



[CLICK HERE](#) to return to the home page

## Notice 89-25

### Introduction

This Notice provides further guidance, in the form of questions and answers, to certain provisions of the Tax Reform Act of 1986 (TRA '86) generally affecting the taxation of distributions from qualified employee plans, section 403(b) annuity contracts, and individual retirement arrangements (IRAs). Guidance has previously been issued in Notice 87-13, 1987-1 C.B. 432, and Notice 87-16, 1987-1 C.B. 446. This Notice is intended to clarify certain provisions of those Notices, and to provide guidance on other issues affecting employee plans, changes in plan valuation date, distributions to federal employees, and distributions of certain annuity contracts.

Until further guidance is published, the guidance provided by these questions and answers may be relied upon by taxpayers to design and administer plans and to determine the tax treatment of plan contributions and distributions. The Service will apply these questions and answers in issuing rulings and in examining returns with respect to taxpayers and plans. If future guidance is more restrictive than that provided in this Notice, such guidance will be applied without retroactive effect. No inference should be drawn, however, regarding issues not <Page 663> addressed in this Notice which may be suggested by a particular question and answer or as to why certain questions, and not others, are included.

### Questions and Answers

Q-1: How does section 72(e)(8) of the Internal Revenue Code, which was added by TRA '86, affect the tax treatment of a distribution of employer securities having net unrealized appreciation?

A-1: Distributions from qualified plans are generally taxed according to the rules of section 72 (relating to annuities). However, section 402(a)(1) provides a specific rule that net unrealized appreciation (NUA) in employer securities attributable to employee contributions shall be excluded from the distributee's gross income. Section 402(e)(4)(J) also provides for the exclusion from gross income of all NUA in employer securities included as part of a lump sum distribution (determined without regard to section 402(e)(4)(H)).

Section 402(j) of the Code provides that the determination of NUA in employer securities shall be made without regard to any transaction in which the plan trustee exchanges the plan's securities for other such securities or disposes of employer securities and uses the proceeds of such disposition to acquire securities of the employer corporation within 90 days (or such longer period as the Secretary may prescribe). This change does not apply to any employee to whom a distribution of money was made after the disposition of securities and before the acquisition of other employer securities.

Section 402(e)(4)(J) of the Code as amended by TRA '86 also provides that a taxpayer may elect not to exclude NUA in employer securities distributed as part of a lump sum distribution

(determined without regard to whether the employee has been a participant in the plan for five or more years). Such an election is to be made by attaching a signed statement to that effect to the income tax return (or amended return) filed for the year in which the distribution was received and by including the NUA as part of the distribution on the Form 4972, or, if no Form 4972 is filed, on line 16 of Form 1040.

The portion of NUA attributable to employee contributions is determined according to section 1.402(a)-1(b) of the Income Tax Regulations and the provisions of the plan document. Under these rules the employee contributions used to purchase the security shall be the amount of the employee contributions properly allocable to the employer security. Employee contributions are treated as properly allocable to employer securities that have been specifically earmarked as purchased with employee contributions. If employer securities cannot be so identified, a ratable allocation may be used. See section 1.402(a)-1(b)(3) of the regulations. Except as provided above, TRA '86 did not change the rules for allocating employee contributions to employer securities, or for excluding NUA received in a lump sum distribution pursuant to section 402(e)(4)(J).

NUA attributable to employee contributions in a distribution that is not a lump sum distribution is excludable from the distributee's gross income. The remainder of the distribution is taxed according to the rules of section 72. Prior to TRA '86, the remainder of a distribution received before the annuity starting date was excluded from gross income until the distributee's investment in the contract had been recovered. TRA '86 amended section 72 by adding section 72(e)(8), which provides for a pro-rata recovery of the employee's investment in the contract according to a ratio, the numerator of which is the employee's investment in the contract, and the denominator of which is the employee's account balance. Since NUA attributable to employee contributions is excluded under the rules of section 402(a)(1), the pro-rata rule of section 72(e)(8) is applied by reducing the employee's account balance by all NUA attributable to employee contributions, whether or not all of such securities are distributed. Notice 87-13, Q, is hereby modified to the extent that it states that the account balance is only reduced by the NUA portion of the distribution.

