Internal Revenue Service

Department of the Treasury

200009066

Significant Index No. 0072-0400

Washington, DC 20224

Contact Person:

Telephone Number:

In Reference to:
T:EP:RA:T:A1

Date:
DEC 08 1999

In re:

This is in reply to your letter dated November 16, 1998, requesting rulings on the application of the basis recovery rules under section 72(d)(1)(B)(iii) of the Internal Revenue Code.

The following facts, representations and documents have been submitted in support of the request:

The is a retirement system established under the laws of the State of ("State") to provide retirement and other benefits for faculty and staff of public universities, colleges and community colleges in the State, and certain affiliated organizations, including employees of itself.

has three retirement plans in its program: a defined benefit plan, a defined contribution plan and a "portable benefit package" within the defined benefit plan that has enhanced refund features but less generous survivor benefits than the defined benefit plan. The subject of the ruling requests is the defined benefit plan.

Under the defined benefit plan, each employee is required to contribute 8% of earnings into the plan. There is 9-1/2% contribution rate for police and firefighters. Prior to January 1, 1981, the required employee contributions were made on an after-tax basis. Since January 1, 1981, the required employee contributions have been picked up by the employers pursuant to section 414(h)(2) of the Code.

In addition to the after-tax employee contributions with respect to the pre-1981 employee contributions, members are permitted to make contributions to the plan to purchase additional service credit. This additional service credit includes prior service with a employer prior to commencing participation in the plan, service for leaves of absence at less than 50% of pay, up to two years of military service and the reinstatement of past service that was forfeited upon acceptance of a refund if the refund amount, plus interest, is repaid. Contributions to purchase service credit are made by members prior to retirement and are generally made on an after-tax basis.

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Survivor benefits under the plan are paid in three circumstances:

1. An active participant with at least one and one-half years of service dies and is survived by a qualifying survivor
2. A terminated deferred vested participant with at least 10 years of service dies and is survived by a qualifying survivor
3. A retired participant (annuitant), who had a qualifying survivor at the time of benefit commencement, dies and is survived by a qualifying survivor.

A "qualified survivor" includes:

- The member's spouse. The member and the spouse must have been married for at least one year before the member's death, except where the member dies before commencing benefits as an annuitant, in which case a spouse of less than one year may qualify as a survivor if the spouse and the member had a child or the spouse adopted the member's child or adopted a child with the member.
- A dependent unmarried child under age 18 (under age 22 if a full-time student.
- An unmarried child over age 18 who was dependent upon the participant by reason of physical or mental disability which began before age 18 (age 22 if a full time student).
- A dependent parent.

In general, survivor benefits are paid in the form of a monthly annuity over the life of the survivor. Survivor benefits are paid to surviving spouses commencing upon the member's death or, if later, when the spouse attains age 50 (unless the spouse has in his or her care the deceased member's dependent child who also qualifies for survivor benefits), and cease upon the spouse's death. If a surviving spouse remarries before age 55, the spouse's survivor benefits are forfeited.

Survivor benefits for a member's dependent nondisabled, unmarried child under age 18 (under age 22 if a full-time student) commence upon the member's death and cease upon the child's attainment of age 18 (age 22 if a full-time student). Survivor benefits for a member's disabled child commence upon the member's death and cease upon the child's marriage, death or when the child ceases to be disabled.

Survivor benefits to dependent parents commence upon the member's death or, if later, the parent's attainment of age 55, and cease upon the parent's death. The parent's survivor benefits are forfeited if the parent remarries prior to attainment of age 55.

In order to have survivor benefits paid on their behalf, an annuitant must have a qualifying survivor both at the time of benefit commencement and at the time of death. If an annuitant does not have a qualifying survivor at the time of benefit commencement, the member's contributions representing the survivor insurance contributions are refunded to the member. Or, those amounts are used to increase the member's pension benefit. A member may have a qualifying survivor at benefit commencement and different qualifying survivor at death (e.g., a first and second spouse or a disabled child at benefit commencement and a spouse at death).

