

Recovery of Investment in the Contract from Payments Received from a Qualified Defined Benefit Plan by an Employee During Phased Retirement

Notice 2016-39

I. PURPOSE

This notice provides guidance in response to inquiries as to whether payments received by an employee from a qualified defined benefit plan¹ during phased retirement are amounts received as an annuity under § 72 of the Internal Revenue Code. For purposes of this notice, phased retirement is an arrangement under which a participant in a qualified defined benefit plan commences the distribution of a portion of his or her retirement benefits from the plan while continuing to work on a part-time basis.

This notice also provides guidance regarding the appropriate present value factors to be used for purposes of determining the basis recovery fraction of each payment received during phased retirement, and provides guidance regarding the time for determining the basis recovery fraction for these phased retirement payments.

This notice does not apply to amounts received from non-qualified contracts. Rev. Proc. 2016-36, 2016-26 I.R.B. ____ (June 27, 2016), provides

¹ For purposes of this notice, the Civil Service Retirement System in chapter 83 of title 5, United States Code, and the Basic Benefit Plan of the Federal Employees' Retirement System, in subchapters I, II, and VI of chapter 84 of title 5, United States Code, are treated as qualified defined benefit plans.

guidance regarding the application of Treas. Reg. §§ 1.72-2(b)(2) and 1.72-4(b)(1) to non-qualified contracts.

II. BACKGROUND

Section 402(a) provides that any amount actually distributed to any distributee by any trust described in § 401(a) is taxable to the distributee in the taxable year in which distributed under § 72.

Section 72(a) provides that, in general, gross income includes any amount received as an annuity under an annuity, endowment, or life insurance contract.

Section 72(b)(1) provides that gross income does not include that part of any amount received under an annuity contract which bears the same ratio to that amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract.

Section 72(c)(1) provides that, for purposes of § 72(b), the investment in the contract as of the annuity starting date is (A) the aggregate amount of premiums or other consideration paid for the contract, minus (B) the aggregate amount received under the contract before the annuity starting date to the extent that the amount was excludible from gross income. Section 72(c)(4) provides that, for purposes of § 72, the annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract.

Section 72(d) provides that, in the case of any amount received as an annuity under a qualified employer retirement plan described in § 72(d)(1)(G) (which includes a plan described in § 401(a)), the investment in the contract is

recovered under the simplified method of § 72(d)(1). Under this method, gross income excludes the portion of a monthly annuity that does not exceed the amount obtained by dividing (1) the investment in the contract (as of the annuity starting date) by (2) the number of anticipated payments determined under the table in § 72(d)(1)(B)(iii).

Section 72(e), which was amended as part of the Tax Reform Act of 1986, P.L. 99-514 (“TRA ‘86”), provides rules that apply to any amount which is received under an annuity, endowment, or life insurance contract and is not received as an annuity. Section 72(e)(2)(B) provides that if an amount to which § 72(e) applies is received before the annuity starting date, then it is included in gross income to the extent allocable to income on the contract and is excluded from gross income to the extent allocable to the investment in the contract.

Section 72(e)(8) provides special rules for amounts not received as an annuity from a trust or contract described in § 72(e)(5)(D) (which includes a qualified retirement plan described in § 401(a)). Under § 72(e)(8)(B) and (C), the amount allocated to the investment in the contract is the portion of the distribution which bears the same ratio to the amount of the distribution as the investment in the contract bears to the vested account balance. Section 72(e)(8)(B) provides that this determination is made at the time of the distribution or at a time prescribed by the Secretary.

The Report of the Senate Finance Committee for TRA ‘86 (S. Rep. No. 99-313, 99th Cong., 2d Sess. 610 (1986)) describing the amendment to § 72(e)(8) states:

The bill modifies the basis recovery rules for pre-annuity starting date distributions to provide for the pro rata recovery of employee contributions. Thus, with respect to a pre-annuity starting date distribution, a participant is entitled to exclude that portion of the payment that bears the same ratio to the total payment as the participant's after-tax employee contributions (and amounts treated as after-tax employee contributions) bears to the total value of the participant's accrued benefit (or account balance) under the plan as of the date of distribution or as of such other time as the Secretary may prescribe. The Secretary is authorized to prescribe appropriate rules for estimating the amounts referred to in the prior sentence if precise calculations would be unjustifiably burdensome.

The Conference Committee Report for TRA '86 states that, with respect to the basis recovery rules for pre-annuity starting date distributions, the "conference agreement generally follows the Senate amendment." H.R. Rep. No. 99-84 (Conf. Report), 99th Cong. 2d Sess. II-462 (1986).

