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

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JAN 18 2001

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Uniform Issue List Numbers 72.07-00 through 72.07-05

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ATTN: ************************************

Legend:

Plan = ***************************************
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state = *******

Ladies and Gentlemen:

This is in response to your letter dated December 20, 1999, as supplemented by correspondence dated October 19 and December 6, 2000, in which you requested a ruling, on behalf participants in the above-named Plan, under sections 72 and 402 of the Internal Revenue Code, and under certain provisions of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), Pub. L. 100-647, 1988-3 C.B. 1.

In furtherance of your ruling request, you have provided, in writing, the following statements and representations:

The Plan is a defined benefit pension plan and trust, created pursuant to provisions in the State's Constitution, to provide retirement benefits to employees of State agencies. The Plan is maintained by the State and does not cover employees of the State's political subdivisions. You represent that the Plan is a

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"governmental plan" under the rules governing section 414(d) of the Code. You further represent that, on **************** the Plan received a favorable determination letter from the Service as to its qualified status under section 401(a) of the Code, as applicable to governmental pension plans.

Plan benefits are financed through a trust fund to which both employees and the State currently contribute ***** percent of the employee's compensation. The trust fund is invested and the proceeds of such investments become a part of the fund. The trust fund exists for the exclusive benefit of members and their beneficiaries and may not be diverted to any other purpose. The trust fund is administered by a six-member Board of Trustees.

The employee contribution goes into an employee account that is periodically credited with a stated interest rate, which is fixed by State law and currently is ****** percent. The interest rate bears no relationship to the investment earnings of the trust. Prior to ***************, employee contributions were treated as after-tax contributions. Pursuant to a private letter ruling issued by the Service on **************, you state that, after December 31, 1987, employee contributions have been "picked up" under section 414(h) (2) of the Code and are treated as pre-tax contributions. However, many employees who currently are retiring from State employment have after-tax employee contributions made before ******************.

A participant's retirement annuity is based upon his or her average compensation and credited years of service. The employee's contributions do not impact the calculation of the retirement annuity.

Historically, the Plan has offered participants a "standard annuity for life" and several joint and survivor annuity options. Upon retirement or separation from service, the employee also is offered the option of requesting a withdrawal of his employee contributions with accumulated interest at the stated interest rate provided by law. An employee's ability to withdraw his or her employee contributions was available on May 5, 1986 to all participants upon separation from service.

During a ****** session the State Legislature amended the Plan to include a partial lump sum distribution("PLSD") The statute now provides that a member of the Plan who is eligible to retire and receive an unreduced service retirement annuity may elect an optional retirement annuity together with a PLSD. The amount of the PLSD may not exceed • * months of a standard service retirement annuity computed without regard to this option. The service retirement annuity is

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reduced actuarially to reflect the PLSD. Individuals who retire on or after ************* may elect the PLSD. The PLSD is paid to a retiree at the same time as the Plan's first annuity payment. An employee's retirement is always effective at the end of a calendar month. The first annuity payment is made to the retiree at the end of the first full calendar month after the effective date of retirement. For example, the first annuity payment for a November 30th retirement would be December 31st.

Based on the statements and representations given above, you request the following rulings:

1. A participant who elects to receive a PLSD from the Plan in exchange for a reduced retirement annuity and who receives the PLSD before or with the first annuity payment will be taxed on the PLSD only to the extent such distribution exceeds the investment in the contract as of December 31, 1986, in accordance with Code § 72(e)(8)(D), as modified by section 1122(h)(9) of the Tax Reform Act of 1986 and Code § 72(e)(5)(A).

2. To the extent the PLSD exceeds the investment in the contract as of December 31, 1986, such excess is taxable to the annuitant in the Plan on a pro-rata basis pursuant to sections 72(e)(8)(A) and 72(e)(2)(B) of the Code.

Section 402(a)(1) of the Code generally provides that an amount actually distributed from an employee's trust described in Code § 401(a) which is exempt from tax under § 501(a), shall be taxable to the distributee in the year of distribution under § 72 (relating to annuities).

Section 72(a) of the Code provides that gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

Code § 72(b)(1) provides that gross income under § 72(a) does not include that part of any payment received as an annuity which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date). Code § 72(b)(2) provides that amounts excluded from income under § 72(b)(1) shall not exceed the total unrecovered investment in the contract as calculated immediately before the annuity starting date.