Two or more qualifying survivors may receive survivor benefits simultaneously. The aggregate amount of monthly survivor benefits paid, and the amount paid to each individual qualifying survivor, depends on various factors. These factors include the total number of survivors, the final average earnings of the member and the amount of the member's earned retirement annuity. In no event will the total survivor annuity be less than 50% of the member's normal retirement annuity or more than 80% of the member's normal retirement annuity.

Based on the foregoing, the following rulings are requested:

(1) The basis recovery method for a annuitant under the plan who commences retirement benefits on or after January 1, 1998, and who has only a spouse and a dependent, nondisabled, unmarried child under age 18 (age 22 if a full-time student) as qualifying survivors at the time of benefit commencement, is required to be made using the table under section 72(d)(1)(B)(iv) of the Code (the "Two Lives Table"), taking into account for this purpose only the combined ages of the participant and spouse.

(2) The basis recovery method for a annuitant under the plan who commences retirement benefits on or after January 1, 1998, and who has only (i) a dependent parent or a disabled child and (ii) a dependent, nondisabled, unmarried child under age 18 (age 22 if a full-time student) as qualifying survivors is required to be made using the Two Lives Table, taking into account only the combined ages of the participant and the dependent parent or disabled child.

(3) The basis recovery method for a annuitant under the plan who commences retirement benefits on or after January 1, 1998, and who has as qualifying survivors a spouse, a disabled child and a dependent parent (or any two of the foregoing) is required to be made using the Two Lives Table, taking into account for this purpose the combined ages of the participant and the youngest survivor annuitant.

(4) The basis recovery method for a annuitant under the plan who commences retirement benefits on or after January 1, 1998, and whose only qualifying survivors are one or more dependent, nondisabled, unmarried children under age 18 (age 22 if a full-time student), is required to be made using the table under section 72(d)(1)(B)(iii) of the Code (the "Single Life Table").

(5) With respect to any annuitant whose basis recovery is determined with respect to the Two Lives Table, the monthly amount excluded from income should not be recalculated upon the death of the member annuitant.

(6) With respect to any annuitant whose basis recovery is determined with respect to the Two Lives Table, upon the death of the member annuitant, the unrecovered basis, if any, is to be allocated by to the survivor benefits payable with respect to the member's surviving spouse, if then living, dependent parent and disabled child, if any, and need not be prorated among any qualifying survivors receiving only temporary annuities (e.g., a dependent, nondisabled, unmarried child).

Section 402(a)(1) of the Code provides that the amount actually distributed to any distributee by an employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the year in which distributed, under section 72 (relating to annuities). Similarly, amounts distributed from employee annuity contracts under section 403(a) and annuity contracts under section 403(b) are taxable to the distributee (in the year in which distributed) under section 72.

Section 72(b) of the Code provides that a portion of the annuity payments received in a taxable year may be excluded from gross income as a return of the distributee's investment according to an exclusion ratio determined at the annuity starting date. The numerator of this ratio is the employee's investment in the contract, and the denominator is the expected return.

Section 1403 of the Small Business Jobs Protection Act of 1996 ("SBJPA") amended section 72(d) of the Code to require the use of a simplified method of recovering the investment in the contract for most annuity distributions from qualified plans under section 401(a) of the Code. The simplified method of section 72(d) of the Code is similar to, but not the same as, the safe-harbor method that was provided in Notice 88-118. Generally, the SBJPA changes to section 72(d) of the Code apply to distributions with annuity starting dates after November 18, 1996.

Section 1075 of the Taxpayer Relief Act of 1997 ("TRA '97") amended the simplified method of recovering the investment in the contract in section 72(d)(1)(B) of the Code to prescribe a different table if the annuity is payable based on the lives of more than one individual. This new table applies to distributions with annuity starting dates after December 31, 1997. For annuities payable based on the life of only one individual, section 1075 of TRA '97 made no changes in the applicable table under the simplified method described by SBJPA.

