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In general, benefits received from a qualified plan are taxable as ordinary income when received. In cases where the participant has a basis in his or her plan account—for example, if non-deductible employee contributions had been made—the portion of each benefit payment which represents recovery of basis (determined under the annuity taxation method of Code Section 72(e)) is not taxable. IRC Sec. 402(a).

When a participant in a qualified retirement plan, including a traditional IRA, dies, his or her undistributed account balance becomes payable to the account's designated beneficiary. Because the account would have been ordinary income if distributed to the account owner prior to death (except to the extent of any unrecovered basis), it is income in respect of a decedent when received by the beneficiary.

If the account owner's estate is the beneficiary (whether by designation or because there is no other beneficiary), the income in respect of the decedent must be reported as taxable income of the estate. In some instances income taxation may be avoided by executor's assigning the qualified plan account to a charity. See, e.g., Ltr. Rul. 200234019.

The income tax treatment of distributions from qualified retirement plans depends on the timing and manner of the distribution. The trend in recent years has been to offer a lump sum distribution as one of the methods of distribution (sometimes the only method), but many plans continue to offer periodic payments (an annuity). In fact, the Code *requires* plans subject to the qualified survivor annuity requirements to offer a life annuity to single participants or a joint and survivor annuity to married participants.

The income taxation of most otherwise-taxable retirement distributions to an employee or his surviving spouse can be delayed by use of a rollover, or rollover contribution, assuming the distribution is an *eligible rollover distribution*. If the employee or surviving spouse makes a rollover to an IRA under the rules set forth in the Code, payouts can be timed to meet the retirement needs of the recipient, or an annuity can be purchased at a later time. Only the required minimum distribution rules (which generally take effect shortly after age 70½) force the recipient to recognize taxable income at some point in the future.

Legislation during the past decade has greatly increased the portability of retirement plan accounts and the ease of making rollovers from one plan to another, or from a plan to an IRA. For this reason, the special averaging treatment for lump sum distributions, which was once a significant tool for minimizing taxation, has diminished in its importance. In fact, five-year averaging was repealed for distributions after 1999; only

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10-year averaging remains, and it is available only to individuals who reached age 50 before January 1, 1986. As a practical matter, the tax rates that are applied to 10-year averaging make it useful only for smaller distributions.

In many cases, a qualified plan makes distributions in the form of assets other than cash, such as an annuity contract, life insurance, or employer securities (which offer special tax deferral advantages).

*Constructive Receipt.*One of the more important changes made by the Economic Recovery Tax Act of 1981 was the elimination of the words "made available" from Code Section 402(a)(1). The effect of this change was to make the doctrine of constructive receipt inapplicable to distributions or withdrawals from any qualified plan.

Before 1982, if a taxpayer could have received a retirement check in the year before it was actually delivered by mail, the check was constructively received —and therefore taxable—in the year the taxpayer could have personally appeared and claimed it. Rev. Rul. 68-126, 1968-1 C.B. 194.

The elimination of the "constructive receipt" doctrine permits unlimited flexibility for plan distributions. For example, a participant eligible to receive lump sum distributions from separate types of qualified plans may elect to receive one lump sum in the year of retirement and the second lump sum in the next taxable year. In this way, the participant can elect favorable lump sum tax treatment on one distribution, while rolling over the second distribution into an IRA.

# Lump Sum Distributions

Prior to legislative changes made by the Small Business Job Protection Act of 1996 (effective for tax years after 1999), favorable tax treatment was accorded lump sum distributions from qualified plans.

A distribution is a “lump sum distribution” if it is: (1) made in one taxable year; (2) of the *balance to the credit* of an employee; (3) payable (a) on account of the employee’s death, (b) after the employee attained age 59½, or (c) on account of the employee’s separation from service (d) or disability (only in the case of a self-employed person); and (4) made from a qualified pension, profit sharing, or stock bonus plan. IRC Sec. 402(e)(4)(D).

The tax treatment of lump sum distributions prior to 2000 was somewhat complicated, because there were several alternative sets of rules, depending upon the age of the

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participant, the number of years of participation in the plan, the date of inception of the plan, and the date of the distribution. The potential alternatives included 10-year income averaging, 5-year income averaging, and capital gain taxation.

Prior to 2000, a taxpayer who received a lump sum distribution after attaining age 59½ was permitted to make an election to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution was made. In general, this election allowed the taxpayer to pay a separate tax on the lump sum distribution that approximates the tax that would have been due if the lump sum distribution had been received in 5 equal installments. If the election were made, the taxpayer would be entitled to deduct the amount of the lump sum distribution from gross income of the year received. Only one such election could be made with respect to any employee.

Under the Tax Reform Act of 1986, individuals who attained age 50 by January 1, 1986, were permitted to elect to use 10-year averaging (under the rates in effect prior to the 1986 Act) in lieu of 5-year averaging. Additionally, such individuals who were participants in plans established prior to 1974 were allowed to retain capital gains treatment with respect to the pre-1974 portion of a lump sum distribution.

The original intent of the income averaging rules for pension distributions was to prevent a bunching of taxable income because a taxpayer received all of the benefits in a qualified plan in a single taxable year. However, liberalization of the tax-deferred rollover rules in 1992 increased taxpayers' ability to determine the time of income inclusion of pension distributions, and in 1996 Congress concluded that this eliminated the need for special rules such as 5-year forward income averaging to prevent bunching of income. Accordingly, the 5-year averaging provision was repealed for lump sum distributions received after 1999.

However, the transitional rule adopted in the 1986 Tax Reform Act, referred to above, was not changed, so that if a lump sum distribution is received after 1999 by a taxpayer who had attained age 50 by January 1, 1986, he may elect 10-year averaging, and may also elect capital gain treatment for the pre-1974 portion, if any, of the distribution.

*Balance to the credit*. The distribution must be of “the balance to the credit of an employee.” To determine whether a distribution is the balance to the credit of the employee: all trusts which are part of the employer’s plan must be treated as one; all pension plans maintained by the employer must be treated as a single plan; all the employer’s profit sharing plans must be treated as one plan; and all the employer’s stock bonus plans must be treated as one plan. IRC Sec. 402(d)(4)(C), prior to repeal

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 by SBJPA ’96; IRC Sec. 402(e)(4)(D)(ii), after 1999 as amended by SBJPA ’96. Even if benefits distributed under a pension plan are reduced by a participant’s account balance in a profit sharing plan, the two plans are still different type plans. Let. Rul. 7841050.

