Internal Revenue Service

Department of the Treasury

Washington, DC 20224

200148084

Significant Index No. 0072-0000

Person to Contact:

Telephone Number:

Refer Reply to:
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In re: Trust =

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This is in reply to your letter dated May 11, 2000, requesting rulings on the proper application of § 72 of the Internal Revenue Code ("Code"). Your request was originally sent to Employee Plans Technical Group 1. That office forwarded your request to our office for response. You modified your original request in letters dated July 27, 2001 and September 4, 2001.

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

The Trust is a group trust arrangement pursuant to Rev. Rul. 81-100, 1981-1 C.B. 326, which is held by the seven (7) cities listed above. The Trust has received a determination letter that states that it is exempt from tax under Code § 501. The Trust has its own employer identification number for distributions.

Each city listed above is a municipal corporation of the State. Each city maintains a defined contribution plan that is qualified under Code § 401(a). Six plans are profit sharing plans and one is a money purchase plan. Three plans have grandfathered cash-or-deferred features. The Trust holds the assets for each plan. Employee participation is optional in three of the plans and is mandatory in the remaining four plans. One plan provides for mandatory employee contributions that are "picked-up" pursuant to § 414(h)(2). Each plan operates on a calendar year basis.

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Each plan provides that a participant contributes the amount they would contribute to social security and the employer also makes a contribution based on what it would contribute to social security. Employee contributions are either mandatory (for those plans that are not 401(k) plans) or elective. Employer contributions allocated to employees are based on the employee contributions. Employee contributions may be either pre-tax or after-tax in the § 401(k) plans, after-tax in the other plans or, in the case of City E, picked up by the employer.

The provisions of each plan allow participants to contribute additional amounts on either a pre-tax (§ 401(k) plans) or on an after-tax basis (other plans), within the limits of Code § 415. These contributions are called Extra Contributions and are not matched by the employer.

The result is that each plan provides for a mixture of pre-tax contributions, after-tax contributions and employer contributions that the Trust must report on at the time of distributions.

All of the plans and the Trust are maintained by a single record-keeper. Participant accounts are separated into the following types:

(1) Extra Employee Contribution Account (after-tax)
(2) Basic Employee Contribution Account (after-tax)
(3) Salary Deferral Employee Contribution Account (where applicable)
(4) Pick-up Employee Contribution Account (where applicable)
(5) Employer Contribution Account
(6) Rollover Account

In accordance with Notice 87-13, 1987-1 C.B. 432, the record-keeper separately accounts for all after-tax contributions and earnings (including pre-1987 contributions where applicable) as one contract. The remaining amounts are accounted for as the main contract. Only one Plan has provisions that permit in-service withdrawals of after-tax contributions since before May 5, 1986. The other plans do not have provisions that would permit pre-1987 amounts to be taken out before all other amounts. The provisions of each plan allow participants to designate the contract from which the plan should make any distributions. The assets of the Trust are invested in pooled funds.

The normal form of benefit under each Plan is a lump sum distribution. Each plan also provides similar optional distribution forms. The optional forms of distribution include monthly, quarterly or annual installments generally, for at least five years but not beyond the life expectancy of the participant. However, the provisions of the plans have also allowed distributions of specific dollar amounts or they are being considered to allow such distributions. The plan provisions also allow a participant to request the trustee buy an annuity contract with their account balance.

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Some of the plans contain provisions that currently permit the participant to accelerate, modify, reduce or defer all or a portion of the unpaid amounts whether paid in installments or otherwise. Also, the provisions of the plans allow a participant to defer distribution and still request partial distributions of their account as frequently as once a month. A participant may continue to request a distribution of their after-tax accounts at any time. Also, participants are permitted to elect small monthly payments as partial distributions that would exceed life expectancy.

Based on the foregoing, the following rulings are requested:

1. Any distribution commenced by a terminating participant (other than a lump sum distribution) that is not an installment distribution (e.g., a partial distribution) shall be treated as a "pre-annuity starting date" distribution taxable in accordance with Code § 72(e)(8), including the provisions of § 72(e)(8)(D) according to the separate account designated by the participant.

2. Any installment distribution commenced by a terminating participant where the participant retains the right to alter the amounts, defer or accelerate subsequent distributions or take interim distributions at any time shall be treated as amounts not received as an annuity and as a "pre-annuity starting date" distribution taxable in accordance with Code § 72(e)(8), including the provisions of § 72(e)(8)(D) according to the separate account designated by the participant.

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

Code § 72 provides rules for the taxation of distributions from qualified plans which are "amounts received as an annuity" and for "amounts not received as an annuity". Code § 72(b) 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.

Code § 72(d)(1)(A) provides that in the case of any amount received as annuity under a qualified plan § 72(b) shall not apply and that the investment in the contract shall be recovered as provided in that subsection. Code § 72(d)(2) provides that employee contributions and any income thereon under a defined contribution plan may be treated as a separate contract.