Under the simplified method, the distributee recovers his or her investment in the contract in level amounts over the expected number of monthly payments determined from the tables below. The portion of each annuity payment that is excluded from gross income by a distributee for income tax purposes is a level dollar amount determined by dividing the investment in the contract by the set number of annuity payments from the tables below.

$$\frac{\text{Investment}}{\text{Expected Number of Monthly Payments}} = \text{Tax free portion of monthly annuity}$$

For annuity starting dates beginning after December 31, 1997, the table used to determine the expected number of payments depends on whether the payments are based on the life of more than one individual. In the case of an annuity payable based on the life of only one individual, the total number of expected monthly annuity payments is based on the annuitant's age at the annuity starting date. The expected number of payments for an annuity based on the life of one individual is set forth in the table below.

Age of Annuitant	*Expected Number of Payments*
55 and under	360
56-60	310
61-65	260
66-70	210
71 and over	160

In the case of an annuity payable based on the life of more than one individual, the total number of monthly annuity payments expected to be received is based on the combined ages of the annuitants at the annuity starting date. The expected number of payments is set forth in the table below.

Combined Ages of Annuitants	*Expected Number of Payments*
110 and under	410
111-120	360
121-130	310
131-140	260
141 and over	210

The investment in the contract is defined under section 72(c)(1) of the Code as the aggregate premiums or other consideration paid (generally, the aggregate amount of after-tax contributions made to the plan), reduced by amounts received before the annuity starting date that were excluded from gross income.

Notice 98-2, I.R.B. 1998-1, provides guidance on the changes made by SBJPA and TRA '97 for the determination of the tax-free portion of annuity payments. The notice provides that the dollar amount determined above, as of the annuity starting date, will be excluded from each monthly annuity payment, even where the amount of the annuity payments change. For example, the amount to be excluded from each annuity payment determined at the annuity starting date remains constant, even if the amount of the annuity payments increases due to cost of living increases, or decreases in the case of a reduced survivor annuity after death of one of the annuitants.

The notice provides that an annuity which is payable over the life of one annuitant with a term certain feature is an annuity based on the life of that individual. Similarly, an annuity which is payable over the life of one annuitant with a temporary annuity payable to the annuitant's child until the child reaches an age specified in the plan (not more than age 25) is an annuity based on the life of that individual. If the annuity is payable to a primary annuitant and more than one survivor annuitant, the combined ages of the annuitants is the sum of the age of the primary annuitant and the youngest survivor annuitant. If the annuity is payable to more than one survivor annuitant but there is no primary annuitant, the combined age of the annuitants is the sum of the age of the oldest survivor annuitant and the youngest survivor annuitant. In addition, any survivor annuitant whose entitlement to payments is contingent on an event other than the death of the primary annuitant is disregarded.

The notice also provides that if the amount to be excluded from each payment is greater than the amount of the annuity payment (e.g., because of decreased survivor payments), then each annuity payment will be completely excluded from gross income until the entire investment is recovered. For those distributees with annuity starting dates after December 31, 1986, annuity payments received after the investment is recovered (generally, after the expected number of payments has been received) are fully includible in gross income. If annuity payments cease by reason of death, a deduction for the unrecovered investment in the contract, if any, is allowed on the distributee's last income tax return.

The notice goes on to provide that where two or more annuitants are receiving payments at the same time, each annuitant will exclude from each annuity payment a pro-rata portion of this amount. This pro-rata portion is determined according to a ratio, the numerator of which is the amount of the beneficiary's annuity payment, and the denominator of which is the total amount of the monthly annuity payments to all beneficiaries.

Issue 1

A annuitant who commences retirement benefits on or after January 1, 1998, has only a spouse and a dependent, nondisabled, unmarried child under age 18 (age 22 if a full-time student) as qualifying survivors at the time of benefit commencement. The child is entitled only to a temporary annuity.