The balance to the credit includes all amounts in the participant’s account (including nondeductible employee contributions) as of the first distribution received after the triggering event. Let. Ruls. 9031028, 9013009. The balance to the credit also includes amounts transferred from that plan to another immediately prior to separation from service. GCM 39396. Only qualified plans are counted.

Occasion for Distribution

The distribution must be payable to the participant on account of the employee’s death, or after his attainment of age 59½, or on account of a regular employee’s separation from service (see below) or after a self-employed person’s disability.

Since a pension plan is defined as a plan which provides benefits on retirement, termination of service, death or disability, it normally may not provide for a distribution simply upon attaining age 59½. TIR 1403, M-15. However, if he has attained age 59½ *and* has also reached normal retirement age, a lump sum distribution may be made, even if he continues working. Let. Rul. 9009055; Special Ruling, October 26, 1976, *CCH Pension Plan Guide*. Furthermore, a distribution made upon plan termination to an employee older than age 59½ but not yet of normal retirement age may also be treated as a lump sum distribution. Let. Rul. 7748053. A *profit sharing* or *stock bonus plan* may provide for a lump sum distribution to a participant who has reached age 59½ without any other requirement. See Let. Ruls. 8908065, 8708041.

*Separation from service.* A “separation from service” is required under the definition of a “lump sum distribution” and thus for purposes of the special averaging and long term capital gains treatment offered to such distributions. See IRC Sec. 402(e)(4)(D). For certain other purposes under the Code, the separation from service standard was replaced under EGTRRA 2001 with a “severance of employment” standard, effective for distributions after December 31, 2001. See IRC Sec. 401(k)(2)(B), as amended by EGTRRA 2001. The severance from employment standard is less restrictive, and is designed to allow employers who acquire a business and hire its employees to make distributions from the former employer’s 401(k) plan, rather than continuing to maintain the plan in addition to their own. For an explanation of the impact of this change.

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Tax Treatment

Special tax treatment is available to certain recipients of lump sum distributions; otherwise, distributions meeting the requirements of a lump sum distribution are taxed as ordinary income. Long term capital gain treatment and 10-year averaging is available for lump sum distributions to certain participants. There is also special treatment for net unrealized appreciation in employer securities distributed in a lump sum distribution.

Two cases have held that the portion of a lump sum distribution attributable to contributions made while the trust was qualified may receive favorable tax treatment even if distribution is made while the trust is*not* qualified. See *Greenwald v. Comm.*, 366 F.2d 538 (2d Cir. 1966); *Hesse v. U.S.*, 47 AFTR 2d 1024 (E.D. Mo. 1981). The Tax Court and the Courts of Appeals for the Fifth, Sixth, and Seventh Circuits have held that the tax treatment should depend upon the trust’s qualification at the time of distribution. See, e.g, *Fazi v. Comm.* 102 TC 695 (1994). See *Woodson v. Comm.* 651 F.2d 1094 (5th Cir. 1981); *Baetens v. Comm.*, 777 F.2d 1160 (6th Cir. 1985), *rev’g* 82 TC 152 (1984) and *rev’g Benbow v. Comm.*, 82 TC 941 (1984); *Cass v. Comm.*, 774 F.2d 740 (7th Cir. 1985), *rev’g Benbow v. Comm.*, 82 TC 941 (1984).

*Special averaging.* The Code provisions allowing 5-year averaging of lump sum distributions were repealed, for tax years beginning after December 31, 1999. However, an “eligible employee” (i.e., one who reached age 50 before January 1, 1986) may elect 10-year averaging of such distributions, and long-term capital gain treatment may be available for the portion of such distribution attributable to pre-1974 plan participation.

If 10-year averaging is elected, the tax on the ordinary income portion is 10 times the tax on 1/10 of the total taxable amount (reduced by the minimum distribution allowance. However, the recipient must use 1986 tax rates, rather than current tax rates, and take into account the prior law zero bracket amount. TRA ’86, Sec. 1122(h)(5); TAMRA ’88, Sec. 1011A(b)(15)(B). (As a practical matter, the larger the distribution, the less likely that 10-year averaging will be advantageous.)

The minimum distribution allowance is $10,000 or one-half of the total taxable amount, whichever is less. However, this must be reduced by 20% of the total taxable amount in excess of $20,000. IRC Sec. 402(d)(1)(D), prior to repeal after 1999 by SBJPA ’96. Thus, if the total taxable amount of the distribution is $70,000 or more there is no minimum distribution allowance.

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|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Col. 1 TaxableIncome $ | Tax on Col. 1 $ | Rate on Excess % | Col. 1 Taxable Income $ | Tax on Col. 1 $ | Rate on Excess % |
| 0 |   | 11 | 17,160 | 2,953.80 | 26 |
| 1,190 | 130.90 | 12 | 22,880 | 4,441.00 | 30 |
| 2,270 | 260.50 | 14 | 28,600 | 6,157.00 | 34 |
| 4,530 | 576.90 | 15 | 34,320 | 8,101.80 | 38 |
| 6,690 | 900.90 | 16 | 42,300 | 11,134.20 | 42 |
| 9,170 | 1,297.70 | 18 | 57,190 | 17,388.00 | 48 |
| 11,440 | 1,706.30 | 20 | 85,790 | 31,116.00 | 50 |
| 13,710 | 2,160.30 | 23 |   |   |   |

Note: This table takes into account the prior law zero bracket amount of $2,480 for 1986. Some tables do not take into account the prior law zero bracket amount. Those tables will produce the same result as this table if $2,480 is added to the 1/10 amount.

An eligible employee makes a special averaging election by filing Form 4972 with his tax return; the election may be revoked by filing an amended return. Temp. Treas. Reg. §11.402(e)(4)(B)-1. An eligible employee can make this election only once, and it must apply to all lump sum distributions he receives for that year.

Under 10-year averaging, the tax on the ordinary income portion of the distribution is 10 times the tax on 1/10 of the “total taxable amount,” reduced by the “minimum distribution allowance.” 1986 tax rates must be used, taking into account the prior law zero bracket amount. TRA ’86, Sec. 1122(h)(5); TAMRA ’88, Sec. 1011A(b)(15)(B).

*Long-term Capital Gain Treatment*. An eligible employee may also elect capital gain treatment for the portion of a lump sum distribution allocable to his pre-1974 plan participation. TRA ’86, Sec. 1122(h)(3). This portion is determined by multiplying the “total taxable amount” by a fraction, the numerator of which is the number of pre-January 1, 1974 calendar years of active plan participation and the denominator of which is the total number of calendar years of active plan participation.

The capital gain portion is taxed at a rate of 20%. TRA ’86, Sec. 1122(h)(3)(B)(ii). A recipient may make only one such election with respect to an employee and the election is treated as an income averaging election for all purposes of the Code. TAMRA ’88, Sec. 1011A(b)(13). The capital gain portion is treated the same way regardless of whether special averaging is used in calculating the tax on the ordinary income portion.

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Years of participation before a plan was “frozen” (i.e., contributions were discontinued) may be taken into account in determining the pre-1974 portion of a distribution from the frozen plan. Also, where a participant’s accrued benefit has been directly transferred from one trust to another in a trustee-to-trustee transfer (instead of a rollover), the particular calendar years of active participation generally include participation in the plan making the distribution and in the other plan which transferred assets to the distributing plan. Let. Ruls. 8830086, 8324109.

*Total taxable amount.* To determine the total taxable amount of a lump sum distribution, the amount of the employee’s cost basis, if any, is determined first (see Periodic Retirement Benefits). That amount is recovered tax-free.

Net Unrealized Appreciation (NUA) on Lump Sum Distributions of Employer Stock

Despite the elimination of income averaging, at least one important benefit in connection with lump sum distributions remains applicable—deferred capital gain treatment for unrealized appreciation on employer stock received in a lump sum distribution. Thus, if the qualified plan participant's account includes stock of the employer which is distributed as part of a lump sum distribution, and the stock has a higher fair market value at the time of the distribution than its value at the time it was originally placed in the participant's plan account, this unrealized appreciation is not taxable until the recipient disposes of the stock—and then at the long-term capital gain rate.

Example 1: Paul is a participant in the qualified retirement plan of XYZ Corp. Under the plan, the employer has contributed shares of XYZ Corp. to Paul's plan account. The plan's basis in the stock (based upon fair market value at the time of each contribution) is $150,000. Paul retires at age 62, and receives a lump sum distribution of all of the XYZ shares in his plan account. The value of the shares at that time is $775,000. For the taxable year of the distribution, Paul has ordinary income of $150,000, but he need not then recognize any income with respect to the unrealized appreciation of $625,000. He takes a basis of $150,000 in the stock, and when it is later sold, he will have a capital gain (or loss) based upon the difference between the net proceeds and his $150,000 basis.

Example 1A: Peter is retiring and his qualified plan balance is $900,000. $600,000 in employer stock and the other $300,000 in mutual funds. The cost basis of the employer stock is $50,000. If Peter takes a lump-sum distribution, and transfers the $600,000 of employer stock to his regular (taxable) brokerage account, he only has to pay tax on $50,000. The other $550,000 ($600,000 market value minus the

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$50,000 cost basis) is Net Unrealized Appreciation (NUA) and, as explained above, is not taxed at the time of transfer. The $300,000 mutual fund investment must also be withdrawn from the plan within the same taxable year in order to have a qualifying lump sum distribution, but the mutual funds can be rolled over to an IRA, with the continued benefits of tax deferral, while the employer stock enjoys the Net Unrealized Appreciation (NUA) tax advantage.

Favorable Treatment also Applicable for Employer Securities Purchased with Employee Contributions

The favorable treatment for unrealized appreciation on employer securities distributed from a qualified plan account also applies to employer securities purchased with employee contributions to the plan, even if the distribution does not qualify as a lump sum distribution. IRC Sec. 402(e)(4)(A), see Distribution of Employer Securities.

Example 2: Mary is a participant in the XYZ Corp. qualified plan. In addition to the employer contributions, Mary makes voluntary employee contributions to the plan, and all of her contributions are used to purchase shares of XYZ Corp. Mary terminates her employment with XYZ and begins working at another company. Mary receives a distribution of all of the XYZ shares that had been acquired in her plan account with her employee contributions. At that time the XYZ shares had a cost basis in the plan of $55,000 and a fair market value of $137,000. The balance of her plan account is rolled over into a qualified plan account with her new employer. The distribution of the XYZ shares is not a part of a lump sum distribution; although there has been a separation from service with XYZ Corp., there was not a distribution of her entire plan account. However, because the XYZ shares distributed had been acquired by the plan entirely with the employee's contributions, Mary can take advantage of the deferral of the capital gain on the unrealized appreciation.

Avoiding any Current Taxation through a Rollover

Although the taxpayer in Example 1 was able to defer tax on the bulk of the value of his lump sum distribution, because it consisted of employer stock, he still had to pay tax on the $150,000 basis portion. (This would not be the case in Example 2, however, since the plan's basis in the stock consisted entirely of after-tax employee contributions.) The immediate taxation in Example 1 could be avoided through a rollover into an IRA, as would clearly be the strategy with respect to lump sum distributions not involving employer securities. Although the portion of a plan distribution that is not includable in gross income does not ordinarily qualify for rollover treatment, the unrealized

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appreciation on employer securities that is deferred under Section 402(e)(4) is an exception. Treas. Reg. §1.402(c)-2, Q&A 3(b)(3). However, when employer securities with substantial unrealized appreciation are involved, a rollover may sacrifice longer-range tax savings for avoidance of the immediate out-of-pocket tax cost attributable to the basis. A rollover will effectively eliminate the advantage of the capital gain rate that would eventually apply to a future sale of the stock. Whether the stock is sold in the IRA or distributed to heirs upon the death of the account owner, the proceeds of the sale, or the value upon distribution, will be taxable as ordinary income. This applies not only to the unrealized appreciation at the time of the rollover, but also to any subsequent appreciation for as long as the stock is held within the IRA.

In a situation, such as in Example 1, where the unrealized appreciation is substantial in relationship to the basis at the time of the lump sum distribution, the eventual future advantage of the long-term capital gain rate may well make it preferable to avoid a rollover and pay the tax currently on the basis portion. On the other hand, if it is expected that the stock is to be sold in the immediate future and that the proceeds will remain in the IRA for several years, it may be more advantageous to do the rollover and sell the stock from the IRA. The avoidance of any tax at the time of sale, coupled with compounded tax-free income for many years may prove more advantageous than the benefit of the capital gain rate from an immediate sale outside the IRA.

It should be noted that if there is a sale without a rollover, the unrealized appreciation as of the date of the distribution will be taxed as long-term capital gain, regardless of the length of time that the stock was held by either the plan or the distributee. (If there was additional appreciation in value between the date of the lump sum distribution and the date of sale, this portion of the capital gain will be treated as short-term or long-term, based upon the holding period subsequent to the distribution. Treas. Reg. §1.402(a)-1(b)(1)(i); see also IRS Notice 98-24, 1998-17 I.R.B. 5.

The above discussion was validated almost to the letter by PLR 200410023 (December 12, 2003), which dealt with a taxpayer who wished to take a lump sum distribution of his entire plan balance, rolling over his cash and nonemployer stock but taking a distribution of his employer stock. The taxpayer requested rulings (a) that the NUA of his company stock is the difference between the cost basis and the fair market value as of the distribution date, so that he would not recognize ordinary income on that portion of the distribution; (b) that any taxable gain on the company stock, no matter when sold, will be treated as capital gain income on the sale of a capital asset held in excess of 12 months to the extent of the original NUA (with excess post-distribution gain taxed as capital gain based on the holding period from the distribution date to the sale date). The Service granted both these ruling requests, which directly parallel the analysis above.

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Avoiding Tax with a Charitable Remainder Trust

Yet another way to take advantage of the deferral of tax on unrealized appreciation upon a lump sum distribution of employer stock is the transfer of the stock to a charitable remainder trust. Even though the taxpayer would still have to report the ordinary income equal to the plan's basis in the stock at the time of the distribution, if the unrealized appreciation is great enough, this income could be more than offset by the charitable contribution deduction that could be claimed for the value of the charitable remainder interest in the stock. The donor would then have a lifetime income interest in the value of the stock without any tax liability resulting from the distribution from the plan.

Death of Employee Prior to Disposition of the Stock

If employer stock has been received in a distribution qualifying for the deferral of unrealized appreciation, what happens if the holder dies before disposing of the stock? Does the deferred unrealized appreciation permanently escape tax through a basis step-up at death? The answer is "no" as to the unrealized appreciation that existed as of the date of the distribution. This amount is considered as "a right to receive income in respect of a decedent" under IRC Section 691(a). Thus, even though the tax may continue to be deferred until the stock is eventually sold, the stepped-up basis under Code Section 1014(a) must be reduced by this deferred income in respect of a decedent. Rev. Rul. 75-125, 1975-1 C.B. 254. However, the stepped-up basis would include any appreciation that may have occurred between the receipt of the distribution from the plan and the date of death.

Lump Sum Distribution upon Death of the Participant

When a plan account is distributed following the death of the participant, this qualifies as a lump sum distribution if the account is fully distributed within one taxable year of the recipient (the estate or one or more beneficiaries), and if the account includes securities of the employer, the deferral of unrealized appreciation is available to the recipient of the stock. The recipient has immediate income in respect of a decedent to the extent of the plan's basis in the stock, and the unrealized appreciation will also be income in respect of a decedent, but only when the recipient eventually sells the stock, and then at long-term capital gain rates.

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# Distribution of Annuity Contract

When a nontransferable annuity contract is distributed to an employee or his beneficiary, the distributee is not taxed on the value of the contract unless and until he surrenders the contract. He is taxed only on the annuity payments as he receives them. IRC Sec. 401(g); Treas. Reg. §1.402(a)-1(a)(2). Moreover, the nontransferability requirement applies only to contracts issued after 1962. If the contract was issued before that date, it qualifies for tax deferral even though it contains no restrictions on transferability. IRC Sec. 401(g); Treas. Reg. §1.401-9.

If the annuity is surrendered in the year of the distribution, the proceeds will be taxed as ordinary income or, if the distribution of the annuity is all or part of a lump sum distribution, under the rules discussed in Lump Sum Distributions.

If the annuity is not surrendered and is part of a lump sum distribution, the value of the annuity is excluded from the “total taxable amount” for purposes of figuring the amount of the distribution subject to capital gains tax. IRC Sec. 402(e)(4)(A). It is also excluded in figuring the amount of the distribution taxed as ordinary income where special averaging is not elected or is unavailable (5-year averaging is unavailable for distributions received after December 31, 1999).

If the employee surrenders the annuity contract after the year of distribution, the gain realized on surrender is taxable as ordinary income and will not qualify for taxation as a lump sum distribution. Rev. Rul. 81-107, 1981-1 CB 201. However, the unsurrendered annuity contract will affect the taxation of any lump sum distribution of which it is a part or which is made in the same year. If the annuity is distributed in an eligible rollover distribution, tax may be deferred by rollover.

In view of the financial problems of a number of insurers, the IRS determined that the nontransferability requirement was not violated by a Section 1035 exchange of an annuity contract distributed from a qualified plan where the taxpayer was simply uncomfortable with the amount of funds invested with a single insurer. Let. Rul. 9233054, GCM 39882 (10-30-92). Both the old and new contracts were materially similar, were nontransferable, and were subject to the spousal consent requirements, as well as meeting the other applicable qualification requirements. See also Let. Rul. 9241007.

Amounts that become payable in cash under qualified plans are not includable in income simply because they are available. IRC Sec. 402(a). Thus, where a plan provides that an employee, upon termination of employment, may take either a single

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sum payment in cash or have the trustee purchase an annuity for him with cash, his election does not have to be made within any specific time after the cash became available. (However, plan distribution provisions must satisfy the minimum distribution requirements.)

# Distribution of Life Insurance Contract

If the contract distributed is a life insurance, retirement income, endowment, or other contract providing life insurance protection, the *fair market value* of the contract at the time of distribution must be included in the distributee’s income to the extent that it exceeds his basis. Treas. Reg. §1.402(a)-1(a)(1)(iii). However, inclusion of the contract’s fair market value in the distributee’s income is not required at the time of distribution to the extent that within 60 days after it is distributed: (1) all or any portion of the contract is irrevocably converted to an annuity (with no life insurance element); or (2) the contract is treated as a rollover contribution under IRC Section 402(c). Treas. Reg. §1.402(a)-1(a)(2).

The fair market value standard also applies if the contract is sold by the plan to a participant or beneficiary. If the fair market value of the contract exceeds the value of the consideration, then such excess (i.e., the “bargain element”) is treated as a distribution to the distributee under the plan for all purposes under the Internal Revenue Code. This treatment of the “bargain element” as a distribution applies for transfers occurring after August 28, 2005. For transfers occurring before August 29, 2005, the “bargain element” is includable in the distributee’s gross income, but is not treated as a distribution for qualification purposes. See Treas. Reg. §1.402(a)-1(a)(1)(iii).

The Department of Labor has stated that these changes to the tax treatment of the bargain element in distributions of life insurance contracts do not affect the relief or conditions provided under prohibited transaction exemption (PTE) 92-6. See DOL Adv. Op. 2006-03A.

The fair market value standard is effective for distributions or sales occurring after February 12, 2004. See Rev. Proc. 2005-25, 2005-17 IRB 962. Fair market value includes the policy cash value and all other rights under the contract (including any supplemental agreements thereto, and whether or not guaranteed). Treas. Reg. §1.402(a)-1(a)(2)(iii). The IRS has issued safe harbor guidance for determining the fair market value of life insurance contracts. See Rev. Proc. 2005-25, above. Under the safe harbor, fair market value may be the greater of: (1) the interpolated terminal reserve and any unearned premiums, plus a pro rata portion of a reasonable estimate of dividends

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expected to be paid for that policy year, or (2) the product of the “PERC amount” (PERC.

*Conversion to annuity contract*. If the policy is converted, it will then be subject to the rules for annuity contracts (provided the annuity is nontransferable; see above). The IRS has taken the position that the mere elimination of the element of risk in a retirement income contract when the reserve exceeds the face amount does not convert the contract of insurance into an annuity contract. According to the IRS, the insured must act to convert the contract into an annuity contract that has at no time contained an element of life insurance protection. Rev. Rul. 66-322, 1966-2 CB 123. If the policy is distributed in a lump sum distribution, the taxable amount is eligible for favorable capital gains and special averaging treatment to the extent that such rules are still applicable; see Lump Sum Distributions.

*Death benefit*. When a life insurance contract matures by reason of the insured’s death *after* the policy has been distributed from the plan, the proceeds are wholly tax-exempt to the beneficiary. Rev. Rul. 63-76, 1963-1 CB 23. For the definition of a “life insurance contract”.

# Distribution of Employer Securities

In General

Under some qualified plans, the employer corporation may contribute its own securities to the trust or the trustee may purchase securities of the employer for allocation to the employees’ accounts. Such a plan may provide for a distribution of these securities after a specified period of time or upon the employee’s separation from service, retirement or death.

If the shares acquired by the trust are those of the employer at acquisition, they do not lose their character as securities of the employer corporation upon merger or sale. Where shares of stock of the employer are acquired by the trust while the corporation was the employer and they are later exchanged for shares of stock of the successor corporation upon merger, the stock of the successor corporation will be treated as securities of the employer on distribution. Rev. Rul. 73-312, 1979-2 CB 142. Likewise, if shares of the employer’s stock credited to the employees’ accounts are transferred to the trust of an acquiring corporation and the employees become the employees of the buyer, the stock is still considered the employer’s stock upon distribution. Rev. Rul. 73-29, 1973-1 CB 198.

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As Part of Lump Sum Distribution

If the securities are included in a lump sum distribution, the entire net unrealized appreciation of the securities is excludable from the gross income of the recipient (employee or his beneficiary) at the time of the distribution. The growth in value since the securities were acquired by the trustee is excludable if the securities were contributed by the employer or purchased with nondeductible employee contributions. IRC Sec. 402(e)(4)(B). The employee may elect out of this deferred treatment. The election is made on the tax return in which the distribution is required to be included in gross income. IRC Sec. 402(e)(4)(B). The balance of the value of the stock is taxable to the recipient under the regular rules for taxing lump sum distributions. See Rev. Rul. 57-514, 1957-2 CB 261.

The excludable appreciation, then, is not taxed unless or until the securities are actually sold by the recipient. The untaxed appreciation is not included in the recipient’s tax basis for the securities. However, if part or all of the unrealized appreciation is excluded as something other than unrealized appreciation, such as nondeductible employee contributions (or, in the case of decedents dying before August 21, 1996, the $5,000 employee death benefit), only the part excluded as unrealized appreciation is not added to basis. Rev. Rul. 74-398, 1974-2 CB 136. If the securities are sold, gain or loss is measured by the difference between the amount taxable at the time of distribution from the trust and the amount realized from the sale. Prop. Reg. §1.402(a)-1(b).

*Example 1.* Employee White’s account in a qualified trust has been credited with (1) 10 shares of employer corporation stock purchased with nondeductible employee contributions at an aggregate cost of $3,000 and (2) 15 shares purchased with employer contributions at an aggregate cost of $4,500. The shares are included in a lump sum distribution upon Employee White’s retirement, at which time they have a value of $10,000. The $2,500 of appreciation may be excluded from White’s gross income. The portion of the trust’s cost attributable to employer contributions ($4,500) is includable. White’s tax basis for any subsequent sale or exchange is $7,500, or $750 a share.

When the recipient sells the securities, the entire amount of excludable appreciation since the securities were acquired by the trust will be taxable to him in the year of the sale. However, the portion representing appreciation prior to the distribution from the trust is treated as long-term capital gain, regardless of how long the recipient has held the securities. The balance of the appreciation, if any, is long-term or short-term capital gain depending upon how long the recipient has held the securities. Prop. Reg.

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§1.402(a)-1(b); Rev. Rul. 81-122 1981-1 CB 202. The distributee’s holding period begins the day after the day the plan trustee delivers the stock to the transfer agent with instructions to reissue the stock in the distributee’s name. Rev. Rul. 82-75, 1982-1 CB 116.

*Example 2.* Assume that the employee in the above example sells the stock for $11,000 five months after receiving it in a distribution from the trust. Of the total $3,500 of gain, $2,500 (appreciation prior to distribution) is taxable as long-term capital gain and $1,000 (appreciation after distribution) is short-term capital gain.