#### Example 1

Employee A has been a participant in Employer X's qualified profit-sharing plan since January 1, 1987. A contributes \$6,000 to the plan over a five year period. All such contributions are invested in X securities, and the fair market value of these securities appreciates to \$10,000. On January 1, 1992, A elects a distribution of X securities equal to one-half of his employee account balance, which has a value of \$5,000. \$2,000 of the distribution constitutes NUA, which is excluded from A's gross income. The remaining portion of the distribution (\$3,000) is taxed according to the fraction determined under section 72(e)(8) after reducing the denominator of the fraction by the \$4,000 NUA allocable to the account as follows:

$$\frac{\$6,000 \text{ employee contributions} \times \$3,000}{\$3,000} = \$3,000 \text{ ----- recovery of } (\$10,000 \text{ account balance} - \$4,000 \text{ NUA}) \text{ basis}$$

Thus, A has no amount includible in gross income and has a basis in the securities distributed of \$3,000.

On January 1, 1993, A receives an X securities distribution of his remaining account balance with a value of \$5,000. \$2,000 of the distribution constitutes NUA which is excluded from income. The remaining portion of the distribution (\$3,000) is treated as a recovery of basis as follows:

$$\frac{\$3,000 \text{ employee contributions} \times \$3,000}{\$3,000} = \$3,000 \text{ ----- recovery of } (\$5,000 \text{ account balance} - \$2,000 \text{ NUA}) \text{ basis}$$

Thus, A has no amount included in gross income as A has a basis in the securities of \$3,000.

Example 2

Employee B has contributed \$10,000 to his employer's qualified defined contribution plan since 1987. One-half of the employee's contributions is invested in a mutual fund and the other one-half is invested in employer securities. The mutual fund and the securities have a value of \$10,000 each. Thus, B's basis in the plan, the NUA in employer securities, and the total value of B's account balance is as follows:

	Basis	NUA	Value
Employer Securities:	\$5,000	\$5,000	\$10,000
Mutual Fund:	\$5,000		\$10,000
Total:	\$10,000	\$5,000	\$20,000

The tax result of the following distributions under section 72(e)(8) is described below for each taxable year.

Year 1: The plan distributes employer securities which have a value of \$3,000. \$1,500 of the distribution constitutes NUA which is excludable from B's gross income. The amount of the distribution that is treated as a recovery of basis is determined as follows: \$10,000 employee contributions x \$1,500 = \$1,000 ----- recovery of (\$20,000 account balance - \$5,000 NUA) basis

Thus, \$1,000 is excluded from gross income as a recovery of basis, and \$500 is included in income. After the distribution, the employer's account stands as follows:<Page 664>

	Basis	NUA	Value
Beginning Balance:	\$10,000	\$5,000	\$20,000
Distribution:	(\$ 1,000)	(\$1,500)	(\$ 3,000)
Ending Balance:	\$ 9,000	\$3,500	\$17,000

Year 2: The plan distributes mutual fund shares with a value of \$3,000. The amount of the distribution that is treated as a recovery of basis is determined as follows: \$9,000 employee contributions x \$3,000 x \$2,000 ----- recovery of \$17,000 account balance - \$ 3,500 NUA) basis

Thus, \$2,000 is excluded from gross income as a recovery of basis, and \$1,000 is included in gross income. After the distribution, the employee's account stands as follows:

	Basis	NUA	Value
Beginning Balance:	\$9,000	\$3,500	\$17,000
Distribution	(\$2,000)	(0)	(\$ 3,000)
Ending Balance:	\$7,000	\$3,500	\$14,000

Year 3: The plan distributes employer securities which have a value of \$4,000. \$2,000 of the distribution constitutes NUA which is excludable from B's gross income. The amount of the distribution that is treated as a recovery of basis is determined as follows: \$7,000 employee contributions x \$2,000 = \$1,333 ----- recovery of (\$14,000 account balance - \$ 3,500 NUA) basis

Thus, \$1,333 is excluded from gross income as a recovery of basis, and \$667 is included in gross income. After the distribution, B's account stands as follows:

