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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Uniform Issue List: 72.02-00
72.07-00 through 72.07-05

T.EP.RA.T1

Legend:

State A .....

Statute B..... .....

Option E.....

System X.....

Dear :

This is in response to a letter dated November 30, 2001, as supplemented by correspondence dated November 10, 2003, December 3, 2003, and December 22, 2003, submitted on your behalf by your authorized representative regarding rulings under section 72 of the Internal Revenue Code (the "Code"). The following facts and representations were submitted in connection with your request.

System X is a defined benefit plan that provides for retirement, death, and disability benefits for certain employees of State A, agencies of State A and certain local jurisdictions. System X is a governmental plan under Code section 414(d) and is intended to be qualified under section 401(a). The terms and conditions of System X are found in Statute B. System X received a favorable determination letter from the Internal Revenue Service dated September 21, 2000.

System X provides for a "normal service retirement allowance" which is a monthly benefit paid to a member on retirement that is based on the member's final average compensation and years of creditable service. Under System X, to receive the normal service retirement allowance, a member must terminate employment, attain age 50 or have at least 25 years of service and apply for the benefits by completing a System X application.

System X is a contributory plan. A member is required to make mandatory contributions equal to a percentage of the member's compensation. System X members' contributions are picked up by State A or other approved participating employer within

the meaning of Code section 414(h)(2). Prior to 1989, however, employee contributions were made on an after-tax basis. Under System X and Statute B, employee contributions can be withdrawn upon separation from service for a reason other than death or retirement. On May 5, 1986, these contributions were permitted to be withdrawn upon separation from service for a reason other than death or retirement by a member pursuant to the predecessor provisions of Statute B. Employee contributions made to other plans including plans sponsored by instrumentalities of State A and its political subdivisions on an after-tax basis have been transferred to System X.

Option E is a program under which a member of System X who has at least 25 and less than 30 years of eligibility service may elect to accrue future retirement benefits in the manner provided by Option E, rather than in the normal manner provided under System X. This method is achieved by treating the Option E participant as though retired from System X, even though the participant continues in employment. As a "retiree" from System X, the Option E participant retains the participant's previously accrued rights to normal service retirement benefits under System X. However, as a System X "retiree," the Option E participant may not accrue additional service credit in System X during the period of Option E participation.

The Option E participant, as a System X "retiree," accrues additional retirement benefits in Option E in the following manner. During the period beginning on the effective date of participation in Option E, System X credits the following amounts to an individual's Option E account: (1) the normal service retirement allowance to which the member would have been entitled had the member in fact terminated employment and retired; (2) the applicable cost-of-living adjustment; and, (3) interest on the balance in the Option E account at the rate of six percent per year, compounded monthly. Although no individual Option E account is actually established, a participant's accrued Option E benefit is calculated annually on a separate basis, and account statements are provided to each participant. The "interest" credit is not related to asset performance, but is fixed by statute. In addition to employee contributions, other contributions to System X are made by State A or other approved participating employer. None of these contributions, employee or employer, are designated to Option E in particular, as there is no discrete fund for Option E. Option E participation may not exceed five years.

Upon termination of the Option E participation period, an Option E participant terminates the employment relationship with State A, a State A agency, or local jurisdiction. At that time, System X commences payment to the Option E participant (or designated beneficiary) of the normal service retirement allowance. In addition to this monthly benefit, the Option E participant (or designated beneficiary) is entitled to receive in a lump sum the amount accrued in the Option E account during the period of Option E participation (the "accumulated Option E benefit"). Distribution of the accumulated Option E benefit is governed by participant election. However, almost all

participants receive the accumulated Option E benefit within 90 days of the date the normal service retirement allowance benefit payments commence.

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

(1) That a retiring participant's aggregate after-tax employee contributions held by System X constitute the employee's "investment in the contract" within the meaning of Code section 72(e)(8)(B).

(2) That the withdrawal feature of System X and Statute B, which allows an employee to withdraw accumulated contributions of the employee if the employee separates from service for a reason other than death or retirement and requests the payment, which was present in the predecessor provision of Statute B on May 5, 1986, constitutes a withdrawal feature described in Code section 72(e)(8)(D).

(3) That the payment of an Option E non-annuity distribution amount constitutes the receipt by a retiring participant of a lump sum payment made in connection with the commencement of annuity payments under a qualified plan, as described in Code section 72(d)(1)(D), such that the payment is taxable under section 72(e) as if received before the annuity starting date.

(4) That, assuming the answers to ruling requests (1), (2) and (3) are in the affirmative, as a payment at or prior to the annuity starting date, for purposes of section 72(e)(8)(B), the Option E amount is subject to the investment in the contract allocation rules of that provision, and also to the special relief afforded under section 72(e)(8)(D), even though Option E was not available under System X or its predecessor in 1986, because the predecessor plan to System X did have a feature (referenced above) permitting the employee withdrawals at May 5, 1986.

With regard to the above ruling requests, Code section 72(a) provides that, except as otherwise provided in this chapter, 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 section 72(e) generally applies to any amount received under an annuity contract but which is not received as an annuity.

Code section 72(e)(2)(A) provides that any amount not received as an annuity and which is received on or after the annuity starting date shall be included in gross income.

Code section 72(d)(1)(D) provides that if, in connection with the commencement of annuity payments under any qualified employer retirement plan, the taxpayer receives a lump sum payment, then such payment will be taxable under subsection (e) as if

received before the annuity starting date, and the investment in the contract shall be determined as if such payment had been so received.