Section 401(a)(11)(A) provides, in general, that in the case of any plan to which the paragraph applies, a trust forming part of such plan shall not constitute a qualified trust unless (i) in the case of a vested participant who does not die before the annuity starting date, the accrued benefit payable to such participant is provided in the form of a qualified joint and survivor annuity, and (ii) in the case of a vested participant who dies before the annuity starting date and who has a surviving spouse, a qualified preretirement annuity is provided to the surviving spouse of such participant.

The flush language following § 401(a)(37) provides, however, that § 401(a)(11) applies only in the case of a plan to which § 411 applies. Section 411(e) provides that § 411 generally does not apply to certain plans, including governmental and church plans.

Section 1.72-2(b)(2) provides in general that amounts subject to § 72 are considered “amounts received as an annuity” only if (i) the amounts are received on or after the annuity starting date,² as defined in § 1.72-4(b), (ii) the amounts are payable in periodic installments at regular intervals over a period of more than one full year from the annuity starting date, and (iii) subject to certain exceptions, the total of the amounts payable are 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 the terms of the contract and in accordance with sound actuarial theory.

Section 1.72-4(b)(1) provides that the term “annuity starting date” is generally the first day of the first period for which the first periodic payment is made under an annuity contract, provided that obligations under the contract have been fixed as of that date.

Q&A-11 of Notice 87-13, 1987-1 C.B. 432, provides that, with respect to distributions from a defined benefit plan before the annuity starting date, the present value of the vested portion of the total accrued benefit of a participant

² Flush language in § 1.72-2(b)(2) provides that this provision of § 1.72-2(b)(2) is disregarded for purposes of determining whether amounts subject to § 72(d) and § 1.72-13 are amounts received as an annuity, but this regulation was not modified to reflect an amendment to the Code that was made after the regulation was issued. The flush language was included in the regulation when it was issued in 1956. T.D. 6211, 21 FR 8853. At that time, § 72(d) (and § 1.72-13) applied a special three year rule for the recovery of basis from amounts received as an annuity by an employee. This special rule was repealed by TRA '86, and the § 72(d) subsection was later used for a new rule by the Small Business Job Protection Act of 1996, P.L. 104-188. Accordingly, the flush language of § 1.72-2(b)(2) no longer reflects the current statute.

under the plan (calculated using the plan's factors if the plan provides for a total distribution in the form of a lump sum, and, in other cases, using the factors specified under § 20.2031-7) is to be treated as the value of the vested portion of the account balance for purposes of § 72(e)(8)(B).

Section 7520, added to the Code by the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, provides that the value of an annuity shall be determined under tables prescribed by the Secretary and by using an interest rate equal to 120 percent of the Federal midterm rate. While the tables under § 20.2031-7 have been revised to take into account the enactment of § 7520, § 7520(b) provides that § 7520 does not apply for purposes of part I of subchapter D of chapter 1 (including § 402). Further, § 1.7520-3(a) provides that § 7520 does not apply to § 72 unless otherwise provided in the regulations under § 72.

III. TREATMENT OF PHASED RETIREMENT PAYMENTS UNDER SECTION 72

A. When payments received by phased retiree during phased retirement are treated as amounts not received as an annuity

Depending on a qualified plan's terms, the plan's obligations to an employee receiving phased retirement payments might not be fixed within the meaning of § 1.72-4(b)(1) during the employee's continued part-time employment. For example, if the terms of the phased retirement program do not fix the employee's date of full retirement, the plan will not, during the period of part-time employment, be able to determine its total retirement obligations to the

employee. An employee's date of full retirement is not fixed if the date can change, for example, due to a unilateral decision of the employee to commence full retirement sooner or pursuant to an agreement between the employer and employee to change the full retirement date. Also, an employee might accrue additional plan benefits during the period of phased retirement that affect the amounts payable to the employee at full retirement. Further, the plan might allow an employee to elect a distribution option at the time of full retirement that could also alter the plan's obligations to the employee. Lastly, a qualified retirement plan might be amended to modify the benefit formula with respect to benefits that are not yet accrued during the period of part-time employment.

Accordingly, payments received by an employee from a qualified retirement plan during phased retirement are not received as an annuity for purposes of § 72 if all the following conditions apply:

1. The employee begins to receive a portion of his or her retirement benefits when he or she enters phased retirement and begins part-time employment, and will not begin receiving his or her entire plan benefits until he or she ceases employment and commences full retirement at an indeterminate future time (for this purpose, even if a full retirement date is agreed upon at commencement of phased retirement, the employee's date of full retirement is indeterminate as long as it is possible that date could change);
2. The plan's obligations to the employee are based in part on the employee's continued part-time employment (which affects both the

duration of the payment of phased retirement benefits and the amount of additional retirement benefits the employee accrues during that period of part-time employment); and

3. Under the plan terms, the employee does not have an election as to the form of the phased retirement benefit to be paid during phased retirement, but elects a distribution option at full retirement that applies to the employee's entire retirement benefit, including the portion that commenced as phased retirement benefits.