	Basis	NUA	Value
Beginning Balance:	\$7,000	\$3,500	\$14,000
Distribution:	(\$1,333)	(\$2,000)	(\$4,000)
Ending Balance:	\$5,667	\$1,500	\$10,000

Year 4: The plan distributes the remaining account balance consisting of \$7,000 cash and \$3,000 employer securities. \$1,500 of the distribution constitutes NUA which is excludable from B's gross income. The amount of the distribution that is treated as a recovery of basis is determined as follows:  $\$5,667 \text{ employee contributions} \times \$8,500 = \$5,667$  ----- recovery of (\$10,000 account balance – \$1,500 NUA) basis

Thus, \$5,667 would be excluded from gross income as a recovery of basis, and \$2,833 would be included in gross income.

Q-2: What is the effective date of section 72(t) for section 403(b) annuity contracts?

A-2: In general, section 1123(e) of TRA '86 provides that the early distribution tax under section 72(t) will apply, with certain exceptions, to distributions under section 403(b) annuity contracts received in the taxable year of the individual taxpayer beginning after December 31, 1986. Section 72(t) applies to all distributions from plans described in section 4974(c) (as amended by TRA '86), which includes section 403(b) annuities. See also Q of Notice 87-13.

Q-3: What withholding rules apply to qualified plan distributions to nonspouse alternate payees?

A-3: Section 3405 of the Code provides that federal income tax must be withheld from all designated distributions unless the individual elects not to have withholding apply. In general, a designated distribution is any payment or distribution from or under an employee deferred compensation plan but does not include the portion of a distribution which it is reasonable to believe is not includible in gross income.

Section 402(a)(9) of the Code provides that, for purposes of section 402(a)(1) and 72, any alternate payee who is the spouse or former spouse of the participant shall be treated as the distributee of any distribution or payment made to the alternate payee under a qualified domestic relations order as defined in section 414(p). The withholding rules therefore are applied as if the spouse or former spouse were the employee. However, there is no similar provision for distributions to nonspouse alternate payees. Therefore, distributions to a nonspouse alternate payee during the lifetime of the participant are not includible in such payee's gross income, but instead are included in the gross income of the plan participant. Consequently, amounts shall be withheld from the distribution as if the plan participant were the payee, unless the plan participant elects not to have the withholding rules apply.

Q-4: May a distribution to a nonspouse alternate payee be rolled over by the nonspouse alternate payee?

A-4: No. Section 402(a)(5) of the Code generally provides rollover treatment only if the distribution is paid to an employee and the employee transfers any portion of the property received to an eligible retirement plan; this rollover treatment applies only to the taxable portion of the distribution. However, a special rollover rule is provided under section 402(a)(6)(F). Under that special rollover rule, if the balance to the credit of the recipient by reason of a qualified domestic relations order (within the meaning of section 414(p)) is paid to the recipient within one taxable year, any portion of the distribution may be transferred to an individual

retirement account or annuity in a qualifying rollover distribution. This treatment is available, however, only for a distribution that would otherwise be includible in the gross income of the recipient. Because the distribution to a nonspouse alternate payee is includible in the gross income of the participant under section 402(a)(9), no part of such a distribution may be rolled over by the nonspouse alternate payee. However, the participant may roll over such amounts by making a contribution to an eligible retirement plan if the requirements of section 402(a)(5) are otherwise satisfied.

Q-5: If an employee who has been cashed-out of a plan described in section 72(e)(8)(D) of the Code subsequently buys back into the plan, will the grandfathered investment in the contract be restored?

A-5: Section 72(e)(8)(D), as added by TRA '86, provides a special grandfather rule for pre-annuity starting date distributions from plans that on May 5, 1986, permitted withdrawal of any employee contributions before separation from service. Under this grandfather provision, the pro-rata rule of section 72(e)(8) will apply only to the extent that the amount of the nonannuity distribution is greater than the remaining amount of the participant's total investment in the trust or contract on December 31, 1986 (See Q of Notice 87-13). Therefore, if an employee has been cashed - out of such a plan before January 1, 1987, a buy-back after December 31, 1986, will not restore the grandfathered investment. In addition, a cash- out of a participant's interest after December 31, 1986, that reduced the participant's December 31, 1986, investment causes a permanent reduction in such grandfathered investment that may not be restored by a later buy-back.