As provided in Notice 98-2, an annuity payable over the life of one annuitant with a temporary annuity payable to the annuitant's child until the child reaches an age specified in the plan (not greater than age 25) is an annuity based on the life of that individual. In essence, such a child is disregarded for purposes of determining the expected number of payments. Therefore, the basis recovery for a annuitant with a spouse and a dependent, nondisabled, unmarried child under age 18 (age 22 if a full-time student) is determined using the Two Lives Table, taking into account only the combined ages of the participant and spouse.

Issue 2

A annuitant under the plan who commences retirement benefits on or after January 1, 1998 has only (i) a dependent parent or a disabled child and (ii) a dependent, nondisabled, unmarried child under age 18 (age 22 if a full-time student) as qualifying survivors. The nondisabled child is entitled only to a temporary annuity. As provided in Notice 98-2, an annuity payable over the life of one annuitant with a temporary annuity payable to the annuitant's child until the child reaches an age specified in the plan (not greater than age 25) is an annuity based on the life of that individual. In essence, such a child is disregarded for purposes of determining the expected number of payments. Therefore, the basis recovery method for that annuitant is made using the Two Lives Table, taking into account only the combined ages of the participant and the dependent parent or disabled child.

Issue 3

A annuitant under the plan that commences retirement benefits on or after January 1, 1998 has as qualifying survivors: a spouse, a disabled child and a dependent parent (or any two of the foregoing). As provided in Notice 98-2, the basis recovery method for the annuitant is made using the Two Lives Table, taking into account the combined ages of the participant and the youngest survivor annuitant.

Issue 4

A annuitant under the plan who commences retirement benefits on or after January 1, 1998, has as qualifying survivors one or more dependent, nondisabled, unmarried children under age 18 (age 22 if a full-time student). As stated above, dependent, nondisabled, unmarried children under age 18 (age 22 if a full-time student) are entitled only to temporary annuities. As provided in Notice 98-2, an annuity payable over the life of one annuitant with a temporary annuity payable to the annuitant's child until the child reaches an age specified in the plan (not greater than age 25) is an annuity based on the life of that individual. In essence, such children are disregarded for purposes of determining the expected number of payments. Therefore, the basis recovery method for the annuitant is made using the attained age of the annuitant and the Single Life Table.

Issue 5

In the event that the basis recovery method for a annuitant is determined using the Two Lives Table, Notice 98-2 provides that the monthly amount excluded from income should not be recalculated upon the death of the member annuitant.

Issue 6

A annuitant whose basis recovery is determined with respect to the Two Lives Table has, upon death, an unrecovered basis. Notice 98-2 provides that where two or more annuitants are receiving payments at the same time, each annuitant will exclude from each annuity payment a pro-rata portion of this amount. This pro-rata portion is determined according to a ratio, the numerator of which is the amount of the beneficiary's annuity payment, and the denominator of which is the total amount of the monthly annuity payments to all beneficiaries.

As we have ruled in the above issues, if at benefit commencement, a member has a child age 18 or less (age 22 or less if a full-time student), such child is, in essence, disregarded when determining the expected number of payments. The Two Lives Table is used to determine the expected number of payments when, at benefit commencement, the member had a spouse, dependent parent or disabled child.

Furthermore, because a nondisabled, unmarried child is, in essence, disregarded, if there is an unrecovered basis at the time of the member's death, that amount is to be allocated to the survivor benefits payable with respect to the member's surviving spouse, dependent parent and disabled child. The amount is not prorated among any dependent, nondisabled, unmarried children.

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

This ruling is based on the assumptions that the defined benefit plan under the is qualified under section 401(a) of the Code and that its related trust is tax-exempt under section 501(a) at all times relevant to this ruling.

Sincerely yours,

James E. Holland, Jr.
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