B. Present value factors for purposes of calculating phased retiree's accrued benefit under § 72(e)(8)

To the extent the phased retirement payments received from a qualified defined benefit plan during the period of part-time employment are amounts not received as an annuity, the rules of § 72(e)(8) apply. Under these rules, the amount excludible from an employee's gross income is a portion of each payment, determined by multiplying the amount of the payment by the ratio of the employee's investment in the contract (that is, the employee's basis) to the total value of the employee's accrued benefit (this ratio is referred to in this notice as the basis recovery fraction). If a plan has present value factors that are used for purposes of calculating lump sum distributions (including partial lump sum distributions), those factors (rather than the factors specified in § 20.2031-7) are to be used in calculating the value of the accrued benefit for purposes of determining the excludible portion of a payment.

C. Time for determining basis recovery fraction under § 72(e)(8)

In order to determine the amount allocated to basis under § 72(e)(8) and excludible from each phased retirement benefit payment, the basis recovery fraction determined in accordance with Section III.B. of this notice must be applied to each payment. Generally, the basis recovery fraction is determined as of the date of the payment to which it is applied, but the incremental changes to the basis recovery fraction resulting from any after-tax contributions made during the period of continued part-time employment and changes in the present value of accrued benefits during this period typically would have no more than a minimal effect on the amount excludible from the employee's phased retirement payments. Therefore, the Treasury Department and the Internal Revenue Service have determined that requiring the repeated recalculation of the basis recovery fraction for each such payment would be unjustifiably burdensome.

Pursuant to the authority provided by § 72(e)(8)(B), the basis recovery fraction with respect to a phased retirement payment need not be redetermined as the employee makes additional after-tax contributions and the present value of the accrued benefit changes during the period of part-time employment. Instead, the basis recovery fraction applicable to a series of phased retirement payments is permitted to be fixed at the time those payments commence. When an employee commences full retirement, the employee's investment in the contract as of the annuity starting date will take into account the investment in the contract recovered during the period of part-time employment and any additional employee contributions made during that period.

IV. EXAMPLE OF BASIS RECOVERY CALCULATIONS FOR PHASED RETIREMENT AND FULL RETIREMENT PAYMENTS

Employer X maintains Plan A, a defined benefit plan providing for after-tax employee contributions that is qualified under § 401(a). Plan A is a qualified governmental plan under § 414(d), and accordingly, is not subject to the rules of § 401(a)(11).

Employer X maintains a phased retirement program under Plan A. Under this program, an employee of Employer X who participates in Plan A and is eligible for immediate retirement under that plan may elect to continue employment with Employer X on a part-time basis, while beginning to receive a portion of his or her retirement benefits. An employee who enters phased retirement under this program continues to earn additional retirement benefits and make after-tax contributions based upon the employee's continuing part-time employment.

Under the phased retirement program, Employer X and an employee participating in the program may agree that the employee's part-time employment will continue for a specified period of time. However, Employer X and the employee may agree at any time to change that period of part-time employment.

The Plan A benefit payments paid to an employee, who is a phased retiree under the phased retirement program, during the period of part-time employment (the "phased retirement benefit") will be the product of (a) the amount that would have been paid to the employee if he or she had fully retired

at the time part-time employment and phased retirement commenced and elected a single life annuity, and (b) the employee's phased retirement percentage. An employee's phased retirement percentage is the percentage of his or her full-time schedule the employee is not scheduled to work during this phased retirement period. Plan A requires that the phased retirement benefit be paid in the form of a single life annuity with no election to receive the benefit in any other form (which is permitted because Plan A is a governmental plan that is not subject to § 401(a)(11)).

When a part-time employee who has elected phased retirement terminates employment and fully retires, the phased retirement benefits cease, and the employee begins to receive a total retirement annuity. This total retirement annuity is equal to the monthly benefit paid during the phased retirement period of part-time employment, increased by any applicable cost-of-living adjustments, plus an additional amount. The additional amount is equal to the product of (a) the monthly amount that would have been payable under Plan A at the time of full retirement if the employee had not elected phased retirement (that is, as if the employee had continued to be employed under his or her full-time schedule), and (b) the employee's working percentage (which is, one minus the employee's phased retirement percentage). The employee may elect to receive the total retirement annuity in the form of a joint and survivor annuity.