Q-6: If an employee receives a distribution of a portion of the balance to the employee's credit after age 59½, is a subsequent distribution to the employee of the remainder of the balance to the credit in a later taxable year a lump sum distribution within the meaning of section 402(e)(4)(A)?

A-6: A lump sum distribution under section 402(e)(4)(A) is a distribution within a single taxable year of the entire balance to the credit of an employee which is paid to the recipient (a) on account of the employee's death, (b) after the employee attains age 59½, (c) on account of the <Page 665> employee's separation from service (in the case of an individual who is an employee without regard to section 401(c)(1)), or (d) after the employee has become disabled (in the case of an employee within the meaning of section 401(c)). The employee's balance to the credit is determined as of the first distribution received after such an event. Additional amounts that are credited to the employee after the date the balance is determined may be treated, but are not required to be treated, as part of the balance to the credit. For example, if in 1989 employee A receives \$100,000 which represents A's entire balance as of January 1, 1989, A will be treated as having received the entire balance to his credit even though an additional \$5,000 is allocated to A's account on December 31, 1989, on account of A's service in 1989.

Q-7: What is the tax treatment of distributions from an IRA containing nondeductible contributions when the participant's basis in the IRA exceeds the value of the IRA?

A-7: For purposes of determining the taxation of IRA distributions, all IRAs maintained for an individual must be aggregated and treated as one IRA. If the IRA owner has made nondeductible IRA contributions, a portion of a distribution from any IRA of such individual must be excluded from income as a return of nondeductible contributions according to a ratio, the numerator of which is the individual's total nondeductible contributions to all IRAs maintained for the individual, and the denominator of which is the total IRA account balance for all such IRAs. If the aggregate account balance of all IRAs is less than the aggregate nondeductible contributions

to all IRAs, distributions are treated as consisting entirely of nondeductible contributions. A loss may be recognized if all IRA accounts have been distributed and the amounts distributed are less than the individual's unrecovered basis. Notice 87-16, D-5, is hereby clarified.

Q-8: How does the early distribution tax under section 72(t) of the Code apply to individuals who retire from the United States Government before age 55 and elect to receive the "lump sum credit" and alternative annuity pursuant to section 204 of the Federal Employees' Retirement System Act of 1986?

A-8: A federal retiree may elect to receive, in lieu of the normal monthly annuity retirement benefit, a "lump sum credit" (an amount generally equal to the retiree's after-tax contributions) and an actuarially reduced annuity. If a federal employee retires prior to the year in which he or she attains age 55, and elects to receive the lump sum credit, the 10-percent additional early distribution tax under section 72(t) will apply to the portion of the lump sum credit that is included in the retiree's gross income. However, this tax will not apply if the federal employee retires during or after the year in which he or she attains age 55. Furthermore, the additional tax will not apply to annuity payments paid after retirement, even if the federal employee retires prior to age 55 and receives his or her lump sum credit.

Q-9: May a federal employee who transfers from the Civil Service Retirement System to the Federal Employees' Retirement System roll over the taxable portion of a refund of employee contributions?

A-9: No. The taxable portion of a distribution may be rolled over into an eligible retirement plan only if the amount of the distribution is at least 50 percent of the employee's balance to the credit, and the distribution is made on account of the employee's death, separation from service, or disability. Since the distribution to federal employees who transfer to the Federal Employees' Retirement System will be less than 50 percent of the employee's balance to the credit, and is not made on account of any of the events described above, rollover treatment is not available.

Q-10: What amount is included in a plan participant's gross income when the participant receives a distribution from a qualified plan that includes a policy issued by an insurance company with a value substantially higher than the cash surrender value stated in the policy?

