How is an employee taxed on preretirement distributions from a qualified plan?

Preretirement distributions, meaning those received before the annuity starting date, that are made to an employee from a qualified plan are fully included in gross income except to the extent allocated to investment in the contract, as described below.[[1]](#footnote-1) Early or premature distributions generally are subject to an additional tax.

A participant, who has an investment or cost basis in a contract under a pension, profit sharing, or stock bonus plan, or under an annuity contract purchased by any such plan, is taxed under a rule that provides for pro rata recovery of cost.[[2]](#footnote-2) The employee excludes the portion of the distribution that bears the same ratio to the total distribution as his or her investment in the contract bears to the total value of the employee’s accrued benefit on the date of the distribution.

The total value of an employee’s account balance generally is the fair market value of the total assets under the account, excluding any net unrealized appreciation attributable to employee contributions, whether or not all of such securities are distributed.[[3]](#footnote-3) 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.[[4]](#footnote-4)

Employee contributions under a defined contribution plan may be treated as a separate contract for purposes of these rules.[[5]](#footnote-5) 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.[[6]](#footnote-6)

Conversely, the IRS privately ruled that there was a single contract in the case of a defined benefit plan that did not credit earnings on employee after-tax contributions and allowed single sum withdrawal of such contributions at retirement, in exchange for actuarially reduced lifetime pension payments. The withdrawn amounts were taxed as preretirement distributions under IRC Section 72(e)(8)(B) and the investment in the contract with respect to the remaining benefit was reduced by the amount of such distribution.[[7]](#footnote-7)

How is an employee taxed on preretirement distributions from a qualified plan?

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.[[8]](#footnote-8)

# Grandfather Rule

If, on May 5, 1986, a plan 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.[[9]](#footnote-9) 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.[[10]](#footnote-10)

An employee who cashed out prior to 1986 and buys back after 1986 cannot use the grandfather rule because there is no pre-1987 investment in the contract. Even if the cash-out occurs 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 that may not be restored by a later buy-back.[[11]](#footnote-11)

Where an employer amended its plan to provide that employees could receive distributions at their request, but not less than the minimum amounts that must be distributed by the applicable distribution date under IRC Section 401(a)(9), distributions were not annuity payments and there was no annuity starting date, so distributions were treated as amounts received before the annuity starting date and were subject to grandfather rule of IRC Section 72(e)(8)(D).[[12]](#footnote-12)

How is an employee taxed on preretirement distributions from a qualified plan?

Where a state’s defined benefit plan allowed eligible participants to elect optional retirement with partial lump sum distributions (“PLSDs”) and PLSDs were received within the window of eligibility specified in TAMRA ’88, Section 1011A(b)(11), the PLSDs were taxable, on a pro-rata basis under IRC Section 72(e) to the extent that they exceeded the recipient’s investment in the plan.[[13]](#footnote-13)

1. IRC Secs. 72(e)(8), 72(e)(2)(B). [↑](#footnote-ref-1)
2. See IRC Sec. 72(e)(8). [↑](#footnote-ref-2)
3. Notice 87-13, 1987-1 CB 432, A-11, as modified by Notices 98-483, 1998-2 CB 365 and 2000-30, 2000-1 CB 1266; Rev. Rul. 2002-62, 2002-2 CB 710. [↑](#footnote-ref-3)
4. IRC Sec. 72(c)(4). [↑](#footnote-ref-4)
5. IRC Sec. 72(d)(2). [↑](#footnote-ref-5)
6. IRC Sec. 414(k)(2); Notice 87-13, 1987-1 CB 432, A-14. See also, Let. Ruls. 9618028, 8916081. [↑](#footnote-ref-6)
7. Let. Rul. 9847032. [↑](#footnote-ref-7)
8. *George v. U.S.*, 96-2 USTC ¶50,389 (Fed. Cir. 1996); *Logsdon v. Comm.*, TC Memo 1997-8. [↑](#footnote-ref-8)
9. IRC Sec. 72(e)(8)(D); see also Let. Ruls. 9652031, 8747061. [↑](#footnote-ref-9)
10. Notice 87-13, 1987-1 CB 432, A-13. See also, Let. Ruls. 8829017, 8829006. [↑](#footnote-ref-10)
11. Notice 89-25, 1989-1 CB 662, A-5, modified by Notice 2002-62. [↑](#footnote-ref-11)
12. Let. Ruls. 200117044, 200117045. [↑](#footnote-ref-12)
13. Let. Rul. 200114040. [↑](#footnote-ref-13)