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MEMORANDUM

TO: MACOMB COUNTY RETIREMENT COMMISSION

FROM: THOMAS C. MICHAUD

RE: BASIS RECOVERY

DATE: MARCH 17, 2006

This memorandum is presented to provide a general overview of the federal tax treatment of distributions from the Macomb County Employees Retirement System under the annuity withdrawal option.

The Macomb County Employees Retirement System ("Retirement System") consists of the applicable provisions of the Retirement Ordinance, as amended, collective bargaining agreements and federal and state laws and regulations. The Retirement System is a qualified defined benefit plan and is administered consistent with the applicable provisions of IRC 401(a).

The Retirement System requires an employee contribution during a member's term of employment. At the time of retirement, certain members may withdraw their accumulated contributions in a lump-sum which includes the member's contributions to the Retirement System and the interest credited on said amounts. Accordingly, the member's accumulated contributions consists of taxable (interest earned on the employee's contributions) and non-taxable amounts (employee contributions made on an after tax basis).

If a member elects to withdraw his/her accumulated contributions, his/her lifetime periodic pension amount will be actuarially reduced to reflect such withdrawal.

The question presented is how are amounts received under the annuity withdrawal option treated for federal tax purposes.

Basis Recovery Rules

IRC §72 is the governing provision for the taxation of qualified annuity distributions, such as the annuity withdrawal provision. Generally, IRC §72 requires any amount received as an annuity to be included in gross income.

Certain exceptions apply to qualified annuities which allow post-tax employee contributions to be excluded from gross income. These post-tax employee contributions represent the participant's **"basis"** or **"investment in the contract"** and are recoverable over the life of the annuity.

The Internal Revenue Service (IRS) does not separate post-tax contributions from pre-tax contributions when dealing with pre-annuity distributions. Instead, the IRS considers **all amounts** the individual is to receive over the entire life of the annuity to be commingled. To the extent an individual receives a distribution of employee contributions under the annuity withdrawal option, the IRS considers such distribution to consist of **both** pre-tax and post-tax dollars (not a straight return of the individual's post-tax employee contributions). The portion of the distribution the IRS considers to be a return of **post-tax** employee contributions is immediately excluded from gross income. The portion of the distribution the IRS considers to be a payment of **pre-tax** dollars is subject to federal income taxation (unless such amounts are rolled over into an IRA or eligible plan).

Thus, the return of the employee's post-tax contributions is considered to be on a **"pro rata"** basis. Although the employee may withdraw the amount of annuity contract that represents post-tax employee contributions and interest, the IRS considers the amount withdrawn to consist of both pre-tax and post-tax dollars.

The bottom line regarding the taxation of annuity withdrawals is that recovery of after-tax employee contributions distributed before the annuity starting date will be on a **pro rata** basis throughout the life of the annuity. IRS Notice 98-2 [1998-1 CB 266] provides for the method of allocation between taxable and nontaxable benefits.

The following formula is used for determining the excludable portion of each annuity payment:

$$\frac{\text{The balance of after-tax contributions to be recovered over the life of the annuity}}{\text{Expected number of payments}}$$

The non-taxable portion of a member's annuity payment is determined by dividing the **"investment in the contract"** by the number of anticipated payments based on the primary recipient's age at the annuity starting date. The member's "investment in the contract" is the total of all after-tax employee contributions as of the annuity starting date. The following table contains the "expected number of payments" under the annuity as determined by the Internal Revenue Service.

Age	# of Payments
55 & Under	360
56-60	310
61-65	260
66-70	210
71 & Over	160

The attached example illustrates the method by which the excludable portion of a *single-life* annuity payment may be calculated when a member elects to withdraw employee contributions under the annuity withdrawal option.