A-10: Subject to certain exceptions not here applicable, section 402(a) of the Code provides that the amount actually distributed by a qualified employees' trust shall be taxable to a plan participant in the year in which so distributed under section 72 (relating to annuities). Section 1.402(a)-1(a)(1)(iii) of the regulations provides that the amount includible in a plan participant's gross income by reason of the distribution of property by the plan shall be the fair market value of such property. Life insurance contracts constitute property within the meaning of this section. Section 1.402(a)-1(a)(2) of the regulations provides that a distributee must include in gross income the cash value of any retirement income, endowment, or other life insurance contract at the time of the distribution. Section 1.72-16(c)(2)(ii) of the regulations indicates that the reserve accumulation in a life insurance contract constitutes the source of and approximates the amount of such cash value.

Individuals who receive an insurance policy as a distribution from a qualified plan use the stated cash surrender value of the policy as its fair market value for purposes of determining the amount includible in their gross income under section 402(a) of the Code. However, this practice is not appropriate where the total policy reserves, including life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the fair market value of

the policy than does the policy's stated cash surrender value. These circumstances are illustrated by the following example.

A is a participant in a qualified noncontributory defined benefit plan. On January 1, 1986, \$400,000 of plan assets were used to purchase an insurance policy. The policy was distributed to A on January 1, 1988, two years after the date of purchase.

The policy provides a stated cash surrender value for each of the first five policy years, as set forth in the table below. The total end of year reserves held by the insurance company for the policy also are set forth in the table. These reserves may include life insurance reserves and any reserves for advance premiums, dividend accumulations, etc. Life insurance reserves, if any, are calculated using the rules in section 807(d) of the Code, which provides rules for determining the amount of those reserves for purposes of calculating the tax liability of the insurance company issuing the policy.

Year	Surrender Value	Reserves
1	\$106,000	\$406,949
2	\$112,360	\$426,596
3	\$119,102	\$447,052
4	\$126,248	\$468,178
5	\$489,908	\$489,908

As the total reserves for the policy at the end of year two, \$426,597, substantially exceed the policy's cash surrender value, \$112,360, the reserves represent a much more accurate approximation of the fair market value of the policy when distributed than does the policy's cash surrender value. Accordingly, the amount includible in A's gross <Page 666> income by reason of the distribution of the policy at the end of year two is an amount equal to the \$426,597 reserve, not the \$112,360 stated cash surrender value at that date.

In the case of a distribution in excess of A's accrued benefit, as defined in section 1.411(a)-7(a)(1) of the regulations, resulting from valuing the policy at \$112,360 rather than \$426,547, the distribution would not be treated as a distribution to A from a qualified plan and, depending upon the facts and circumstances of the case, could be treated as a reversion to the employer. Of course, depending on the facts and circumstances, such distributions could disqualify the plan because they raise a number of qualification issues under, for example, section 415 of the Code, limitations on benefits and contributions, section 401(a) requirements that benefits be definitely determinable, and section 401(a)(4), discrimination in contributions and benefits, particularly if A was a member of the group of employees in whose favor discrimination is prohibited and other employees were not provided with similar distributions.

Q-11: Does the 10-percent tax under section 72(t) apply to amounts that are included in a plan participant's gross income pursuant to section 72(m)(3)?

A-11: No. Section 72(m)(3) provides generally that employer contributions and trust income that are treated under regulations as having been applied to the purchase of life insurance protection for a plan participant must be included in the participant's gross income. However, such an amount is not treated as a distribution for purposes of section 72(t).

Q-12: In the case of an IRA or individual account plan, what constitutes a series of substantially equal periodic payments for purposes of section 72(t)(2)(A)(iv)?

A-12: Section 72(t)(1) imposes an additional tax of 10 percent on the portion of early distributions from qualified retirement plans (including IRAs) includible in gross income. However, section 72(t)(2)(A)(iv) provides that this tax shall not apply to distributions which are

part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and beneficiary. Section 72(t)(4) provides that, if the series of periodic payments is subsequently modified within five years of the date of the first payment, or, if later, age 59½, the exception to the 10 percent tax under section 72(t)(2)(A)(iv) does not apply, and the taxpayer's tax for the year of modification shall be increased by an amount, determined under regulations, which (but for the 72(t)(2)(A)(iv) exception) would have been imposed, plus interest.

Payments will be considered to be substantially equal periodic payments within the meaning of section 72(t)(2)(A)(iv) if they are made according to one of the methods set forth below.