Employee M participates in Plan A and is fully vested in his benefits. In Year 1 Employee M elected to begin part-time employment and phased retirement under Employer X's phased retirement program and to work 40

percent of his full-time schedule. Accordingly, Employee M had a working percentage of 40 percent and a phased retirement percentage of 60 percent. If Employee M had fully retired at the time he began part-time employment, he would have been entitled to a single life annuity under Plan A of \$2,000 per month. Employee M received his first monthly payment under the phased retirement program in April of Year 1, at age 63. During his part-time employment in Year 1, Employee M received payments from Plan A of \$1,200 per month ($\$2,000 \times 60$ percent). These payments were annually increased with a cost-of-living adjustment, resulting in a monthly payment of \$1,225 in Year 2 and a monthly payment of \$1,250 in Year 3 until Employee M fully retires with payments of his total retirement annuity beginning in April of Year 3. Employee M receives his final monthly payment from Plan A under the phased retirement program in March of Year 3.

At the time of his full retirement at age 65, Employee M would have been entitled to a single life annuity from Plan A of \$2,400 per month if he had not elected phased retirement. At full retirement, Employee M's total retirement annuity payable from Plan A as a single life annuity is \$2,210 per month, equal to the sum of \$1,250 and \$960 ($\$2,400 \times 40$ percent). At the time of full retirement, Employee M elects a joint and survivor benefit based on the total retirement annuity of \$2,210 per month. The survivor annuity is payable to Employee M's spouse, who is age 60 at the time of Employee M's full retirement.

At the time Employee M elected to commence phased retirement and to begin part-time employment under Employer X's phased retirement program, he

had made after-tax contributions to Plan A of \$50,000. During the period of part-time employment, Employee M made an additional \$5,000 in after-tax contributions to Plan A.

Plan A does not pay total distributions in the form of a lump sum, but pays partial lump sum distributions to participants in certain circumstances. At the time Employee M commenced part-time employment in order to commence receiving benefits under the phased retirement program, the present value factor used under Plan A to determine a single sum equivalent of an immediate annuity for an employee at age 63 was \$180 for each dollar of monthly annuity.

Based on the present value factors under Plan A, the present value of Employee M's benefit as of the time phased retirement benefits commenced under the plan and Employee M began part-time employment equaled \$360,000 ($\$2,000 \times 180$). Accordingly, Employee M's basis recovery fraction is 13.9 percent, determined by dividing \$50,000 (the total of after-tax contributions as of that time) by \$360,000 (the present value of Employee M's accrued benefit). This basis recovery fraction is applied to the first distribution to determine the amount includible in gross income.

In accordance with Section III.C of this Notice, at the time phased retirement benefits begin, the plan administrator of Plan A fixes an employee's basis recovery fraction that applies to all of the employee's phased retirement payments during the period of part-time employment. This means that 13.9 percent of each phased retirement payment is allocable to Employee M's investment in the contract and is therefore not includible in gross income.

Because Employee M commenced phased retirement in April of Year 1 and fully retires in April of Year 3, under the phased retirement program Employee M receives nine monthly payments of \$1,200 in Year 1, 12 monthly payments of \$1,225 in Year 2, and three monthly payments of \$1,250 in Year 3. Employee M therefore recovers basis under the phased retirement program of \$1,501.20 in Year 1 (13.9 percent X 9 X \$1,200), \$2,043.36 in Year 2 (13.9 percent X 12 X \$1,225), and \$521.25 in Year 3 (13.9 percent X 3 X \$1,250) for a total recovered basis from the phased retirement payments of \$4,065.81.

Under § 72(c)(1), with respect to payments at full retirement, Employee M's investment in the contract as of the annuity starting date takes into account the investment in the contract recovered during the period of part-time employment and any additional employee contributions made during that period. At the annuity starting date, Employee M has an investment in the contract of \$50,934.19 (\$50,000 plus \$5,000 in additional contributions minus \$4,065.81 in recovered basis). Because Employee M is receiving a joint and survivor annuity, the number of anticipated payments is determined under the table applicable to annuities payable over the lives of more than one person set forth in § 72(d)(1)(B)(iv). Further, because the combined age of Employee M and the survivor annuitant is 125, the number of anticipated payments set forth in that section is 310. Accordingly, the portion of each monthly annuity payment allocable to investment in the contract is \$164.30 (\$50,934.19 divided by 310). This portion of each monthly payment to Employee M (or his beneficiary) during

full retirement is excludible from income until the investment in the contract (\$50,934.19) is recovered.

V. EFFECT ON OTHER DOCUMENTS

Notice 87-13 is modified.

VI. EFFECTIVE DATE

This notice applies to taxable years beginning on or after January 1, 2016. Taxpayers may, however, elect to apply the notice to taxable years beginning before that date. This notice does not apply to amounts received from non-qualified contracts.

VII. DRAFTING INFORMATION

The principal author of this notice is Robert M. Walsh of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the IRS participated in the development of this guidance. For further information regarding this notice, you may contact Mr. Walsh at 202-317-4102 (not a toll-free call).