In 1997, the **Taxpayer Relief Act** made a slight alteration in the way the non-taxable portion of a joint annuity is calculated. Prior to the **Taxpayer Relief Act of 1997**, the number of anticipated payments was based on the age of the ***primary recipient*** of the annuity irrespective of whether the annuity was a single life annuity or a joint and survivor annuity. Beginning in 1998, the Internal Revenue Code make a distinction between single life annuities and annuities paid over multiple lifetimes. The Code now requires a different table be used to determine the number of payments when joint and survivor annuities are involved. The table listed above continues to be used for single life annuities; however, **for joint annuity starting dates beginning on or after January 1, 1998, the following table will be used:**

Combined Ages of Annuitants on Annuity Starting Date	# of Payments
110 & Under	410
111-120	360
121-130	310
131-140	260
141 & Over	210

In conclusion, instead of a retiree's employee post-tax dollars being immediately excluded from gross income, the IRS requires those dollars to be excluded in small increments throughout the life of the annuity. It is important to note that the Internal Revenue Code does provide for the *eventual* recovery of *all* post-tax employee contributions. Once the retiree's entire amount of post-tax employee contributions has been recovered, all subsequent amounts received under the annuity are included in the retiree's gross income. Alternatively, in the event the retiree and/or beneficiary die prior to recovering the entire post-tax amounts (i.e., investment in contract), any unrecovered basis/investment will be allowable as a deduction on the retiree's final return. IRS Notice 98-2.

I have attached an IRS letter ruling which addresses this topic for your review and consideration.

As always, if you have any questions or require additional information please do not hesitate to contact this office. Thank you.

EXAMPLE I

EXCLUSION RATIO

A.	Annual Straight Life Benefit		$50,000
B.	Accumulated Member Contributions		
	(1) After-Tax Contributions		$22,000
	(2) Interest and Other Non-Taxed Contributions		$30,000
	(3) Total		$52,000
C.	Type of Annuity (single or multiple life)		Single
	Date of Birth		05/01/1951
	Beneficiaries Date of Birth		N/A
	Effective Date of Retirement		04/01/2001
	Age Last Birthday		49
	Beneficiary's Age Last Birthday		N/A
D.	Interest Rate (120% of the federal mid-term rate, compounded annually and rounded to nearest 1.2%)		6.1%
E.	Annuity Factor (using mortality table 90 CM published in IRS regulation Section 20.2031-7T)		13.2109
F.	Present Value of Benefit		$660,545
G.	After Tax Contributions as a Percent of Present Value of Benefits [B(1) ÷ F × 100]		3.31%
H.	Contributions to be Recovered Over a Period of Years [B(1)]		$22,000
I.	Number of Months for Recovery of Member Contributions (From table above).		360
J.	Monthly Pension Excludable From Tax	[H ÷ I]	$61.11
K.	Annual Pension Excludable From Tax	[J × 12]	$733.33

Monthly Pension Payment Received on and after 04/01/2031 Will Be 100% Taxable.

EXAMPLE II

EXCLUSION RATIO
[WITH ANNUITY WITHDRAWAL]

A.	Annual Straight Life Benefit Before Annuity Withdrawal	$50,000
B.	Accumulated Member Contributions	
	(1) After-Tax Contributions	$22,000
	(2) Interest and Other Non-Taxed Contributions	$30,000
	(3) Total	$52,000
	(4) Amount of Annuity Withdrawal	$52,000
C.	Type of Annuity (single or multiple life)	Single
	Date of Birth	05/01/1951
	Beneficiaries Date of Birth	N/A
	Effective Date of Retirement	04/01/2001
	Age Last Birthday	49
	Beneficiary's Age Last Birthday	N/A
D.	Interest Rate (120% of the federal mid-term rate, compounded annually and rounded to nearest 1.2%)	6.1%
E.	Annuity Factor (using mortality table 90 CM published in IRS regulation Section 20.2031-7T)	13.2109
F.	Present Value of Benefit Before Withdrawal	$660,545
G.	After Tax Contributions as a Percent of Present Value of Benefits Before Withdrawal [B(1) ÷ F × 100]	3.31%
H.	Portion of Annuity Withdrawal to be Treated as Refund of Member's Investment [G × B(4)]	$1,721.20
I.	Portion of Annuity Withdrawal to be Considered to be Taxable Income in the Year of Withdrawal and Reported on Form 1099R. [B(4) - H]	$50,278.80
J.	Remaining Balance of Contributions to be Recovered Over a Period of Years [B(1) - H]	$20,278.80
K.	Number of Months for Recovery of Member Contributions (From table above).	360
L.	Monthly Pension Excludable From Tax [J ÷ K]	$56.33
M.	Annual Pension Excludable From Tax [L × 12]	$675.90

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Monthly Pension Payment Received on and after 04/01/2031 Will Be 100% Taxable.

PRIVATE RULING 9847032

"This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code."

Section 72

Annuities

0072.07-00

PLR 9847032; 1998 PLR LEXIS 1546

DATE: August 26, 1998

Refer Reply to: OP:E:EP:T:1, Room 6214

Attention: * * * [*5]

LEGEND:
Employer A = * * *
State B = * * *
Plan X = * * *

Dear * * *

1. This letter is in response to correspondence dated July 10, 1997, as supplemented by letters dated September 25, 1997, October 28, 1997, and January 26, 1998, from your authorized representative, in which you request a private letter ruling under section 72 of the Internal Revenue Code from the Internal Revenue Service.

2. Your authorized representative submitted the following facts and representations with the request:

3. Employer A maintains Plan X, a defined benefit plan qualified under Code section 401(a). Pursuant to the laws of State B, all non-civilian, non-privately employed, and non-temporary employees of Employer A must participate in Plan X. A percentage of each participant's salary is deducted and paid into Plan X. These after-tax employee contributions, together with regular, semi-annual or annual contributions by Employer M, and investment earnings finance all pension benefits under Plan X.

4. Participants in Plan X are allowed to withdraw the value of their aggregate employee contributions in a lump sum upon retirement in exchange for an actuarially reduced lifetime periodic pension. This practice is commonly referred to as the "annuity withdrawal option". Employer A represents that certain of its employees who will retire in 1997 are considering whether to elect the annuity withdrawal option.

5. The operative provisions of this form of payment are as follows: (a) the annuity withdrawal option is an option that allows an eligible employee member to elect to receive his/her aggregate contributions in a single lump sum payment upon normal retirement and thereby forfeit the portion of his/her retirement benefits (including any automatic spouse-dependent coverage, contingent pension or other optional form) financed thereby; (b) the actuarial present value of the remaining periodic lifetime retirement benefit after the payment of the annuity withdrawal (actuarially equivalent benefit) shall be computed using the investment return (interest) and mortality assumptions employed by Plan X for the purposes of its actuarial valuations at the time this option is effective for the employee member; (c) the annuity withdrawal option may be combined with any other optional form of retirement benefit currently available under Plan X; (d) in order to elect this option, the written request filed with the Employer A's clerk by an eligible employee member must be on forms provided or approved by Plan X's Board of Trustees, must be executed by both the eligible employee member and his/her spouse, if any, and must be witnessed; (e) after the election of this option has been made and accepted by Plan X's Board of Trustees, it cannot be modified or rescinded without the written consent of the Board, which consent will not be given if it would be detrimental to Plan X; and (f) any and all income tax consequences to the employee member resulting from the election of this option are the sole responsibility of the employee member and the Board disclaims the assumption of any such responsibility but encourages the employee member to seek the counsel of a competent tax advisor in this regard before electing this option.

6. The retiring participants have not made any prior withdrawals of employee contributions. Their accounts are fully vested pursuant to the Plan's vesting schedule. In addition, earnings are not credited to after-tax employee contributions.

7. Based on the foregoing facts and representations, your authorized representative requests the following rulings:

1) The annuity withdrawal option constitutes the receipt by a retiring participant of a lump sum payment in connection with the commencement of annuity payments under a qualified employer retirement plan such that the payment is taxable under Code section 72(e) as if received before the annuity starting date, and the retiring participant's investment in the contract for purposes of Code section 72(d)(1) shall be determined as if so received;

2) A retiring participant's aggregate after-tax employee contributions to Plan X constitute both the retiring participant's "investment in the contract" and "account balance" within the meaning of Code section 72(e)(8)(B); and

3) A retiring participant's investment in the contract as of the annuity starting date within the meaning of Code sections 72(c)(1), and 72(d)(1)(B)(i)(II) and section 1.72-6 of the federal Income Tax Regulations ("the regulations") is the amount of the participant's aggregate after-tax employee contributions minus any annuity withdrawal amount.

8. With respect to ruling request 1, Code section 402(a) states that, except as otherwise provided in this section, any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under section 72 (relating to annuities).

9. Code section 72(a) states 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.

10. Code section 72(d)(1) provides special rules for qualified employer retirement plans. Code section 72(d)(1)(D) and (G), which was added to the Code by the Small Business Job Protection Act of 1996, Pub. L. 104-188, 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. Accordingly, we conclude that, with regard to ruling request 1, the payment of a lump sum under the annuity withdrawal option constitutes the receipt by a retiring participant of a lump sum payment in connection with the commencement of annuity payments under a qualified plan such that the payment is taxable under Code section 72(e) as if received before the annuity starting date, and the investment in the contract is determined as if the payment had been so received.

11. With regard to ruling request 2, Code section 72(e) provides rules for taxing distributions which are received under an annuity contract but are not annuity payments. Under Code section 72(e)(2)(B), such a distribution which is received before the annuity starting date (1) shall be included in gross income to the extent allocable to income on the contract, and (2) shall not be included in gross income to the extent allocable to the investment in the contract.

12. Code section 72(e)(8), which was added to the Code by section 1122(c)(3)(A) of the Tax Reform Act of 1986, Pub. L. No. 99- 514 ("TRA '86"), provides a pro rata basis recovery rule to non-annuity payments from a qualified plan that are received before the annuity starting date. Specifically, Code section 72(e)(8)(A) provides that notwithstanding any other provision of Code section 72(e), in the case of any amount received before the annuity starting date from a plan described in Code section 72(e)(5), Code section 72(e)(2)(B) shall apply to such amounts. Code section 72(e)(5) includes a plan qualified under Code section 401(a). Code section 72(e)(8)(B) further provides that the amount allocable to the investment in the contract under Code section 72(e)(2)(B) shall be the portion of the distribution which bears the same ratio to such amount as the investment in the contract bears to the employee's account balance.

13. The term "investment in the contract" is defined in Code section 72(e)(6), for purposes of Code section 72(e), as of any date as the aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under current or prior income tax laws.

14. Code section 72(e)(8)(C) provides that any amount to which an employee does not have a nonforfeitable right shall not be treated as part of the account balance. In this regard, **Notice 87-13, 1987-1** C.B. 432, provides guidance on provisions of Code section 72 that were added to the Code by TRA '86, including section 72(e)(8). In particular, Q&A-11 of **Notice 87-13** provides that the vested portion of the account balance in the case of a defined benefit plan is the present value of the vested portion of the total accrued benefit of a participant.

15. The ratio described in Code section 72(e)(8)(B) applies to distributions from each separate contract. The rules of section 1.72- 2(a) of the regulations are used to determine whether there is a separate or single contract for tax purposes. Section 1.72-2(a)(3)(i) provides that each separate program of the employer consisting of interrelated contributions and benefits shall be considered a single contract. In this case, the annuity withdrawal option results in an actuarially reduced lifetime periodic pension reflecting the value of the annuity withdrawal amount. The lump sum distribution affects the amount of the employees' subsequent retirement annuity, and it is only through the election of the annuity withdrawal option that a retiring participant may withdraw his or her aggregate contributions and still be eligible for the periodic annuity. Moreover, no earnings are credited to after-tax employee contributions under the Plan. Therefore, the lump sum payment and the reduced annuity payments are both part of the same program of interrelated contributions and benefits and as such, constitute distributions from a single contract for purposes of Code section 72.

16. With regard to ruling request 2, we conclude that a retiring participant's aggregate after-tax employee contributions constitute the retiring participant's investment in the contract under Code section 72(e)(8)(B). However, the present value of the vested portion of the total accrued benefit of a participant under the defined benefit plan is to be treated as the value of the vested portion of the account balance. We note that in this regard, a participant may be fully vested without yet being entitled to receive the full employer-provided benefit under the Plan and even though the periodic pension payments are based on a retiring participant's life expectancy.

17. With regard to ruling request 3, Code section 72(c)(1) defines, for purposes of annuity distributions from a qualified plan, the term "investment in the contract" as of the annuity starting date is the aggregate amount of premiums or other consideration paid (generally, the aggregate amount of after-tax contributions made to the plan), reduced by the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under Subtitle A (Income Taxes) or prior income tax laws. Accordingly, a retiring participant's investment in the contract as of the annuity starting date is the amount of the participant's aggregate contributions minus the amount of the prior lump sum distribution that is allocable to the investment in the contract under the provisions of Code section 72(e)(8)(B) as discussed above.

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

Sincerely yours,

John Swieca
Chief, Employee Plans
Technical Branch 1