



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

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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

SEP 20 2005

U.I.L. 72.00-00
U.I.L. 402.08-01

SE.T:EP:RA:T2

LEGEND:

Taxpayer A = *****

Plan X = *****

Plan Y = *****

Dear *****:

This is in response to a request for a private letter ruling dated October 24, 2002, which was submitted on your behalf by your authorized representative concerning the tax treatment of the distribution of certain benefits under section 72(t) of the Internal Revenue Code (Code).

The following facts and representations were made in support of your ruling requests:

Taxpayer A maintained Plan X since [REDACTED] for its employees. Effective January 1, [REDACTED] Plan X was converted from a traditional defined benefit plan to a cash balance plan. Prior to January 1, [REDACTED] Plan X provided participants with a pension benefit based on two percent of the participant's final five-year average pay multiplied by years of service, up to a maximum of forty percent of final five-year average pay for a participant with twenty or more years of credited service. For participants hired prior to January 1, [REDACTED] Plan X provides a subsidized sixty percent spousal death benefit.

Under Plan X, the normal form of benefit distribution for a married participant was a qualified joint and survivor annuity that provides a monthly benefit payable for

the life of the participant, with a fifty percent survivor benefit payable monthly for the life of the spouse upon the death of the participant. For a married participant hired prior to January 1, [REDACTED] and who had twenty years of service as of December 31, [REDACTED] the normal form of benefit distribution was a subsidized sixty percent qualified joint and survivor annuity. For an unmarried participant, the normal form of benefit distribution is a straight life annuity, payable in equal monthly installments for the life of the participant. Plan X also provided for optional forms of benefit distribution which may have been elected by the participant with spousal consent, if applicable. The optional forms of benefit distribution included: (1) a joint and survivor annuity with an actuarial equivalent amount paid to the participant, and upon the death of the participant, a selected percentage of such amount to be paid to the participant's beneficiary for life or (2) a years certain and life option which provided retirement benefit payments to the participant for his lifetime with a guaranteed minimum period of five years but no more than ten years guaranteed payment period, as specified by the participant.

Effective January 1, [REDACTED] Plan X was converted to Plan Y, a cash balance plan design under which participants' benefits will be defined in terms of a hypothetical "cash balance account" established for each participant. The opening cash balance account of each participant as of January 1, [REDACTED] was an amount equal to the present value of the participant's accrued benefit under Plan X as of December 31, [REDACTED]. Effective January 1, [REDACTED], each participant will accrue additional benefits under Plan X in an amount equal to five percent of the participant's compensation up to the Social Security taxable wage base plus ten percent of compensation in excess of the taxable wage base, and interest credited on such amounts. Each participant as of December 31, [REDACTED] was eligible for accrual of benefits under the formula as in effect on that date if greater than the accrual under the cash balance formula for a period of five years.

The subsidized spousal benefits provided under Plan X prior to January 1, [REDACTED] were grandfathered for participants hired on or before December 31, [REDACTED]. The grandfathered benefits were not included in the participants' opening cash balance account. The grandfathered benefits will be continued to be payable only in the annuity forms provided under Plan X prior to January 1, [REDACTED].

Effective January 1, [REDACTED] upon the occurrence of a distributable event, under Plan Y, participants may elect to receive a portion of their cash balance account in a lump sum. The remaining portion of the participant's cash balance account must then be distributed in the form of an annuity. The portion of the cash balance account that may be distributed in a lump sum will be determined under section 6.04(a)(3) of Plan Y. The amounts distributed in the form of a lump sum payment under Plan Y will generally be substantially larger than the monthly annuity payments made to the participants. Plan Y provides for a graduated increase in the percentage that may be received as a lump sum over a period of five years with the remaining percentage which must be distributed as an annuity decreasing proportionately. Notwithstanding, the excess of the grandfathered

benefits over the portion of the cash balance account payable in a lump sum will continue to be paid only in the form of an annuity offered under Plan X.

Section 2.50 of Plan Y defines separation of service as death, retirement, resignation, discharge or any absence that causes the participant to cease to be an employee. Section 6.01 of Plan Y states that the benefit payable to a participant upon the participant's separation from service for reasons other than death is the vested accrued benefit (reduced for early commencement, if applicable) or its actuarial equivalent as of the participant's benefit payment date.

Section 6.08 of Plan Y provides for distributions that qualify as eligible rollover distributions to be transferred in a trustee-to-trustee transaction to one of a number of retirement plans listed. In addition, the section defined eligible rollover distribution as a distribution from Plan Y, excluding any distribution that is (1) one of a series of substantially periodic payments (not less frequently than annually) over the life (or life expectancy) of the individual, the joint lives (or joint life expectancies) of the individual and the individual's designated beneficiary, or a specified period of not more than ten or more years; (2) any distribution to the extent such distribution is required under section 401(a)(9) of the Code; and (3) any distribution to the extent such distribution is not included in gross income.

Based on the aforementioned facts and representations, you have requested the following rulings:

1. The distribution of a portion of Plan Y benefits to a participant as a lump sum distribution will not cause the portion of Plan Y benefits distributed as an annuity (either from a participant's election to receive a portion of his cash balance account as an annuity or as a grandfathered annuity benefit) to be treated as other than a series of substantially equal periodic payments for purposes of application of the ten percent additional tax on early distributions from qualified retirement plans under section 72(t) of the Code.
2. A rollover of a lump sum distribution of any portion of a participant's cash balance account under Plan Y to an eligible retirement plan as defined under section 402(c)(8)(B) (either a direct trustee to trustee rollover or a rollover made within 60 days of the date of the date of distribution) will result in an annuity being the only distribution option available under Plan Y, and therefore prevent the application of the section 72(t) tax to any portion of the participant's remaining annuity distribution under Plan Y.

Section 72(a) of the Code provides that 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.

Section 72(d) of the Code provides a special rule for annuity payments made under a qualified retirement plan. Section 72(d)(1)(D) of the Code provides that

in the case of a lump sum distribution paid in connection with the commencement of annuity payments, generally such payment shall be taxable under section 72(e) of the Code as if received before the annuity starting date, and the investment in the contract for purposes of this paragraph shall be determined as if such payment had been so received. Section 72(e) addresses the taxation of any amounts received under an annuity, endowment or insurance contract that is not received as an annuity. Section 72(e)(2)(A) provides that any such amount received on or after the annuity starting date shall be included in gross income.

Section 72(e)(2)(B) provides that any such amount received before the annuity starting date shall be included in gross income to the extent allocable to income on the contract, and excluded from income to the extent allocable to investment in the contract.

Section 72(t)(1) of the Code generally provides that if a taxpayer receives any amount from a qualified retirement plan (as defined in section 4974(c) of the Code), the taxpayer shall be subject to an additional tax equal to 10 percent of the portion of such distribution that is includible in taxable income. However, certain types of distributions are excepted from the application of the additional tax under section 72(t)(2). Included among these exceptions and relevant to this discussion are distributions that are:

- (i) made on or after the date on which the employee attains age 59½;
- (ii) made to a beneficiary (or to the estate of the employee) on or after the death of the employee;
- (iii) attributable to the employee's being disabled within the meaning of subsection 72(m)(7);
- (iv) part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary; and
- (v) made to an employee after separation from service after attainment of age 55.

Section 402(a) of the Code provides that any amount actually distributed to any distributee by any employees' trust described in section 401(a) of the Code which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which the amount is distributed, under section 72 (relating to annuities), unless otherwise provided under section 402.

Section 402(c)(1) of the Code provides, in relevant part, that if any portion of the balance to the credit of an employee in a qualified trust is paid to the employee in

an eligible rollover distribution, and the distributee transfers any portion of the property received in such distribution to an eligible retirement plan, then such distribution (to the extent so transferred) shall not be includible in the gross income for the taxable year in which paid.

Section 402(c)(2) of the Code provides that in order for an eligible rollover distribution to be excluded from the gross income of the employee, the transfer described in 402(c)(1) must occur no later than 60 days after receipt of the distribution.

Section 402(c)(4) defines an "eligible rollover distribution" as any distribution to an employee of all or a portion of the balance to the credit of the employee in a qualified trust, except that such term shall not include any distribution which is one of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or for a special period of 10 years or more.

Section 402(c)(8) of the Code defines an "eligible retirement plan" as (i) an individual retirement account described in section 408(5); (ii) an individual retirement annuity described in section 408(b) (other than an endowment contract); (iii) a qualified trust; (iv) an annuity plan described in section 403(a); (v) an eligible deferred compensation plan described in section 457(b) which is maintained by an eligible employer described in section 457(e)(1)(A); and (vi) an annuity contract described in section 403(b).

Notice 89-25, 1989-1 C.B. 662, Q&A-12 was modified by Revenue Ruling 2002-62, 2002-42 I.R.B. 710. Q&A-12 of Revenue Ruling 2002-62 provides, among other things, that payments are considered to be substantially equal periodic payments within the meaning of Code section 72(t)(2)(A)(iv) if they are made in accordance with the required minimum distribution method, the fixed annuitization method, or the fixed amortization method (the three methods described in Q&A-12 of Notice 89-25). The three methods are:

- (i) the required minimum distribution method where the annual payment for each year is determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payments are redetermined each year;
- (ii) the fixed amortization method where the annual payment is determined by amortizing in level amounts the account balance over a specified number of years determined using the chosen life expectancy table and the chosen interest rate; or

- (iii) the fixed annuitization method where the annual payment for each year is determined by dividing the account balance by an annuity factor that is the present value of an annuity of \$1 per year beginning at the taxpayer's age and continuing for the life of the taxpayer (or the joint lives of the individual and beneficiary).

Section 1.402(c)-2, Q&A-3 of the Income Tax Regulations (regulations) provides that unless specifically excluded, an eligible rollover distribution means any distribution to an employee or a spousal distributee of all or any portion of the balance to the credit of the employee in a qualified plan.

Section 1.402(c)-2, Q&A-5 of the regulations provides that a series of substantially equal periodic payments over a specified period is determined at the time the payments begin, and by following the principles of section 72(t)(2)(A)(iv), without regard to contingencies or modifications that have not yet occurred.

Section 1.402(c)-2, Q&A-6 of the regulations provides that a payment is treated as independent of the payments in a series of substantially equal payments, and thus not part of the series, if the payment is substantially larger or smaller than the other payments in the series. An independent payment is an eligible rollover distribution if it is not otherwise excepted from the definition of eligible rollover distribution. This is the case regardless of whether the payment is made before, with or after payments in the series.

In this case, upon the occurrence of a distributable event, participants in Plan Y may elect to receive a portion of their cash balance account in a lump sum with the remaining portion distributed in the form of an annuity. Pursuant to the terms of Plan Y, the amounts distributed in the form of a lump sum distribution will be substantially larger than the monthly annuity payment that will be made to a participant. The amount of a participant's Plan Y account balance that can be distributed in the form of a lump sum payment will increase from twenty percent to one hundred percent over a period of five years. At the end of the five-year period, the participants may elect to receive all of their Plan Y account balance in the form of a lump sum payment or in the form of an annuity.

Under section 1.402(c)-2, Q&A-6 of the regulations, a payment is treated as independent of the payments in a series of substantially equal payments and not part of the series if the payment is substantially larger or smaller than the other payments in the series. Because the lump sum distributions, pursuant to the terms of Plan Y, will be significantly larger than the amount of the monthly annuity, the lump sum distributions are considered independent of the other payments in the series of substantially equal and are eligible for rollover treatment.

Under section 72(t) of the Code, a distribution that is not part of a series of substantially equal periodic payments is subject to the 10 percent additional tax

unless one of the exceptions in section 72(t)(2)(A)(iv) applies. Assuming that a participant elected to receive all or a part of his or her benefit in the form of a lump sum distribution, that distribution will be subject to the additional 10 percent tax unless the participant is over age 55 and one of the exceptions applies.

Code section 402 provides that distributed amounts are included in gross income in the year of receipt unless paid in the form of an eligible rollover distribution and are either rolled over or directly transferred to an eligible retirement plan. An eligible rollover distribution does not include a distribution which is one of a series of substantially equal periodic payments within the meaning of section 72(t)(2)(A)(iv). The regulations provide that the determination of whether a distribution is one of a series of periodic payments is to be made in accordance with principles of Code section 72 at the time the distribution is made without regard to contingencies or modifications that have not yet occurred.

You represent that each of the annuities offered under Plan Y constitutes a series of substantially equal periodic payments under the principles of Code section 72(t)(2)(A)(iv) and that the payment of the annuity will be determined at the time the distribution is to begin. The annuity portion of the distribution of the participant's Plan Y account balance will be actuarially determined, using the balance of the account reduced by any amount that will be distributed as a lump sum. You further represent that the amount paid under a grandfathered annuity will be determined without regard to the amount credited to the participant's Plan Y account balance, and therefore determined without regard to the lump sum payment. Such benefits paid as an annuity will constitute a series of substantially equal periodic payments within the meaning of Code section 72(t)(2)(A)(iv).

The lump sum distributions will be significantly larger than the amount of the monthly annuity. Thus, the lump sum distributions are considered independent of the other payments in the series of substantially equal payments and are eligible for rollover treatment. Also, if a participant receives a lump sum payment in addition to the payment of an annual annuity over the life of the participant in substantially equal payments, then only the lump sum is treated as a distribution that is not part of a series of substantially equal periodic payments. The single sum payment is not an amount payable at regular intervals over a period of more than a full year.

Accordingly, we conclude with respect to ruling request number one that the distribution of the portion of Plan Y benefits to a participant as a lump sum distribution will not cause the portion of Plan Y benefits distributed as an annuity (either from a participant's election to receive a portion of his cash balance account as an annuity or as a grandfathered annuity benefit) to be treated as other than a series of substantially equal periodic distributions from qualified retirement plans under section 72(t)(2)(A)(iv) of the Code.

With respect to your second ruling request, the additional tax imposed on early distributions under Code section 72(t)(1) only applies to amounts not otherwise excepted from the additional tax under Code section 72(t)(2)(A)(iv) that are includible in the gross income of the distributee. Section 402(c) of the Code excludes from the distributee's gross income amounts that constitute an "eligible rollover distribution" within the meaning of Code section 402(c)(4) and amounts that are rolled over to an eligible retirement plan within the 60-day rollover period. Code section 402(c)(4), in pertinent part, provides that an eligible rollover distribution is defined as a distribution to the employee of any portion of the balance to the credit of the employee in a qualified trust, except that such term does not include any distribution that is one of a series of substantially equal periodic payments within the meaning of Code section 72(t)(2)(A)(iv).

Section 1.402(c)-2 of the regulations contemplates that a plan participation may receive payments that constitute an eligible rollover distribution and those that do not. Section 1.402(c)-2, Q&A-6 of the regulations describe payments that are independent of payments that constitute a series of substantially equal period payments as payments that are significantly larger or smaller than the payments constituting the series. You have represented that under the terms of Plan Y the lump sum distributions of a portion of a participant's accrued benefit in Plan Y will be significantly larger than the monthly annuity payment and therefore independent of such annuity payments. Since these lump sum payments are considered independent of the monthly annuity payments, such lump sum payments will constitute eligible rollover distributions within the meaning of Code section 402(c) and to the extent that such payments are rolled over to another eligible retirement plan within the 60-day rollover period, such amounts will be excludable from the participant's gross income and not subject to the 10 percent additional tax under Code section 72(t)(1). Further, since we have concluded that the annuity payments will constitute payments that constitute a series of substantially equal periodic payments, such payments will also be excluded the 10 percent additional tax under 72(t).

Therefore, with respect to ruling request number two, we conclude that a rollover of a lump sum distribution of any portion of a participant's cash balance account under Plan Y to an eligible retirement plan as defined under section 402(c)(8)(B) (either a direct trustee to trustee rollover or a rollover made within 60 days of the date of the date of distribution) will result in an annuity being the only distribution option available under Plan Y, and therefore prevent the application of the Code section 72(t)(1) additional tax to any portion of the participant's remaining annuity distribution under Plan Y.

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

These rulings are based on the assumptions that Plan Y is qualified under section 401(a) of the Code and that its related trust is tax-exempt under section 501(a) at all times relevant to this ruling.

A copy of this letter has been sent to your authorized representative in accordance with a power of attorney on file in this office.

If you have any questions, please contact *****
SE:T:EP:RA:T2.

Sincerely yours,



Joyce E. Floyd, Manager
Employee Plans Technical Group 2

Enclosures:

- Copy of the Original Ruling
- Deleted copy of ruling letter
- Notice of Intention to Disclose