Code § 72(e)(1) of the Code generally applies to any amount, received under an annuity, endowment, or life insurance contract that

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is not received as an annuity, if no provision of this subtitle (other than this subsection) applies with respect to such amount.

Code § 72(e) (2) (A) provides that any amount received on or after the annuity starting date shall be included in gross income.

Code § 72(e) (2)(B) provides that, with regard to any amount received before the annuity starting date, such amounts will be included in gross income to the extent allocable to income on the contract. and shall not be included in income to the extent allocable to the employee's investment in the contract.

Code § 72(c) (4) defines "annuity starting date" in the case of any contract as the first day of the first period for which an amount is received as an annuity under the contract.

Code § 72(e) (5)(D)(i) provides that, except as provided in paragraph (8), below, the above provisions apply to any amounts received as a distribution from a plan qualified under § 401(a).

Code § 72(e) (8) (A) provides that, notwithstanding any other provision of this subsection, in the case of any amount received before the annuity starting date from a trust or contract described in paragraph (5)(D), paragraph (2)(B) shall apply to such amounts.

Code § 72(e)(8)(D) provides that, in the case of a plan which on May 5, 1986, permitted the withdrawal of any employee contributions before separation from service, § 72 (e)(8)(A) shall apply only to the extent that amounts received before the annuity starting date (when increased by amounts previously received under the contract after December 31, 1986,) exceed the investment in the contract as of December 31, 1986.

Section 1011A(b)(11) of TAMRA retroactively amended the Tax Reform Act of 1986 by adding § 1122(h)(9). Section 1122(h) (9) created the following special rule for retirement plans maintained by a state government:

> In the case of a plan maintained by a State which on May 5, 1986 permitted withdrawal by the employee of employee contributions (other than as an annuity), [Code] section 72(e). . shall be applied-
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> (A) without regard to the phrase 'before separation from service' in paragraph (8)(D), and

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(B) by treating any amount received (other than as an annuity) before or with the 1st annuity payment as having been received before the annuity starting date.

TAMRA § 1011A(b)(11) expanded the class of participants in state government retirement plans who are eligible for the special relief afforded under Code § 72(e)(8)(D). Prior to the TAMRA amendment, the tax relief available under the Code was limited to participants who opted for in-service distributions from the Plan. After enactment of the TAMRA provision, the class of state employees eligible for the special tax treatment expanded to include those who received a lump sum or partial lump sum distribution after separation from service and on or before the former employee's annuity starting date.

In this case, the Plan, as of May 5, 1986, permitted a retiring employee to withdraw his or her employee contributions other than as an annuity, after separation from service. The PLSD is an amount received before or with the first annuity payment under the Plan and is, therefore, deemed to have been received on or before an employee's annuity starting date under the Plan. Because the Plan provided a withdrawal option on the appropriate date, and because the PSLD is received within the window of eligibility specified in TAMRA § 1011A(b)(11), (i.e., before or with a participant's first annuity payment), it meets the criteria for the special tax treatment accorded to individuals participating in a plan maintained by a state government.

Accordingly it is ruled that:

1. A participant who elects to receive a PLSD from the Plan in ex-change for a reduced retirement annuity, and who receives the PLSD before or with the first annuity payment will be taxed on the PLSD only to the extent such distribution exceeds the investment in the contract as of December 31, 1986, in accordance with Code § 72(e)(8)(D), as modified by section 1122(h)(9) of the Tax Reform Act of 1986 and Code § 72(e)(5)(A).

2. To the extent the PLSD exceeds the investment in the contract as of December 31, 1986, such excess is taxable to the annuitant in the Plan on a pro-rata basis as provided under sections 72(e)(8)(A) and 72(e)(2)(B) of the Code.

This ruling is directed only to the taxpayer or organization requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent. Should you have any questions regarding the scope or substance of the ruling letter, please contact ************** of my staff at **************. ***.

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This letter expresses no opinion as to whether the Plan satisfies the requirements for qualification under Code § 401(a). The determination as to whether a plan is qualified under § 401(a) is within the jurisdiction of the Manager, Employee Plans Determinations Programs, Cincinnati, Ohio, and the appropriate Area Office of the Employee Plans Examination Division.

Sincerely,

John Swieca, Manager
Employee Plans Technical Group 1
Tax Exempt and Government
Entities Division

Enclosures:

- Deleted Copy of Ruling Letter
- Notice 437, Notice of Intent to Disclose

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