Significant Index No. 0072-0000

200317045

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

JAN 3 2003

T:EP:RA:T3

This letter is a further response to your letter dated July 24, 2000, requesting five rulings on behalf of TRS. We have previously responded to requests one through four. We are now responding to request five as modified by your letter of October 13, 2000.

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

TRS is a defined benefit governmental plan covering teachers of the State. The State has authorized a program where retired teachers can be re-hired in areas where there is a shortage of qualified teachers. Such re-hiring is done on a one-year contract basis. It is possible that these contracts may get renewed, depending on the availability of teachers in the area.

When a retiree is re-hired, they are entitled to continue receiving their annuity. However, when they resume working they must make a 9.855% after-tax contribution to TRS. The retiree's employer contributes an equal matching amount to TRS. Both the employee contributions and the employer contributions are separately accounted for within TRS (the account for employer contributions also includes income on the amounts in the employee contribution account). Employees are fully vested in both of these separate accounts.

TRS separately accounts for pre-retirement amounts and post-retirement amounts with employee after-tax contributions also separately accounted for. Separate accounts are also maintained for each year of post-retirement re-employment.

When a teacher originally retires, the retirement benefit may be taken in the form of an annuity, a lump sum distribution or in a series of lump sum distributions. Upon termination of re-employment, contributions stop and the retiree may withdraw all the funds in accounts established after being re-hired. Such withdrawal may be in the form of an annuity, a lump sum or in a series of lump sum distributions. The form of withdrawal is independent of the form of withdrawal for the retiree's original retirement. The retiree may also withdraw these funds at any time after the end of their first year of re-employment.

Based on the foregoing, Ruling Request 5 was requested:

> Retiree contributions representing after-tax contributions made by retirees under the re-employment program constitute a member's "investment in the contract" as defined in Code § 72(c), and such amounts when received by retirees from TRS upon termination of re-employment will not be includible in a retiree's gross income under § 72.

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.

The investment in the contract is defined under Code §72(c)(1) 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.

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 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.

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 1.72-1(d) of the regulations provides, in part, that in the case of "amounts not received as an annuity", if such amounts are received after an annuity has begun and during its continuance, amounts so received are generally includible in gross income. Amounts not received as an annuity which are received at any other time are generally includible in income only to the extent that such amounts exceed the investment in the contract.

Section 1.72-1(d) of the regulations makes references to "the contract". In this case, there are (at least) two contracts: one representing the "pre-retirement contributions" and one (or more) representing the "post-retirement contributions". As described above, TRS separately accounts for pre-retirement amounts and post-retirement amounts with employee after-tax contributions also separately accounted for. Separate accounts are also maintained for each year of post-retirement re-employment. Because of the separate accounting, TRS maintains separate contracts within the meaning of Code §72(d).

Therefore, in the case of a re-hired retiree who after termination of his or her re-employment elects to receive the after-tax contributions made during the re-employment period in the form of an annuity, such annuity is taxed as amount from a separate contract in accordance with Code § 72(b). Thus, each annuity representing contributions made to TRS in such years is also taxed in accordance with § 72(b).

With respect to the accounts maintained for after-tax employee contributions, the after-tax contributions are the consideration paid for the accounts. Accordingly, the investment in the contract for the separate accounts consisting of the employee after-tax contributions for a year is the aggregate after tax contributions held in the accounts reduced by distributions of after tax contributions from the accounts. Because the interest on the after-tax contributions is included in other accounts, the entire amount in the accounts for after-tax contributions constitutes investment in the contract.

Similarly, a post-retirement lump sum received after the pre-retirement annuity amount had begun represents amounts from a contract separate from the annuity contract for pre-retirement contributions. Because each lump sum is an "amount not received as an annuity", each such distribution is taxed in accordance with Code § 72(e)(2).

Accordingly, based on the above, Retiree Contributions representing after-tax contributions made by re-hired retirees constitute a retired Member's "investment in the contract". Thus, such amounts when received as an annuity upon termination of re-employment as taxed in accordance with Code § 72(b). Such amounts when received as a lump sum distribution are taxed in accordance with § 72(e)(2). In general, such amounts so received are includible in gross income only to the extent that they represent amounts in excess of the investment in the contract. These taxation rules apply to the distributions from each separate contract that a member has within TRS (i.e., pre-retirement contributions – both employee and employer provided – and for each year of post-retirement employment contributions –both employee and employer provided).

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 TRS is qualified under Code § 401(a) and that its trust is tax-exempt under § 501(a) at all times relevant to this ruling.

This ruling has been prepared by who may be reached at .

Sincerely yours,

Frances V Sloan

Frances Sloan, Manager
Employee Plans, Technical Group 3

Enclosures:
Deleted copy of ruling
Notice 437

Cc: