LUMP-SUM DISTRIBUTIONS FROM EMPLOYER RETIREMENT PLANS

By Clark Blackman and Ellen J. Boling

When your plan is invested in employer stock, special tax rules and planning opportunities arise that should be considered before you decide whether or not to roll over the distribution.

In order to attract and retain a talented workforce, most companies offer retirement benefits such as 401(k) and profit sharing plans to their employees. Very often, those plans may be invested in stock of the employer company. As an employee, when you retire or otherwise leave your company, you are usually entitled to take the balance in your retirement plan with you. As a result, you must select a distribution method for withdrawing the value of your retirement plan.

This article discusses a common type of retirement plan distribution method: the lump-sum distribution. Under the lump-sum distribution method, the value of your retirement plan is paid to you and you may choose whether to roll over a portion or all of the assets to an IRA (or another qualified plan). When your plan is invested in employer stock, special tax rules and planning opportunities arise that should be considered before you decide whether or not to roll over the distribution.

In this article, we focus on why you might want to keep the lump distribution assets rather than rolling them into an IRA. So that you may determine the form of distribution most advantageous to your particular situation, it is important for you to understand the federal tax treatment that applies to a lump-sum distribution.

WHAT IS IT?

The concept of a lump-sum distribution is important because only lump-sum distributions are eligible for special tax rules. Lump-sum distributions may only occur from a qualified retirement plan, and then only if the distribution meets the definition of a lump-sum distribution. For your distribution to be considered a "lump-sum distribution," it must meet the following criteria:

- It must be a total distribution of your retirement account.
- It must be the first distribution that occurs after a "qualifying event," which is: a separation from employment (including retirement), attaining age 59½, or death.
- It may be a single distribution or series of distributions occurring in a single tax year.

Distributions from an individual retirement account (IRA) are never considered a lump-sum distribution.

You can roll all, or any part, of your lump-sum distribution into a new qualified plan or IRA. The advantage of an IRA rollover is that tax is postponed until the money is withdrawn from the IRA and you can achieve complete diversification of investments inside your account with no current tax cost. The disadvantage is that you forfeit the use of special tax rules that we'll introduce later in this article.

EMPLOYER STOCK

The biggest reason to consider a lump-sum distribution of employer stock is

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TABLE 1. TAX TREATMENT OF DISTRIBUTIONS

Distributed Asset (No Rollover to IRA)	What Is Taxed?
Employer Stock	Lower of Average Cost or Fair Market Value*
Cash	Cash Received
Other Assets	Fair Market Value

**The participant can elect to pay tax at the time of distribution on the stock's fair market value, even if it is higher than the trustees' cost. Absent any such election, the participant's basis in the stock after distribution is the lower of cost or fair market value.*

the income tax advantage. In the year of the distribution, you pay tax on the trustee's cost basis of the employer stock. The trustee's cost basis ("cost") equals the cumulative purchase price paid by the plan for the employer shares in your account. However, when you sell those shares later on, the difference between the fair market value on the date of the distribution and the cost will be taxed at long-term capital gain rates (the maximum federal capital gain tax rate is currently 20%).

Let's look at an example for one share of stock:

Distribution Fair Market Value	$75.00
Cost	(25.00)
Gain at Distribution	$50.00

In the year of distribution, you pay tax on the trustee's cost basis—$25 in this example—at your ordinary tax rate (unless you qualify for taxation under Special Rule #2 discussed later). If you then sold the stock at, say, $80 per share within one year after your lump-sum distribution, the following happens:

Sale Price	$80.00
Basis	(25.00)
Gain on Sale	$55.00

In this instance, $50.00 of the gain would be taxed at long-term capital gain rates because it is the net unrealized appreciation (NUA) on the lump-sum distribution and automatically receives long-term capital gain treatment, regardless of your holding period after distribution. Any additional appreciation ($5 in this example) is taxed as ordinary income unless the stock is held for more than one year after the lump-sum distribution. If your strategy is to hold the stock for a long period of time before you sell it, and you expect the stock to appreciate in value, you have converted a considerable amount of income from ordinary to capital gain treatment by taking the distribution in the form of stock rather than rolling the stock to your IRA. (Distributions from IRAs are taxed as ordinary income.)

