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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OCT 15 2002

Uniform Issue List: 402.07-00, 402.08-01

T:EP:RA:T4

Legend:

Taxpayer A =

Taxpayer B =

Company M =

Stock Exchange N =

Plan X =

Amount 1 =

Dear :

This letter is in response to a ruling request dated June 13, 2002, submitted by your authorized representative concerning sections 72, 170, 401, 402, 408, 664, 1223, and 2522 of the Internal Revenue Code ("Code").

This ruling will only address the first three ruling requests within the jurisdiction of the Employee Plans Office of the Internal Revenue Service. The other rulings you requested will be addressed separately by the Office of Chief Counsel, Passthroughs and Special Industries.

The following facts and representations have been submitted in support of the rulings requested:

Taxpayer A is married to Taxpayer B. Taxpayer A was employed by Company M, which sponsors Plan X. Your authorized representative asserts that Plan X is qualified under Code section 401(a). Plan X holds stock of Company M that is listed on Stock Exchange N.

Taxpayer A was a participant in Plan X. Taxpayer A currently holds Amount 1 shares of Company M stock that were distributed to her from Plan X.

Your authorized representative asserts that Plan X's trustee represented to Taxpayer A that the total cost basis of the Amount 1 shares of stock distributed to Taxpayer A was subject to ordinary income tax. Also, the Plan X trustee represented that this basis was properly calculated under section 1.402(a)-1(b)(2)(ii) of the Income Tax Regulations ("regulations").

Taxpayer A retired in 1990, at which time she severed her employment relationship with Company M. Taxpayer A was greater than 59 ½ years of age on the date she severed employment with Company M.

Plan X permits its participants to elect to have lump sum distributions of Company M stock. Taxpayer A took a distribution of the entire balance to her credit in Plan X within one taxable year ending on November 20, 2000. Taxpayer A directed that a portion of said distribution be directly rolled over to an IRA pursuant to a trustee-to-trustee transfer described in Code section 401(a)(31) and that the Company M shares with net unrealized appreciation (the "Non-Rollover Shares") be contributed to a Charitable Remainder Unitrust ("CRUT"), which will comply with the requirements of Code section 664. The initial trustee of the CRUT will be Taxpayer A. Additionally, Taxpayer A may contribute other property to the CRUT. The total value of shares contributed to the CRUT will be less than 10 percent of the value of the outstanding stock of Company M.

The remainder beneficiaries of the CRUT will be public charities as defined in Code sections 170(c) and 170(b)(1)(A).

Based on the above facts and representations, the following rulings have been requested:

1. The distribution of the entire Plan X account balance after retirement satisfied the requirement of a lump sum distribution within one year of the receipt of the balance to the credit of Taxpayer A's Plan X account balance within the meaning of Code section 402(e)(4)(D)(i).

2. The net unrealized appreciation, within the meaning of Code section 402(e)(4), is the difference between the cost basis and the fair market value of the Non-Rollover Shares on the date said shares were distributed to Taxpayer A.

Therefore, Taxpayer A will not have recognized ordinary income on the portion of the Non-Rollover Shares representing the net unrealized appreciation.

3. Any taxable gain on the subsequent sale of the Non-rollover Shares will be treated as capital gain income on the sale of a capital asset held in excess of 12 months, to the extent of the original net unrealized appreciation, regardless of the time period between the date said shares were distributed from Plan X and the sale date. Post-distribution gain in excess of the net unrealized appreciation amount will be taxed at the applicable capital gain rate based on the holding period of the stock from the distribution date to the sale date.

With respect to your three ruling requests, Code section 402(a) provides, generally, that an amount actually distributed to a taxpayer by a trust described in Code section 401(a) which is exempt from tax under Code section 501(a) shall be taxable in the year of distribution except as otherwise provided in Code section 402.

Code section 402(c)(1) provides, generally, that if (A) any portion of the balance to the credit of an employee in a qualified trust is paid to the employee in an eligible rollover distribution, (B) the distributee transfers any portion of the property received in such distribution to an eligible retirement plan, and (C) in the case of a distribution of property other than money, the amount so transferred consists of the property distributed, then such distribution (to the extent so transferred) shall not be includible in gross income for the taxable year in which paid.

Code section 402(c)(4) provides that the term "eligible rollover distribution" means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust except the following distributions:

(A) any distribution which is one of a series of substantially equal periodic payments (not less frequently than annually) made—

(i) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and employee's designated beneficiary, or

(ii) for a period of 10 years or more,

(B) any distribution to the extent the distribution is required under section 401(a)(9), and

(C) any hardship distribution described in section 401 (k)(2)(B)(i)(IV).

Code section 402(c)(8) defines eligible retirement plan as (i) an individual retirement account described in section 408(a), (ii) an individual retirement annuity described in section 408(b) (other than an endowment contract), (iii) qualified retirement plan described in section 401(a), (iv) an annuity plan described in section 403(a), (v) an eligible deferred compensation plan described in section 457(b) which is maintained by an eligible employer described in section 457(e)(1)(A), and (vi) an annuity contract described in section 403(b).

Code section 402(c)(3) provides, generally, that section 402(c)(1) shall not apply to any transfer of a distribution made after the 60th day following the day on which the distributee received the property distributed.

Code section 401(a)(31)(A) provides that a trust shall constitute a section 401(a) qualified trust only if the plan of which such trust is a part provides that if the distributee of any eligible rollover distribution --

(i) elects to have such distribution paid directly to an eligible retirement plan, and

(ii) specifies such eligible retirement plan to which such distribution is to be paid (in such form and at such time as the plan administrator may prescribe),

such distribution shall be in the form of a direct trustee-to-trustee transfer to the eligible retirement plan so specified.

