VOLUME 74 ◆ NUMBER 3

Employee Benefit Plan Review

Ask the Experts

By Marjorie M. Glover, David Gallai, and Rachel M. Kurth

Net Unrealized Appreciation

Q I hold employer stock in my 401(k) plan account. I have come across references to net unrealized appreciation in some of the plan's documents and notices that I have received. What is net unrealized appreciation?

A Net unrealized appreciation (also referred to as "NUA") refers to the increase in value of the employer stock held in a participant's 401(k) plan account over the cost or basis of that stock to the plan trust currently holding it. There is a potential tax benefit to plan participants when they receive distributions from their 401(k) plan accounts that include employer stock. This potential tax benefit is addressed in Section 402(e)(4) of the Internal Revenue Code ("IRC").

Under the federal tax rules, when a plan participant receives a distribution from a 401(k) plan, the participant must generally include the amount of that distribution in income in the year of receipt. However, under Section 402(e)(4), if the distribution includes employer stock, and subject to a few other conditions (see the next paragraph), then the amount of any NUA associated with that stock in excludible from the participant's income at the time of distribution. Instead, the NUA will be includible in the participant's income at such later date when the distributed employer stock is sold by the participant. That NUA will then potentially be taxed at long-term capital gains rates rather than at ordinary income tax rates.

Among the conditions for securing the NUA tax benefit, the employer stock must qualify as "securities of the employer corporation" under Section 402(e)(4). This is generally the case with employer stock funds, and probably is the case with your 401(k) plan account given the references to net unrealized appreciation in your plan's documents and notices.

However, you should confirm this with the 401(k) plan administrator, especially if you work for an entity other than the entity whose stock is held in your 401(k) plan account (for example, if you work for a subsidiary and the stock fund holds the stock of the parent company).

Another condition is that the participant receive a distribution of the employer stock in-kind, rather than liquidating the employer stock and receiving a distribution in cash. Yet another condition is the requirement that the participant receive the distribution in a lump-sum. For this purpose, a lump-sum distribution can be a single payment or multiple payments over a single tax year. Lastly, the participant must receive their entire plan account balance as part of the lump-sum distribution in a single tax year.

While NUA treatment is generally beneficially, everyone's financial circumstances and tax situation are unique. Before taking a distribution from your 401(k) plan, you should consult with a financial or tax advisor to determine whether you are eligible for this NUA tax benefit and whether that benefit, or another course of action, would be best for your circumstances.

Qualified Birth or Adoption Withdrawals

Q Our company sponsors a 401(k) plan and a frozen pension plan. I read that, due to a change in the law, employees are now allowed to withdraw retirement funds for birth or adoption without paying the 10 percent penalty. Does this change apply only to individual retirement arrangements or also to company retirement plans? Are we required to amend our plans to provide for these withdrawals or is this change optional? If we are required to amend our plans, what is the deadline to make the amendments? Also, would these types of withdrawals be considered hardship withdrawals?

A Under the recently-enacted Setting Every Community Up for Retirement Enhancement Act ("SECURE Act"), parents are now allowed to withdraw funds from eligible retirement plans, up to $5,000 per parent for a "qualified birth or adoption of a child" ("QBOAD"), without incurring a 10 percent penalty that might otherwise apply under IRC Section 72(t) if the funds are withdrawn prior to attaining age 59½.

A QBOAD may be offered under an "eligible retirement plan" within the meaning of IRC Section 402(c)(8)(B), which includes individual retirement accounts ("IRAs"), 401(k) and other defined contribution plans, 403(b) plans, and 457(b) governmental plans. A QBOAD may not be offered under a defined benefit pension plan, such as a traditional pension plan or cash balance pension plan. As a result, your company generally could amend its 401(k) plan (but not its defined benefit pension plan) to offer QBOADs.

Eligible retirement plans are not required to offer QBOADs. Employers that do wish to offer QBOADs may do so as early as January 1, 2020. However, for the reasons noted below, employers may wish to wait until further guidance is issued before offering QBOADs. The formal deadline for amending an eligible retirement plan to offer QBOADs is the last day of the plan year beginning on or after January 1, 2022 (December 31, 2022 for plans which have a calendar year plan year). It is possible that the IRS may extend this deadline further.

A QBOAD is not considered to be a hardship withdrawal and is not subject to the hardship distribution rules. Instead, a QBOAD is a separate type of withdrawal that is subject to a separate set of rules. However, because the hardship withdrawal rules generally require that a participant exhaust all other currently available plan distributions, it may be necessary to coordinate QBOADs and hardship withdrawals in certain cases.

A QBOAD is limited to $5,000 per individual for the birth or adoption of an "eligible adoptee." An eligible adoptee generally includes an individual (other than a spouse's child) who has not attained age 18 or who is physically or mentally incapable of self-support. The QBOAD limit is per individual. As a result, a plan participant and the participant's spouse may each receive $5,000 for the birth or adoption of an eligible adoptee.

The SECURE Act allows repayment of a QBOAD, subject to certain requirements and limitations. For example, in the case of a 401(k) plan or another defined contribution plan, repayment is permitted only for participants who remain eligible to make plan contributions.

The SECURE Act did not address a number of questions related to administration of QBOADs, including, for example:

(1) What documentation is required to substantiate a QBOAD;
(2) How to coordinate or apportion the $5,000 limit among multiple eligible retirement plans (for example, where a participant withdraws funds from both an IRA and 401(k) plan);
(3) Whether the $5,000 limit applies per child or per birth or adoption (in the case of twins, it is not yet clear whether the individual's limit would be $10,000 ($5,000 for each child) or $5,000 (for the birth)); and
(4) How QBOAD repayments must be administered.

It is expected that the IRS will issue further guidance on these and other questions related to QBOADs in the future. For this reason, employers may wish to consider waiting until further guidance has been issued before offering QBOADs.

Marjorie M. Glover, a partner in the New York City office of Norton Rose Fulbright US LLP, focuses her practice on executive compensation and employee benefits law, corporate governance and risk oversight and employment law. David Gallai, who also is a partner in the firm's New York City office, practices in the areas of employment counseling, executive compensation, and employee benefits. Rachel M. Kurth is a senior counsel at the firm. They can be reached at marjorie.glover@nortonrosefulbright.com, david.gallai@nortonrosefulbright.com, and rachel.kurth@nortonrosefulbright.com, respectively.