While there are tax advantages to taking a lump-sum distribution of employer stock, do not overlook the potential investment risk you may create by taking a large distribution of stock. If the lump-sum distribution represents a large portion of your total net worth, and it is invested solely in one stock, you have increased your investment risk through non-diversification of your assets. If you are uncomfortable with a large percentage of your net worth being invested in one stock, you should consider a rollover of either part, or all, of the employer stock.

Another reason to consider a lump-sum distribution is for accomplishing estate planning and charitable giving goals. Transferring shares of low-basis stock to an heir or to a charity not only moves the current value of taxable assets out of your estate, but also removes the future appreciation on those assets. By giving away existing and future appreciation, you are also giving away the income tax cost of selling those assets. Remember that your basis and acquisition date of stock you give away transfers to the new owner. As an added benefit, directly gifting highly appreciated stock to a charity creates a current income tax deduction for the full fair market value of the stock given (some limitations do apply).

Low-basis stock in your hands is also valuable for more complex planning techniques. For example, if you wish to establish a charitable remainder trust, you could use the low-basis stock to fund the trust.

Very often one spouse will own a disproportionately large amount of the family's assets because that spouse is employed and is the owner of various employee benefit plans. In order to better equalize the estates of a married couple, and take advantage of the estate tax exemption amount ($675,000 as of this year), the person who has a large retirement account may wish to transfer assets to their spouse. Shares received as a lump-sum distribution and transferred to a spouse result in no current gift taxes.

PARTIAL ROLLOVERS

It is important to understand that a lump-sum distribution of stock is not an all-or-nothing proposition. You can take a total distribution of stock from your retirement plan and choose to keep only a portion of the shares and roll the remainder to your IRA. In order to determine the number of shares of employer stock to receive outright, you must determine your "willingness" to hold employer stock and balance this with your "need" to fund expenses, gifts for estate and charitable purposes, etc.

The first step in assessing how much employer stock to keep is to determine what percentage of your investment portfolio you are willing to hold as employer stock for the long term. Answer this question by assuming the entire plan balance was rolled to an IRA and decide

TABLE 2. TAX RESULTS FROM SELLING SHARES: DIFFERENT SHARE PRICE SCENARIOS

	Scenario 1: Fair Mrkt Value Grows		Scenario 2: Fair Mrkt Value Falls Above Cost		Scenario 3: Fair Mrkt Value Falls Below Cost	
	Hold Stock 1 Yr or Less	Hold Stock More Than 1 Yr	Hold Stock 1 Yr or Less	Hold Stock More Than 1 Yr	Hold Stock 1 Yr or Less	Hold Stock More Than 1 Yr
(A) Cost	50	50	50	50	50	50
(B) Mkt Value at Distrib.	60	60	60	60	60	60
(C) Sale Price	70	70	55	55	40	40
(D) Basis (lesser of A and B)	50	50	50	50	50	50
(E) Total Gain/(Loss) (C - D)	20	20	5	5	(10)	(10)
(F) Built in Long-Term Gain (lesser of (B - A) and E, but not less than 0)	10	10	5	5	0	0
(G) Short-Tm Gain/(Loss) (E - F)	10		0		(10)	
(H) Long-Tm Gain/(Loss) (E - F)		10		0		(10)
(I) Total Gain/(Loss)	20	20	5	5	(10)	(10)

what percentage of employer stock to keep in the IRA. This percentage represents the non-diversified portion of your retirement assets.

Diversification is an important concept when trying to minimize your investment risks. Therefore, you must be willing to accept the "business" risk that comes with owning a large block of employer stock, knowing that this risk could be substantially reduced through diversification.

SPECIAL RULES

Special rule #1

Employer stock received in a lump-sum distribution that is not rolled to an IRA or another qualified plan is taxed at its cost even if another part of the lump-sum distribution is rolled into an IRA or another qualified plan.

Assets other than employer stock are taxed differently at distribution, as reflected in Table 1.

