Distributions during Employment

# In General

Generally, distributions before termination of employment are permitted only under profit sharing plans. See B—Profit Sharing Plans Explained, subsection Distributions. Further, such distributions generally are not afforded favorable tax treatment unless the employee is over age 59½—and indeed may also be subject to a 10% penalty tax.

Pre-retirement distributions received (before the annuity starting date by an employee who has a cost basis under a pension, profit sharing or stock bonus plan, or under an annuity contract purchased by any such plan are taxed under a rule which provides for pro rata recovery of cost. IRC Sec. 72(e)(8). (The “annuity starting date” is the first day of the first period for which an amount is received as an annuity under the plan or contract. IRC Sec. 72(c)(4).)

The foregoing rules apply to amounts received after July 1, 1986. Amount received prior to July 2, 1986 were taxed under a “cost recovery” rule permitting recovery of basis before taxing any of the distribution as interest. IRC Sec. 72(e)(5)(D). The employee excludes that portion of the distribution which bears the same ratio to the total distribution as his investment in the contract bears to the total value of the employee’s total account balance as of the date of the distribution.

For purposes of these rules, the value of the employee’s total account balance is the fair market value of the total assets under the account, excluding all net unrealized appreciation in employer securities attributable to employee contributions, whether or not all of such securities are distributed. Notice 87-13, 1987-1 CB 432, A-11, as modified by Notice 89-25, 1989-1 CB 662, A-1.

Employee contributions under a defined contribution plan may be treated as a separate contract for purposes of these rules. IRC Sec. 72(d)(2). For purposes of applying this rule, a defined benefit plan is treated as a defined contribution plan to the extent that employee contributions (and earnings thereon) are credited to a separate account to which actual earnings and losses are allocated. IRC Sec. 414(k)(2); Notice 87-13, 1989-1 CB 662, A-14. See also, Let. Ruls. 9618028, 8916081. A lump sum distribution received under the alternative form of the Civil Service Retirement System annuity did not qualify as a defined contribution plan or a hybrid plan under these rules; thus it was not subject to separate contract treatment. *George v. U.S.*, 96-2 USTC ¶50,389 (Fed. Cir. 1996); *Logsdon v. Comm.*, TC Memo 1997-8.

Distributions During Employment

# Grandfather Rule

If a plan on May 5, 1986 permitted in-service withdrawal of employee contributions, the pro rata recovery rules do not apply to investment in the contract prior to 1987. Instead, investment in the contract prior to 1987 will be recovered first, and the pro rata recovery rules will apply only to the extent that amounts received before the annuity starting date (when added to all other amounts previously received under the contract after 1986) exceed the employee’s investment in the contract as of December 31, 1986. IRC Sec. 72(e)(8)(D). See also, Let. Rul. 8747061.

If employee contributions are transferred after May 5, 1986 from a plan that permitted in-service withdrawals to another plan permitting such withdrawals, the pre-1987 investment in the contract under both plans continues to qualify for this grandfather treatment. If the transferor plan did not permit such in-service withdrawals, only the pre-1987 investment in the contract under the transferee plan qualifies. Notice 87-13, 1987-1 CB 432, A-13. See also, Let. Ruls. 8829017, 8829006.

An employee who cashed-out prior to 1986 and buys back after 1986 cannot use this grandfather rule—there is no pre-1987 investment in the contract. But even if the cash-out occurred after 1986 and there was investment in the contract as of December 31, 1986, the cash-out causes a permanent reduction in the grandfathered investment which may not be restored by a later buy-back. Notice 89-25, 1989-1 CB 662, A-5.