice 2014-54, IRB 2014-41, 670, the IRS provided guidance on the allocation of after-tax amounts and pre-tax amounts to multiple rollovers from a single distribution, but did not discuss the treatment of NUA.
23. LTR 200202078 (Oct. 19, 2001); LTR 200038050 (June 26, 2000); LTR 199919039 (Feb. 16, 1999).
24. Joint Committee on Employee Benefits Q&A with the U.S. Treasury Department and IRS based on meeting with staff, May 12, 2000, Item 17.
25. Code Sec. 402(e)(4)(B).
26. Code Sec. 402(c)(1), (2).
27. Reg. §1.402(a)-1(b)(2)(i). For this purpose, a plan participant must treat two or more distributions of securities in a tax year as a single distribution. *Id*.
28. Rev. Rul. 57-514, 1957-2 CB 261.
29. The favorable tax treatment of NUA is limited to distributions from qualified plans. It is not available for distributions from IRAs. Code Sec. 402(e)(4).
30. Alternatively, the plan participant may determine the optimum rollover amount mathematically as R = T ÷ (T + I) × D, where R equals the rollover amount, T equals the otherwise taxable portion of the distribution, I equals the investment portion of the distribution, and D equals the total amount of the distribution.
31. *Id*.
32. *Cf.,* Vorris J. Blankenship, *Rollovers to Roth IRAs Are Complicated by Substance-Over-Form Doctrines,* TAXES, Sept. 2015, at 43.
33. Code Sec. 409(h)(4)–(6); Reg. §54.4975-7(b)(1)(ii), (b)(1)(iii), (b)(10), (b)(11).
34. Code Sec. 409(h)(1)(B).
35. Code Sec. 409(h)(4). Note that such a repurchase option may be exercised for a period of 15 months after the distribution of employer securities that were purchased by the ESOP with the proceeds of a loan from the employer or other "disqualified person," or guaranteed by such a person. Reg. §54.4975-7(b)(1)(ii), (b)(1)(iii), (b)(10), (b)(11).
36. Code Sec. 409(h)(4), (h)(5). Adequate security means something more than a mere promissory note representing the employer's full faith and credit. LTR 9438002 (Apr. 29, 1994). However, a standby letter of credit should normally suffice. LTR 200846024 (Aug. 18, 2008).
37. LTR 200841042 (June 17, 2008).
38. Code Sec. 1222(3); Reg. §1.402(a)-1(b)(1)(i); Notice 98-24, 1998-1 CB 929.
39. Code Sec. 664(d).
40. Code Sec. 2522(c)(2)(A); Code Sec. 170(e), (f).
41. Code Sec. 664(c).
42. Code Sec. 664(b). *See generally* LTR 200202078 (Oct. 19, 2001); LTR 200038050 (June 26, 2000); LTR 199919039 (Feb. 16, 1999).

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