Payments shall be treated as satisfying section 72(t)(2)(A)(iv) if the annual payment is determined using a method that would be acceptable for purposes of calculating the minimum distribution required under section 401(a)(9). For this purpose, the payment may be determined based on the life expectancy of the employee or the joint life and last survivor expectancy of the employee and beneficiary.

Payments will also be treated as substantially equal periodic payments within the meaning of section 72(t)(2)(A)(iv) if the amount to be distributed annually is determined by amortizing the taxpayer's account balance over a number of years equal to the life expectancy of the account owner or the joint life and last survivor expectancy of the account owner and beneficiary (with life expectancies determined in accordance with proposed section 1.401(a)(9)-1 of the regulations) at an interest rate that does not exceed a reasonable interest rate on the date payments commence. For example, a 50 year old individual with a life expectancy of 33.1, having an account balance of \$100,000, and assuming an interest rate of 8 percent, could satisfy section 72(t)(2)(A)(iv) by distributing \$8,679 annually, derived by amortizing \$100,000 over 33.1 years at 8 percent interest.

Finally, payments will be treated as substantially equal periodic payments if the amount to be distributed annually is determined by dividing the taxpayer's account balance by an annuity factor (the present value of an annuity of \$1 per year beginning at the taxpayer's age attained in the first distribution year and continuing for the life of the taxpayer) with such annuity factor derived using a reasonable mortality table and using an interest rate that does not exceed a reasonable interest rate on the date payments commence. If substantially equal monthly payments are being determined, the taxpayer's account balance would be divided by an annuity factor equal to the present value of an annuity of \$1 per month beginning at the taxpayer's age attained in the first distribution year and continuing for the life of the taxpayer. For example, if the annuity factor for a \$1 per year annuity for an individual who is 50 years old is 11.109 (assuming an interest rate of 8 percent and using the UP-1984 Mortality Table), an individual with a \$100,000 account balance would receive an annual distribution of \$9,002 ( $\$100,000/11.109 = \$9,002$ ).

Q-13: Will the Service grant automatic approval of a change in valuation date for certain plans maintained by partnerships, S corporations, and personal service corporations (hereinafter referred to a "employers") that change their taxable year pursuant to section 806 of TRA '86?

A-13: Yes, provided certain requirements are met. A change in valuation date is a change in funding method requiring approval by the Internal Revenue Service. If a change in plan year is made in order for the plan year to continue to coincide with the employer's new taxable year, the plan's valuation date may be changed, without requesting prior approval from the Service, provided the requirements set forth below are satisfied.



1. The employer's taxable year and the plan year must coincide both before and after the change in taxable year.
2. The plan's valuation date is either the first day of the plan year or the last day of the plan year, both before and after any change in plan year. For example, if the valuation date was the first day of the plan year before any change in plan year, the plan must continue to use the first day of the plan year, including the first day of the short plan year, as the valuation date after the change in plan year.
3. The employer's taxable year was changed to comply with section 706 of the Code, as amended by section 806 of TRA '86.
4. The principles regarding the creation and maintenance of amortization bases stated in section 4 of Rev. Proc. 85-29, 1985-1 C.B. 581, must be followed.
5. There must be attached to the Schedule B for the plan year of change a statement signed by the plan administrator (within the <Page 667> meaning of section 414(g) of the Code) or an authorized representative of the plan sponsor stating that the plan administrator or plan sponsor agrees to the change in funding method.

A change in valuation date made pursuant to the requirements described above constitutes a change in funding method in determining whether Rev. Proc. 85-29 may be used in future plan years. If the change is made as part of an overall process to conform the plan year to a new calendar taxable year adopted by the employer pursuant to section 806 of TRA '86, the change in valuation date will be timely if all the requirements for change in valuation date specified in Rev. Proc. 85-29 are satisfied by the later of the time for filing the employer's tax return for the year ended December 31, 1987, or [sixty days after the date of publication of this Notice in the Internal Revenue Bulletin] and all the requirements under Rev. Proc. 87-27, 1987-1 C.B. 769, for automatic approval of a change in plan year are satisfied by August 26, 1988 (See Announcement 88-97, 1988-26 I.R.B. 47).

#### Reliance

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.