Code section 72(e)(8)(A) provides that notwithstanding any other provision of Code section 72(e), in the case of any non-annuity amount received before the annuity starting date from a qualified plan, section 72(e)(2)(B) shall apply to such amounts.

Code section 72(e)(2)(B) provides that a non-annuity payment which is received before the annuity starting date (1) shall be included in gross income to the extent allocable to the income on the contract, and (2) shall not be included in gross income to the extent allocable to the investment in the contract.

Code section 72(e)(8)(D) provides that in the case of a plan which on May 5, 1986, permitted withdrawal of any employee contributions before separation from service, subparagraph (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 the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), Pub. L. No. 100-647, 1988-3 C.B. 1, created the following special rule that in the case of a retirement 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 without regard to the phrase "before separation from service" in paragraph (8)(D) and by treating any amount received other than as an annuity before or with the first annuity payment as having been received before the annuity starting date.

Code section 72(e)(6) defines the "investment in the contract" for purposes of subsection (e) as of any date to be the aggregate amount of premiums or other consideration paid for the contract as of such date minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income.

Notice 87-13, 1987-1 C.B. 432, Q&A 13, provides that if employee contributions are transferred after May 5, 1986, from a plan that permitted in-service withdrawals on May 5, 1986 ("transferor plan") to another plan ("transferee plan") that did not permit such in-service withdrawals, the investment in the contract as of December 31, 1986 under the transferor plan (or the portion of the transferee plan that comprises the transferor plan) will continue to qualify for the special grandfather rule in Code section 72(e)(8)(D). Investment in the contract as of December 31, 1986 under the transferee plan (or the portion of the post-transfer plan that comprises the transferee plan) will not qualify for the grandfather rule and is to be treated under the transferee plan, for purposes of

section 72(e), as though it is not part of the investment in the contract on December 31, 1986. Instead such investment in the contract shall be treated as post-1986 investment in the contract subject to section 72(e)(8)(B).

In this case, with respect to ruling request (1), System X prior to 1989 and the predecessor to System X provided for after-tax employee contributions. In addition, after-tax contributions were transferred to System X from other qualified plans. Thus, a retiring participant's after-tax employee contributions held by System X, minus any amounts previously received under System X by the participant, to the extent that such amounts were excludable from gross income, constitute the participant's "investment in the contract" under Code section 72(e)(6), which definition applies for purposes of section 72(e)(8)(B).

Regarding ruling request (2), Code section 72(e)(8)(D) generally requires that the withdrawal feature apply to in-service withdrawals. As indicated above, section 1011A(b)(11) of TAMRA modified this requirement for plans maintained by a State to include withdrawals of employee contributions permitted on or after separation from service. On May 5, 1986, the predecessor to System X, a plan maintained by State A, provided that participants could withdraw after-tax employee contributions on separation from service. Thus, we conclude that the withdrawal features of System X and Statute B allowing an employee to withdraw employee contributions, and the predecessor to System X and Statute B, which was present on May 5, 1986, constitute a withdrawal feature under section 72(e)(8)(D).

Regarding ruling request (3), you represent that almost all participants in Option E receive their accumulated Option E benefit within 90 days of the date the normal service retirement allowance benefit payments commence. An accumulated Option E benefit paid in a lump sum within the 90-day period constitutes a lump sum payment made in connection with the commencement of annuity payments within the meaning of Code section 72(d)(1)(D). As such, it is treated as an amount received before the annuity starting date under section 72(e). Thus, we conclude with respect to ruling request (3) that such payment of the accumulated Option E benefit within the 90-day period constitutes a lump sum payment made in connection with the commencement of annuity payments under a qualified plan as described in section 72(d)(1)(D), such that the payment is taxable under section 72(e) as if received before the annuity starting date.

With respect to ruling request (4), we concluded above that System X provided for the withdrawal of employee contributions on May 5, 1986, through its predecessor, on separation from service which satisfies the special relief afforded by section 1011A(b)(11) of TAMRA. Pursuant to Notice 87-13 and TAMRA, this relief applies to after-tax employee contributions that were transferred from State-sponsored plans which contained the appropriate withdrawal language as of May 5, 1986. We further

concluded in ruling (3) above that the distribution of the accumulated Option E benefit within 90 days of the date the normal service retirement allowance benefit payments commence is treated as an amount received before the annuity starting date. Thus, we conclude that the accumulated Option E benefit will be taxable to the extent the amount distributed exceeds the participant's investment in the contract as of December 31, 1986, pursuant to Code section 72(e)(8)(D), to the extent not previously withdrawn. However, any pre-1987 after-tax employee contributions transferred from plans maintained by instrumentalities or political subdivisions of State A will not be treated, for purposes of section 72(e)(8)(D), as investment in the contract as of December 31, 1986. In addition, any portion of the accumulated Option E benefit received in excess of the pre-1987 investment in the contract will be taxable pursuant to the pro rata basis recovery rule of section 72(e)(8)(B).

This ruling expresses no opinion with respect to the taxability of an accumulated Option E benefit received after 90 days of the date the normal service retirement allowance benefit payments commence.

No opinion is expressed as to the federal tax consequences of the transaction described above under any other provisions of the Code.

The above rulings are based on the assumption that System X is qualified under Code section 401(a) and its related trust exempt from tax under section 501(a) at all relevant times.

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

Should you have any questions or concerns regarding this letter, please contact at .

Sincerely yours,

Carlton Watkins

Carlton Watkins, Manager
Employee Plans Technical Group 1

Enclosures:
Notice of Intention to Disclose
Deleted Copy of Ruling

cc: