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

OFFICE OF
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The Honorable David McIntosh
U.S. House of Representatives :
Washington, D.C. 20515-1402

Attention: Ms. Krista Kafer

Dear Mr. McIntosh:

This letter responds to your inquiry of October 3, 2000, on behalf of your constituent, . has questions about the taxation of "after-tax" contributions upon distribution of benefits from the (Plan). Attached to letter is a letter of September 22, 2000, from and a private letter ruling issued to the Plan in June, 1989.

Based upon the descriptions in these materials, the Plan appears to be a qualified plan maintained by the that provides two separate benefits:

- A pension provided by employer contributions.
- An annuity provided from an account consisting of the participant's after-tax contributions, plus earnings.

After-Tax Contributions to a Qualified Plan are Not Taxed Upon Distribution

Under the Internal Revenue Code (the Code) a participant's after-tax contributions (referred to here as the cost) to a qualified plan are not taxed upon distribution. Instead, each distribution of benefits from such a plan includes a tax-free portion relating to the after-tax contributions. For example, for annuity payments, a participant who makes after-tax contributions to a qualified plan may exclude a portion of each payment from income as a recovery of his or her cost. This tax-free part of each payment is figured when the payments start and remains the same each year. The rest of each payment is taxable. Similarly, if a participant receives a nonannuity (or nonperiodic) distribution, he or she can prorate the distribution and exclude a portion of it from income as a recovery of cost. Any unrecovered cost at the time of the participant's death is deductible on the final income tax return of the decedent.

For example, one option under the Plan is that a participant may elect to receive a monthly annuity benefit from his annuity account as well as a monthly pension benefit

from the pension plan. has suggested that we use his own benefit as an example. The letter says that, as of June 30, 2000, he was 53 years old and entitled to retire immediately. If he retires, he will receive an annuity from the pension plan. If he elects to receive an annuity from his annuity account, he will receive a total monthly annuity benefit of $. This amount is paid beginning at age 53 for the remainder of his life. For the first 360 months, $ of each payment will be taxable and $ of each payment will be nontaxable. The nontaxable amount of each payment is equal to after-tax contributions ($) divided by 360. Accordingly, his cost is recovered over the 360 months. If dies before the payments are completed, any unrecovered cost would be deductible on his final income tax return.

A Distributee Can Roll Over the Portion of the Distribution That is Treated as Taxable

As noted above, when a participant makes after-tax contributions to a plan, a portion of each nonperiodic distribution is treated as a recovery of cost. In this case, a distributee may roll over the portion that is treated as taxable. For example, if a participant in a qualified plan receives a distribution of $30,000, and $10,000 of that distribution is treated as a nontaxable recovery of cost, then the participant may roll over up to $20,000 to an individual retirement account. Thus, the participant is treated as having rolled over only amounts out of the taxable portion of the distribution.

Other Rules that Allow for Special Tax Treatment of Distributions

Under some circumstances, after-tax contributions can be treated as a “separate contract” and a distribution of these amounts can be fully excluded from income. However, in the June, 1989 private letter ruling, the Internal Revenue Service concluded the annuity account in this Plan is not a separate contract. Therefore, his after-tax contributions are not to be treated as a separate contract and instead are taxed by the pro rata recovery rules described above.

A special rule also applies for after-tax contributions contributed before 1987 to certain state retirement plans. [Section §72(e)(8)(D) of the Code and §1011A(d)(11) of the Technical and Miscellaneous Revenue Act of 1988]. The June 1989 letter ruling and the letter indicate that this special rule allows pre-1987 contributions to be paid to him tax-free.

Form 1099-R is Used to Track Distributions and Unrecovered Costs

also asked how the unrecovered cost is tracked. Distributions from qualified plans are generally reported to distributees on Form 1099-R. The total amount of the distribution for the year as well as the taxable amount of the distribution

are provided on the form. If a total distribution is made (that is, the entire balance of the account is distributed within one year), the total employee contributions that may be recovered tax-free must be shown. The form is also used when distributions are made to a beneficiary or to an estate upon the death of the participant.

I hope this information is helpful to you. If you have additional questions or concerns, please contact me at (202) 622-6000 or Rob Walsh of my staff at (202) 622-6090 (not toll-free numbers).

Sincerely,

ALAN TAWSHUNSKY
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(Employee Benefits)
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