Excluded appreciation prior to distribution which is realized on sale of the stock by the recipient of a distribution on account of the death of the employee or by a person inheriting the stock from the employee is income in respect of a decedent. As such it is taxed as long-term capital gain, and a deduction may be taken for the estate tax attributable to inclusion in the deceased employee’s estate of any part of the appreciation prior to distribution. Rev. Rul. 69-297, 1969-1 CB 131; Rev. Rul. 75-125, 1975-1 CB 254.

A participant receiving greatly appreciated employer securities as part of his lump sum distribution should carefully consider whether or not to roll over those securities to an IRA. Generally, distributions from rollover IRAs are ordinary income and receive no special tax advantage.

# Periodic Retirement Benefits

Noncontributory Plan

If the employee has no cost basis for his interest in the plan, the full amount of each payment is taxable to him as ordinary income. Treas. Reg. §1.72-4(d)(1). Normally, the employee will have no cost basis if the plan is noncontributory and no life insurance protection has been provided under the plan. For example, an employee who receives $400 a month under his company’s noncontributory group annuity plan must report the entire $4,800 a year as taxable income.

However, where life insurance protection has been provided, the employee may have some cost basis (the aggregate one-year term costs that have been taxed to him) even though the plan is noncontributory. See below.

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Recovery of Employee’s Cost Basis

An employee may recover his cost basis (if any) tax-free from distributions he receives under the plan. IRC Secs. 402(a)(1), 402(e)(4)(D), 72(f).

*A common law employee’s cost basis* consists of any or all of the following amounts:

1. total nondeductible contributions made by the employee if the plan is contributory (Contributions on behalf of shareholder-employees of S corporations which exceeded the excludable limits applicable in years beginning before January 1, 1984 and were, consequently, includable in income are included in this amount.);

2. the sum of the annual one-year term costs of life insurance protection that has been includable as taxable income (if payment is being received under the contract that provided the life insurance protection). Treas. Regs. §§1.72-8, 1.72-16(b)(4);

3. any other employer contributions (other than excess deferrals—) that have already been taxed to him, such as where a nonqualified plan was later qualified;

4. employer contributions made after 1950 and before 1963 while the employee was a resident of a foreign country; (Treas. Reg. §1.72-8(a)(3). Such contributions made after 1962 cannot be included in cost basis unless the plan, as of March 12, 1962, required that they be made to fund pre-1963 services.);

5. the amount of any policy loans included in income as a taxable distribution;

6. while amounts attributable to voluntary deductible employee contributions are not part of basis, to the extent they have been taxable to the employee because they were used to purchase a life insurance contract, it would seem they should be included in basis (if benefits are received under the contract).

This cost basis must be reduced by any amounts previously distributed to the employee which were excludable from gross income as a return of all or part of his basis. IRC Sec. 72(f); Treas. Regs. §§1.72-8, 1.72-16(b)(4), 1.402(a)-1(a)(6), 1.403(a)-2. See also Rev. Rul. 72-149, 1972-1 CB 218.

*A self-employed person’s cost basis* consists of the following amounts:

1. the nondeductible 50% of contributions made before 1968 (after subtracting the cost of incidental benefits, if any, such as waiver of premium and health insurance benefits and, in the case of an owner-employee, the P.S. 58 costs of life insurance protection); Treas. Reg. §1.72-17A; IRC Sec. 404(a)(10), prior to amendment by Pub. Law 89-809 (11-13-66);

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2. contributions on behalf of owner-employees under the 3-year average rule for determining contributions to level premium insurance and annuity contracts in excess of the deductible limit (in effect in years beginning before 1984); IRC Secs. 401(e), 415(c)(7). Both repealed by Pub. Law. 98-369, §713(d);

3. nondeductible voluntary contributions, if any, to a contributory plan; Treas. Reg. §1.61-11(a); IRC Secs. 402(a), 403(a), 72;

4. the amount of any policy loans included in income as a taxable distribution;

5. probably any amounts taxed to the individual because they were attributable to voluntary deductible employee contributions used to purchase life insurance (if benefits are received under the contract). See IRC Sec. 72(o).

Regular Annuity Payments

If the employee has a cost basis for his interest in the plan, the payments are taxed as discussed below, depending on his annuity starting date. To determine the employee’s cost basis, see Recovery of Employee's Cost Basis. The tax treatment is the same whether payment is made directly from the qualified trust or annuity plan, or the trust buys an annuity and distributes it to the employee. IRC Secs. 402(a)(1), 403(a)(1). However, distribution of an annuity contract itself affects the tax on lump sum distributions (see Distribution of Annuity Contract).

For tax purposes, there is no requirement that the annuity be paid in equal amounts or that it be paid over the lifetime of the recipient. In many instances, amounts taxed as annuities are simply distributions of installment payments from the plan. One of the distinct advantages of an installment form of distribution to an employee of his benefit is that the portion of the benefit not yet paid will continue to grow tax-free. Generally, if an installment method of distribution is elected, a participant’s benefit is segregated into a separate account and invested conservatively (or at the direction of the participant himself). The participant receives the benefit of his segregated account, including all of the tax-free growth it has earned. Depending upon the number of years over which installments are paid, the installment method of distribution can generate significantly greater after-tax dollars than can the favorable lump sum distribution.

Certain premature distributions are subject to an additional tax, as are certain excessive retirement distributions.

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Annuity Starting Date After December 31, 1997

For an employee who has a cost basis for his interest, whose annuity starting date is after December 31, 1997, and whose annuity is payable over two or more lives, a special table was added by 1997 legislation. The excludable portion of each monthly payment is determined by dividing the employee’s investment in the contract by the number of anticipated payments as follows: IRC Sec. 72(d)(1), as amended by TRA ’97.

|  |  |
| --- | --- |
| If the combined ages ofthe annuitants are: | Number ofpayments: |
| Not more than 110 | 410 |
| More than 110 but not more than 120 | 360 |
| More than 120 but not more than 130 | 310 |
| More than 130 but not more than 140 | 260 |
| More than 140 | 210 |

Annuity Starting Date after November 18, 1996

If the employee has a cost basis for his interest, and his annuity starting date is after November 18, 1996, the payments are taxed under a special rule that is similar to the simplified safe harbor announced in 1988 and described below. IRC Sec. 72(d), as amended by SBJPA ’96. Under that rule, the investment in the contract is recovered according to a schedule set forth in the Code instead of using the exclusion ratio. For purposes of this rule, the employee’s investment in the contract does not include any adjustment for a refund feature under the contract. IRC Sec. 72(d)(1)(C), 72(c)(2).

Assuming the contract is payable over the employee’s life expectancy, the excludable portion of each monthly payment is determined by dividing the employee’s investment in the contract by the number of anticipated payments contained in the following table (IRC Sec. 72(d)(1)(B)):

|  |  |
| --- | --- |
| Age | Number of Payments |
| Not more than 55 | 360 |
| More than 55 but not more than 60 | 310 |
| More than 60 but not more than 65 | 260 |
| More than 65 but not more than 70 | 210 |
| More than 70 | 160 |

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This table does not apply if the annuitant is age 75 or over unless there are fewer than 5 years of guaranteed payments under the annuity. IRC Sec. 72(d)(1)(E). It would appear that for an annuitant who is 75 or older and whose contract provides for 5 or more years of guaranteed payments, the rules for annuities with a starting date after July 1, 1986 and before November 19, 1996 would be applied.

If the contract provides for a fixed number of installment payments, the number of monthly annuity payments provided for under the contract is used instead of the number listed on the table. See IRC Secs. 72(d)(1)(B)(i)(II), 72(c)(3)(B). If payments under the contract are not made on a monthly basis, appropriate adjustments must be made to the number of payments determined above to reflect the basis on which payments are made. IRC Sec. 72(d)(1)(F).

If a lump sum is paid to the taxpayer in connection with the commencement of the annuity payments, it will be taxable as an amount not received as an annuity under Section 72(e), and treated as received before the annuity starting date. Such a taxpayer’s investment in the contract will be determined as if the lump sum payment has been received. IRC Sec. 72(d)(1)(D).

The total amount the employee can exclude may not exceed his investment in the contract, and if the employee dies prior to recovering his full investment in the contract, any unrecovered investment will be allowable as a deduction on his final return. IRC Secs. 72(d)(1)(B)(ii), 72(b)(2), 72(b)(3).

Annuity Starting Date After July 1, 1986 and Before November 19, 1996

If the employee has a cost basis for his interest, and his annuity starting date is after July 1, 1986 and before November 19, 1996, the payments are taxed either under the regular annuity rules or (if certain requirements are met) under the simplified safe harbor described below. IRC Secs. 402(a), 72, 403(a); Notice 88-118, 1988-2 CB 450. In other words, the employee’s cost basis may not be fully recovered from the first payments, but must be recovered by excluding from gross income a fixed percentage of each payment over the payment period.

Under the regular annuity rules, a fixed percentage (i.e., the “exclusion ratio”) must be determined as of the annuity starting date. IRC Sec. 72(b); Treas. Reg. §1.72-4(a). Basically, the exclusion ratio is determined by dividing the *investment in the contract* by the *expected return* under the contract. The resulting quotient is the percentage of each payment that may be excluded from gross income. With respect to distributions from qualified plans, the employee’s cost basis in the plan is his *investment in the*

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*contract.* And the total amount it is estimated he will receive under the plan is his *expected return. .*In the case of a straight life annuity, this expected return is determined by multiplying the total amount he will receive each year by the number of years in his life expectancy according to Table I or Table V of the Annuity Tables, whichever is applicable. If the employee’s annuity starting date is after December 31, 1986, the total amount which the employee can exclude during his lifetime is limited to his investment in the contract. IRC Sec. 72(b)(2). For annuity starting dates prior to 1987, the exclusion ratio continued to apply, even to amounts received in excess of the employee’s investment in the contract.

*Example.* Employee Black retires in December, 1988, at age 65. He is not married. He has elected to receive a life annuity under the plan, but had the option to elect an annuity for a period certain. On January 1, 1989, he starts receiving payments under his company’s qualified contributory pension plan. The pension arrangement will pay him $800 a month for life. Black’s cost basis in the plan (including his own contributions and amounts that have been taxed to him) is $12,000. Mr. Black has made contributions both before July 1, 1986 and after June 30, 1986, but because Mr. Black could have elected an annuity for a period certain, he may not elect to calculate his excludable amount separately with respect to the pre-July and post-June portions. The life expectancy for age 65 is 20 years. So total expected return from the plan is $192,000 (20 × $9,600). Employee Black’s exclusion ratio is therefore $12,000/$192,000, or 6.3%. Each year he will exclude $604.80 (6.3% of $9,600) from gross income, until he has excluded the full $12,000. And each year he will include in gross income $8,995.20 ($9,600 - $604.80), until the full $12,000 has been recovered, after which he will include the full $9,600.

If an employee dies prior to recovering his full investment in the contract, the unrecovered investment will be allowed as a deduction to him on his final return. IRC Sec. 72(b)(3)(A); TAMRA ’88, §1011A(b)(12). If payments are guaranteed and the refund beneficiary does not recover the amount unrecovered at decedent’s death, the beneficiary may deduct the remaining unrecovered investment in the contract. IRC Sec. 72(b)(3).

Simplified “Safe Harbor” Method

A simplified safe harbor method can be used if the annuity payments depend on the life of the employee or the joint lives of the employee and a beneficiary. If the employee is age 75 or older when the annuity payments commence, this method can be used only if less than five years of payments are guaranteed. Notice 88-118, 1988-2 CB 450. A distributee may use the safe harbor method even if the payor does not issue a Form W-

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2P based on the safe harbor method. Under this method, investment in the contract is the employee’s cost basis in the plan. No refund feature adjustment has to be made. Investment in the contract is divided by the total number of monthly annuity payments expected. This number is taken from the following table and is based on the employee’s age at the annuity starting date:

|  |  |
| --- | --- |
| Age | Number of Payments |
| 55 and under | 300 |
| 56-60 | 260 |
| 61-65 | 240 |
| 66-70 | 170 |
| 71 and over | 120 |

The same expected number of payments applies regardless of whether the employee is receiving a single life annuity or a joint and survivor annuity. The dollar amount excluded from each payment does not change, even if the amount of the payments increase or decrease. Notice 88-118, above. Of course, if the annuity starting date is after December 31, 1986, annuity payments received after the investment in the contract is recovered are fully includable in income. IRC Sec. 72(b)(2).

