



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

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

SEP 15 2004

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

Legend:

State A .....

Statute B.....

System X.....

Dear :

This is in response to a letter dated February 19, 2004, as supplemented by correspondence dated May 28, 2004, and July 8, 2004, 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 pension benefits to non-certified employees of public schools in State A pursuant to Statute B. System X, a plan intended to be qualified under Code section 401(a), is maintained by State A and its provisions are found in Statute B. Benefits under System X are funded through both mandatory employee contributions and employer contributions. Normal retirement benefits under System X are based on the participant's age and years of credited service and payable in monthly installments ("retirement allowance") upon the participant's retirement. System X also provides that a participant who is eligible for a retirement allowance, who has not previously received a retirement allowance, including a disability retirement allowance, and who meets certain age and/or service requirements, may elect to receive a partial lump sum distribution ("Lump Sum Payment") by notifying System X when applying for retirement benefits. Statute B provides that the monthly retirement allowance a participant would have received absent such an election will be reduced on an actuarially equivalent basis. On May 5, 1986, System X permitted participants to withdraw their accumulated employee contributions on termination of employment. System X does not accept, nor has it historically accepted, after-tax employee contributions from non-state retirement plans that may be attributable to employee contributions made prior to 1987 or from state plans that did not have a withdrawal feature on May 5, 1986.

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

- (1) A Lump Sum Payment from System X is eligible for the special tax treatment under Code section 72(e)(8)(D), as modified by section 1011A(b)(11) of TAMRA; and
- (2) A Lump Sum Payment paid before or with the first annuity payment under System X will be treated as having been received before the annuity starting date, and will be excluded from gross income up to the amount of the participant's pre-1987 after-tax employee contributions.

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(e)(8)(A) provides that notwithstanding any other provision of 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.

In this case, with respect to ruling request (1), System X is a state plan that provided for the withdrawal of after-tax employee contributions on May 5, 1986, on separation from service. System X permits an eligible participant to elect a Lump Sum Payment that, under Statute B, is paid on or before commencement of payment of the participant's monthly retirement allowance. Thus, with regard to ruling request (1), a Lump Sum Payment satisfies the requirements for the special relief afforded Code section 72(e)(8)(D), as modified by TAMRA. Thus, we conclude with respect to ruling request (2), that a Lump Sum Payment will be treated as being received before the annuity starting date and taxable only to the extent such payment exceeds the participant's investment in the contract as of December 31, 1986 (i.e., pre-1987 after-tax employee contributions). Any portion of a Lump Sum Payment 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).

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.

A copy of this letter ruling is being sent to your authorized representative pursuant to a power of attorney on file with this office.

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

Sincerely yours,

*Carlton A. Watkins*

Carlton A. Watkins, Manager  
Employee Plans Technical Group 1

Enclosures:

Notice of Intention to Disclose  
Deleted Copy of Ruling

cc: