

Part III.--Administrative, Procedural, and Miscellaneous

Net Unrealized Appreciation in Employer Securities

Notice 98-24

PURPOSE

This notice provides guidance concerning the tax treatment of net unrealized appreciation in employer securities distributed from a qualified retirement plan, to the extent such appreciation is realized in a subsequent taxable transaction. Specifically, this notice provides guidance regarding the holding period to be used for determining the capital gains tax rate that applies with regard to net unrealized appreciation under § 1(h) of the Internal Revenue Code ("Code") as amended by § 311 of the Taxpayer Relief Act of 1997 ("TRA '97"), Pub. L. 105-34. This guidance applies to sales or other dispositions of employer securities that occur before the later of January 1, 2001, or the date further guidance is issued.

BACKGROUND

Section 402(e)(4)(A) of the Code provides that in the case of a distribution other than a lump sum distribution, the amount actually distributed to a distributee from a trust described in § 401(a) which is exempt from tax under § 501(a) shall not include any net unrealized appreciation in employer securities attributable to amounts contributed by the employee.

Section 402(e)(4)(B) provides that in the case of a lump sum distribution which includes employer securities, there shall be excluded from gross income the net unrealized appreciation attributable to the employer securities.

Section 402(e)(4)(C) provides that, for purposes of § 402(e)(4)(A) and (B), net unrealized appreciation and the resulting adjustments to basis are determined in accordance with regulations.

Section 1.402(a)-1(b)(1)(i) of the Income Tax Regulations provides that the amount of net unrealized appreciation 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 six months to the extent such appreciation is realized in a subsequent taxable transaction. Net gain realized by the distributee in a subsequent taxable transaction that exceeds the amount of the net unrealized appreciation at the time

of distribution shall constitute a long-term or short-term capital gain, depending on the holding period of the securities in the hands of the distributee. In 1956, when this regulation was issued, the long-term capital gains tax rate applied to the sale or exchange of a capital asset held for more than six months.

Rev. Rul. 81-122, 1981-1 C.B. 202, states that the amount of net unrealized appreciation that is not included in the basis of the securities in the hands of a distributee at the time of distribution is considered a gain from the sale or exchange of a capital asset held for more than one year to the extent it is realized in a subsequent transaction. When this revenue ruling was published, the long-term capital gains tax rate applied to the sale or exchange of a capital asset held for more than one year.

Section 311 of TRA '97 reduces the capital gains tax rate on the sale or exchange of certain assets held for more than 18 months from 28 percent to 20 percent (10 percent in the case of gain that would otherwise be taxed at 15 percent), effective generally for amounts properly taken into account after May 6, 1997. See Notice 97-59, 1997-45 I.R.B. 7. The 28-percent maximum capital gains tax rate continues to apply to the sale or exchange of assets held for 18 months or less but more than one year.

CAPITAL GAINS RATE APPLICABLE TO NET UNREALIZED APPRECIATION

Under this notice, the amount of net unrealized appreciation 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 that such appreciation is realized in a subsequent taxable transaction. Accordingly, for a sale or other disposition of employer securities that occurs after May 6, 1997, 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 net unrealized appreciation, the disposition qualifies for the rate for 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.

The guidance provided in this notice applies to sales or other dispositions of employer securities that occur before the later of January 1, 2001, or the date further guidance is issued. This guidance is for purposes of the Code and regulation sections cited above. No inference is intended with regard to any other section of the Code or regulations that deals with capital gains treatment.

COMMENTS

Beginning in 2001, § 311 of TRA '97 reduces the capital gains tax rates for gain from certain assets that are held for more than 5 years ("qualified 5-year gain"). The 10-percent rate is reduced to 8 percent for taxable years beginning after December 31, 2000. The 20-percent rate is reduced to 18 percent for property the holding period for which begins after December 31, 2000.

The Service invites comments with respect to the computation of the holding period for purposes of the reduced capital gains tax rates for qualified 5-year gain as these rates apply to net unrealized appreciation (for example, whether to use an actual holding period, a deemed holding period, or a combination). Comments should be submitted by October 24, 1998.

Comments can be addressed to CC:DOM:CORP:R (Notice 98-24), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, D.C. 20044. In the alternative, comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 98-24), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

DRAFTING INFORMATION

The principal author of this notice is Steven Linder of the Employee Plans Division. For further information regarding this notice, please contact the Employee Plans Division's taxpayer assistance telephone service at (202) 622-6074 or (202) 622-6075, between the hours of 1:30 p.m. and 3:30 p.m. Eastern time, Monday through Thursday, or Mr. Linder at (202) 622-6214. These are not toll-free numbers.