An employee with a post-1987 annuity starting date makes the election to use the safe harbor method by reporting the taxable portion of the annuity payments received in a year under that method on the income tax return for that year. An employee with a pre-1988 annuity starting date may elect to use the safe harbor method only for those payments received after 1987 or for all payments by filing amended returns for prior years. If the safe harbor method is used only for those payments received after 1987, the calculation is performed using the actual annuity starting date, but the employee begins reporting the safe harbor taxable amount beginning with the 1988 taxable year. Notice 88-118, above.

An employee may change the method used to report the tax treatment of annuity payments by filing an amended return for all open tax years as long as the year containing the annuity starting date is an open year. Ibid.

Annuity Starting Date On or Before July 1, 1986

If the employee’s annuity starting date is on or before July 1, 1986, payments will be taxed according to one of these two methods: (1) the 3-year cost recovery rule, or (2) the regular annuity rules. The size of the employee’s cost basis in relation to the total amount of payments he will receive during the first 3 years determines which of these

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methods applies. If total guaranteed payments receivable by the employee during the 3-year period beginning with the date of the first payment will equal or exceed his cost basis, the 3-year cost recovery rule applies. If total guaranteed payments during the first 3-year period will be less than the employee’s cost basis, the regular annuity rules apply. IRC Sec. 72(d), prior to repeal by TRA ’86, §1122(c)(1). In determining which rule applies, the employee’s cost basis should not be reduced by the value of any refund feature in connection with a life annuity settlement. *Clifford H. Searl*, 35 TC 1217 (1961).

Under the 3-year cost recovery rule, the employee excludes from gross income all guaranteed payments until they equal his cost basis; thereafter, all amounts received are fully taxable as ordinary income IRC Sec. 72(d), prior to repeal by TRA ’86, §1122(c)(1). Amounts received, if any, in excess of guarantees, are includable in gross income. IRC Sec. 72(e)(1); Reg. §1.72-11(b)(2). The three-year cost recovery rule was repealed for employees with an annuity starting date after July 1, 1986. TRA ’86, §1122(c)(1).

*Example.* Employee Brown retired on December 1, 1985. Beginning January 1, 1986, he began receiving $200 a month ($2,400 a year) for life from his company’s pension plan. His total cost basis for his interest is $5,000. Since payments for the first 3 years ($7,200) will exceed his cost basis, the 3-year-rule applies. White may exclude the entire $2,400 from his gross income in 1986 and 1987. In 1988, he will exclude $200 of the payments from gross income, and will include $2,200. Thereafter all payments received by him will be fully includable in gross income.

Once a determination has been made as to which method applies to the annuity payments, whether the 3-year cost recovery method or the life expectancy ratio method, that method continues to apply even though the terms of the contract are modified so that the periodic payments are received for a different term than originally provided — as where, after annuity payments first begin, an election is made to take a reduced monthly amount in order to add survivorship benefits. If the life expectancy ratio method was originally used, a new exclusion ratio is computed and used, even if under the new contract the employee’s unrecovered contributions will be recovered in the next 3 years. If the 3-year cost recovery rule originally applied, the employee continues to use that full recovery of contributions method even though under the modified terms of the contract his contributions will not be recovered in 3 years. Rev. Rul. 74-334, 1974-2 CB 30.

Variable Annuity Payments

In general, variable benefits are taxable under the same basic rules that apply in taxing fixed amount annuities. When the employee has a cost basis for his interest in the plan

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and the annuity starting date is after June 30, 1986, the payments are taxed under the annuity rules as expressly applied to variable payments. Thus, the amount excludable from the employee’s gross income each year is determined by dividing his cost basis (adjusted for any refund or period-certain guarantee) by the number of years in the payment period. Treas. Reg. §1.72-2(b)(3). If the annuity is payable for a life or lives, the payment period is determined by use of the IRS annuity tables.

For annuities with a starting date after December 31, 1986, the present value of any refund feature is not to be taken into account in calculating the unrecovered investment in the contract; however, such amounts are still taken into account in calculating an individual’s exclusion ratio. IRC Sec. 72(b)(2)(A), as amended by SBJPA ’96. The unrecovered investment in the contract affects only those annuitants who die before the annuity payments end (i.e., the amount of their deduction on their final year return) and the annuitant’s cost recovery date (i.e., the date upon which the annuity holder recovers his investment in the contract).

Once the investment in the contract has been adjusted by subtracting the value of the period-certain guarantee, an excludable amount is determined by dividing the adjusted investment in the contract by the life expectancy taken from Table I or V. Taking the example above, the excludable amount is determined as follows:

|  |  |
| --- | --- |
| Pre-July 1986 investment in the contract (adjusted for period certain guarantee) | $ 4,440 |
| Life expectancy from Table I (male age 65) | 15 years |
| Excludable amount ($4,440 ÷ 15) | $ 296 |
| Post-June 1986 investment in the contract (adjusted for period certain guarantee) | $ 952 |
| Life expectancy from Table V (age 65) | 20 years |
| Excludable amount ($952 ÷ 20) | $ 47.60 |
| Amount excludable from gross income each year ($296 + $47.60) | $343.60 |

With respect to annuities with starting dates prior to July 1, 1986, payments are taxed under the annuity rules or under the “3-year cost recovery” rule (see Recovery of Employee's Cost Basis). In determining whether the 3-year cost recovery rule applied, it was assumed that every payment to be received after commencement of the payout period would be equal to the first payment. Treas. Reg. §1.72-13(d).

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# Distributions to Alternate Payees

Generally, income tax law provides that income is taxed to the person who earns the income. However, in the case of retirement plan distributions made pursuant to qualified domestic relations orders, an alternate payee who is the spouse or former spouse of the participant will be treated as the distributee of a retirement plan distribution. IRC Sec. 402(a)(9).Payment under a qualified domestic relations order of the balance to the credit of such an alternate payee may be treated as a lump sum distribution if a distribution of the balance to the credit of the employee would be treated as a lump sum distribution. IRC Sec. 402(e)(4)(O), as added by TAMRA ’88 and effective for distributions after 1984.

Federal income tax must be withheld from distributions to an alternate payee who is the spouse or former spouse of the participant unless the spouse or former spouse elects not to have the withholding rules apply. Notice 89-25, 1989-1 CB 662, A-3.

There is no similar rule treating alternate payees who are not the spouse or former spouse of the participant as the distributees of payments made pursuant to a QDRO. Thus, the participant is treated as the distributee for such purposes. Notice 89-25, above, A-3, A-4.