If stock is distributed as part of a lump-sum distribution and not rolled into an IRA, the cost, not the fair market value, is taxable. Your cost for each share of stock distributed is the average cost for all shares in your account.

For instance, if you have employer stock distributed to you, rather than selling it inside the plan and then taking a cash distribution, the stock may have a lower current taxable value using your average cost. If you decide to sell the stock for diversification reasons after a lump-sum distribution, capital gain taxes would be paid on the difference between the fair market value of the stock on the date of sale and its cost.

Subsequent Sale of Assets: Once you receive assets from a lump-sum distribution and do not roll them to an IRA, you establish your cost for calculating gain or loss on any subsequent sale. Your cost basis in those assets equals the taxable income you reported as a result of their distribution to you from the retirement plan. Current tax laws provide for a maximum federal tax rate of 20% on net long-term capital gains.

Employer Stock: Your basis in employer stock upon distribution is the lower of the average cost or the fair market value at distribution. Capital gain or loss will depend upon the difference between this basis and the subsequent sale price. Whether the gain or loss is long-term or short-term will depend, in part, upon whether the shares were held for more than one year from the date of distribution.

Regardless of how long you hold the stock after the distribution, any gain on its subsequent sale, up to the fair market value at distribution, is a long-term capital gain. Any gain beyond the fair market value at distribution will be long-term if you held the shares for more than one year from the date of the distribution. If you held the shares for one year or less, the remainder of the gain would be short-term and subject to ordinary federal income tax rates.

There are several possibilities resulting from the fluctuating value of the stock that lead to different tax results when you sell the shares. Table 2 provides examples that illustrate the results of these various situations. In each case, the cost is lower than the fair market value at distribution. Note that if the fair market value at the date of distribution is less than your cost, it is not advisable to take the stock in a lump-sum distribution as there is no benefit to this alternative. Therefore, the difference between the cost and fair market value at distribution affects the amounts, if any, treated as long-term gain or loss upon subsequent sale. These examples are meant as a guide only and you should seek help from your own advisors upon the actual sale of your stock.

Other Assets: All other assets received in the distribution are valued and taxed at their fair market value at distribution. Any gain or loss upon subsequent sale of the other assets would be based upon a comparison between fair market value at distribution and fair market value at time of sale. Whether the gain or loss is short-term or long-term depends upon whether you held the assets for one year or less prior to sale.

Special Rule #2

Ten-year averaging and 20% capital gain elections are available for a lump-sum distribution only if no part of the plan account balance has ever been rolled into an IRA or another qualified plan. You must have been born prior to 1936 to be eligible for either 10-year averaging or 20% capital gains elections.

If you qualify, you can elect "averaging" to determine your tax. The advantage of averaging is that it may reduce the rate of tax that applies to your lump-sum distribution.

The averaging election can be made only once in your lifetime or at your death and all lump-sum distributions received in that one taxable year must be included in the election. If you elect to use the averaging method of taxation, the distribution may be subject to a 20% withholding requirement. The election and averaging calculations are made on IRS Form 4972, Lump-sum Distributions, which you attach to your personal federal income tax return for the year in which the lump-sum distribution is made.

Special Rule #3:

If you separated from your employer before the calendar year in which you reach age 55, a 10% premature distribution tax penalty applies. This special tax rule relates to any part of the taxable value of the lump-sum distribution not rolled to an IRA. If the cost of employer stock is lower than its fair market value at the time of distribution, and you have not made an election to use the fair market value, the 10% premature distribution penalty will apply to the lower cost and not the fair market value.

CONCLUSION

When severing ties with your employer, choosing a distribution method for your retirement account is not always easy. Balancing your long-term personal financial planning goals with the tax consequences of the distribution is critical. Give careful consideration to the federal tax consequences associated with each type of retirement plan distribution or you could incur a painful and unnecessary tax bill. Factors to consider include:

- The circumstances of your distribution (e.g., your age, reason for distribution, etc.);
- The form of the distribution (cash vs. employer stock); and
- What you do with the distribution (e.g., rollover).

Because of the large amounts of money involved, you may want to contact your tax or financial planning advisor to help you assess your unique situation and to determine your best strategy. ◆