Code section 401(a)(31)(B) provides that subparagraph (A) shall apply only to the extent that the eligible rollover distribution would be includible in gross income if not transferred as provided in subparagraph (A) (determined without regard to sections 402(c) and 403(a)(4)).

The term "eligible rollover distribution" when used in section 401(a)(31) has the same meaning as when used in section 402(c).

The term "eligible retirement plan" when used in section 401(a)(31) includes IRAs defined in sections 408(a) and 408(b).

Generally, a direct trustee-to-trustee transfer described in section 401(a)(31) constitutes a "direct rollover" of an "eligible rollover distribution" and is entitled to tax deferred treatment pursuant to section 402(c).

Section 1.401(a)(31)-1 of the regulations, Q&A-5, provides that an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover is not currently

includible in the distributee's gross income under section 402(c).

Section 1.401(a)(31)-1 of regulations, Q&A-15, provides, in pertinent part, that a direct rollover is a distribution and rollover of the eligible rollover distribution and not a transfer of assets and liabilities.

Code section 402(e)(4)(D)(i) provides that, for purposes of this paragraph, the term "lump sum distribution" means the distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient -- (I) on account of the employee's death, (II) after the employee attains age 59 1/2, (III) on account of the employee's separation from service, or (IV) after the employee has become disabled within the meaning of Code section 72(m)(7), from a trust which forms part of a Code section 401(a) plan which is exempt from tax under Code section 501(a).

Code section 402(e)(4)(D)(i)(III) is applied to an individual who is an employee without regard to section 401(c)(1).

Code section 402(e)(4)(B) provides that, for purposes of Code section 402(a) and Code section 72, in the case of any lump sum distribution which includes securities of the employer corporation, there shall be excluded from gross income the net unrealized appreciation (NUA) attributable to that part of the distribution which consists of securities of the employer corporation.

With respect to NUA, section 1.402(a)-1(b)(1)(i)(b) of the regulations provides that, in the case of a total distribution, the amount of NUA which is not included in the basis of securities in the hands of the distributee at the time of distribution shall be considered gain from the sale or exchange of a capital asset held for more than six months to the extent that such appreciation is realized in a subsequent taxable transaction.

Section 1.402(a)-1(b)(2)(i) of the regulations provides that the amount of the NUA in securities of the employer corporation which are distributed by the trust is the excess of the market value of such securities at the time of distribution over the cost or other basis of such securities to the trust. Thus, if a distribution consists in part of securities which have appreciated in value and in part of securities which have depreciated in value, the NUA shall be considered to consist of the net increase in value of all the securities included in the distribution.

Code section 402(e)(4)(C) provides that, for purposes of subparagraph (B), NUA and the resulting adjustments to basis shall be determined in accordance with regulations prescribed by the Secretary.

Notice 98-24, 1998-17 I.R.B. 5 provides that the amount of NUA which is not included in

the basis of the securities in the hands of the distributee at the time of distribution is considered a gain from the sale or exchange of a capital asset held for more than 18 months to the extent such appreciation is realized in a subsequent taxable transaction. The actual period that an employer security was held by a qualified plan need not be calculated in order to determine whether, with respect to the NUA, the disposition qualifies for the rate of capital assets held for more than 18 months. However, with respect to any further appreciation in the employer securities after distribution from the plan, the actual holding period in the hands of the distributee determines the capital gains rate that applies.

With respect to long-term capital gains treatment during calendar year 2000; the year in which Taxpayer A received her Plan X distribution, the long-term capital gain holding period was 12 months.

In this case, Taxpayer A, who had not yet attained age 70 ½, received a distribution of her entire Plan X account balance in a single tax year as a result of her separation from service with Company M. The single sum distribution included Company M stock. Taxpayer A's Plan X distribution is a "lump sum distribution" as that term is used in Code section 402(e)(4)(D).

Taxpayer A's distribution is also an "eligible rollover distribution" as that term is used in Code sections 401(a)(31) and 402(c)(4). Thus, all or any portion of it may be rolled over or directly transferred into an individual retirement arrangement set up and maintained in Taxpayer A's name.

Finally, neither the Code nor the regulations, promulgated thereunder, preclude a distribution from being treated as a lump sum distribution under Code section 402(e)(4)(D) for purposes of Code section 402(e)(4)(B) even if a portion of the distribution is either rolled over or directly transferred into an individual retirement arrangement.

Thus, with respect to your first three ruling requests, we conclude as follows:

1) The distribution of the entire Plan X account balance after retirement met the requirement of a lump sum distribution within one taxable year of the recipient of the balance to the credit of Taxpayer A's Plan X account balance within the meaning of Code section 402(e)(4)(D)(i).

2) The net unrealized appreciation, within the meaning of Code section 402(e)(4), is the difference between the cost basis and the fair market value of the Non-Rollover Shares on the date said shares were distributed to Taxpayer A. Therefore, under Code

section 402(e)(4)(B), Taxpayer A will not recognize ordinary income on the
net unrealized appreciation of the Non-Rollover Shares.

3) Any taxable gain on the subsequent sale of the Non-Rollover Shares will be treated as capital gain income on the sale of a capital asset held in excess of 12 months, to the extent of the original net unrealized appreciation, regardless of the time period between the date said shares were distributed from Plan X and the sale date. Post-distribution gain in excess of the net unrealized appreciation amount will be taxed at the applicable capital gain rate based on the holding period of the stock from the distribution date to the sale date.

No opinion is expressed as to the tax treatment of the transaction described herein under the provisions of any other section of either the Code or regulations that may be applicable thereto.

This letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

This ruling letter was prepared by of this Group. He may be contacted at

Pursuant to a power of attorney on file with this office, a copy of this ruling letter is being sent to your authorized representatives.

Sincerely yours,

Alan C. Pipkin
Manager, Technical Group 4
Employee Plans