Code § 72(e), which provides rules for the taxation of amounts not received as an annuity, distinguishes between those such amounts received on or after the annuity starting date and those received before the annuity starting date.

Code § 72(e)(2) provides general rules for the taxation of "amounts not received as an annuity". Paragraph (B), which provides the method of basis recovery for such amounts that are received before the annuity starting date, states that (i) they shall be included in gross income to the extent allocable to income on the contract, and (ii) they shall not be included in gross income to the extent allocable to the investment in the contract.

Code § 72(e)(8)(A) provides that paragraph (2)(B) applies to non-annuity payments received before the annuity starting date for distributions from qualified plans.

Code § 72(e)(8)(B) provides that for purposes of paragraph (2)(B), the amount allocated to the investment in the contract is the portion of the distribution that has the same ratio to such amount as the investment in the contract bears to the account balance. Together, paragraphs (A) and (B) make-up what is referred to as the "pro-rata basis recovery rules" for non-annuity distributions received before the annuity starting date.

Code § 72(e)(8)(D) provides an exception to the general rule and applies to investments in the contract as of December 31, 1986. This section provides that in the case of a plan that on May 5, 1986, permitted withdrawal of any employee contributions before separation from service, the pro-rata basis recovery rules apply only to the extent that amounts received under the contract exceed the investment in the contract as of December 31, 1986.

Section 1.72-1(b) of the Income Tax Regulations provides, in general, that "amounts received as an annuity" are amounts which are payable at regular intervals over a period of more than one full year from the date on which they are deemed to begin, provided the total of the amounts so payable or the period for which they are to be paid can be determined as of that date. Any other amounts to which the provisions of Code § 72 apply are considered to be "amounts not received as an annuity".

Section 1.72-2(b)(2) of the regulations provides in more detail the general definition of "amounts received as an annuity" contained in §1.72-1(b). Section 1.72-2(b)(2)(iii) states that, except as indicated in §1.72-2(b)(3), the total of the amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory.

Section 1.72-2(b)(3)(i)(a) of the regulations provides, in part, that notwithstanding the requirement of § 1.72-2(b)(2)(iii), if amounts are to be received for a definite or determinable time under a contract which provides that the amounts of the periodic payments may vary in accordance with investment experience (as in certain profit-sharing plans), cost of living indices, or similar fluctuating criteria, each such payment received shall be considered, to the extent enumerated therein, as an amount received as an annuity.

For purposes of determining the annuity starting date under §§ 1.72-1(b) and 1.72-2(b)(2) of the regulations, § 1.72-4(b) provides a definition for annuity starting date. In the case of a series of installment payments that would satisfy the description of amounts received as an annuity under § 1.72-2(b)(2), the annuity starting date would be the first day of the period (year, half-year, quarter, month, or otherwise, depending on whether payments are to be made annually, semiannually, quarterly, monthly, or otherwise) which ends on the date of the first annuity payment.

The first request concerns amounts that are received as partial distributions. These partial distributions are not part of an installment distribution. The amounts paid under these plans may be distributed at irregular intervals or in uneven amounts. The total of the amounts paid at regular intervals cannot be determined as of the date payments begin. Accordingly, pursuant to § 1.72-1(b) of the regulations, such distributions are considered "amounts not received as an annuity".

The second request concerns installment distributions where the participant retains the right to alter the amounts and timing of the distributions at any time. The total of the amounts paid at regular intervals cannot be determined as of the date payments begin. Accordingly, pursuant to § 1.72-1(b) of the regulations, such distributions are considered "amounts not received as an annuity".

The plans have provisions that account for employee contributions (and earnings) separately from the other contributions (and earnings) under the plans and thereby maintain separate contracts within the meaning of Code §72(d) and Q&A-14 of Notice 87-13. Plan provisions allow employees to designate which separate account the distributions will be made from.

Each plan has provisions that permit interim and irregular withdrawals of amounts whether or not installment payments have begun and the total of the amounts to be paid at regular intervals cannot be determined as of the date payments begin as required under § 1.72-1(b) of the regulations. Thus, as discussed above, such distributions are "amounts not received as an annuity" and, as such, are not considered to be made after an annuity starting date. Therefore, these payments are treated under Code § 72(e) as "amounts received before the annuity starting date".

Accordingly, the payments described in both ruling request 1 and ruling request 2 are taxable in accordance with § 72(e)(8), including the provisions of § 72(e)(8)(D) pursuant to the separate account designated by the participant.

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

This ruling is based on the assumptions that each plan is qualified under Code § 401(a) and that the Trust is tax-exempt under § 501(a) at all times relevant to this ruling.

Sincerely,

James E. Holland, Jr., Manager
Employee Plans Actuarial Group 1
Tax Exempt and Government Entities
Division