MASSACHUSETTS PERAC

TAXATION
AND
REPORTING REQUIREMENTS
WORKBOOK

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TABLE OF CONTENTS

I. INTRODUCTION 1

II. SUMMARY OF FEDERAL TAXATION LAW 1

A. Code § 72 Taxation Rules 1

1. General Income Tax Rules 1
2. Historic Basis Recovery Rules 1
3. Current Basic Recovery Rule: Revised Simplified Method 3
4. Annuity Starting Date 4
5. Duration of Basis Recovery 5
6. Lump Sum Payments 5
7. Importance of Basis Recovery Calculation for 1099-R Reporting 6
8. Premature Distribution Tax 6

B. Taxation of Disability Benefits 8

1. Disability Benefits in the Nature of Workers' Compensation 8
2. Other Disability Benefits 9

C. Taxation of Death Benefits 9

1. $5,000 Death Benefit Exclusion 9
2. Death Benefits in the Nature of Workers' Compensation 9
3. Exclusion Under Code Section 101(h) 10

D. Application of Taxation Rules to Chapter 32 Disability and Death Benefit Provisions 11

1. Section 6, Ordinary Disability 11
2. Section 7, Accidental Disability 11
3. Section 12, Regular Death Benefit for Active Members 12
4. Section 9, Accidental Death Benefits 12
5. Section 100, Firefighter and Police Officer Accidental Death Benefits 12
6. Section 101, Death of Disabilitant Who was on Accidental Disability 13

III. SPECIAL LUMP SUM DISTRIBUTION RULES 13

A. Introduction 13

B. 10 Year Averaging 14

C. Capital Gains Treatment 15

IV. REPORTING ON QUALIFIED DOMESTIC RELATIONS ORDERS 15

A. Definitions under the Code 15

B. Governmental Plans Conditions 15

C. Importance of QDRO Status 16

1. Qualification 16
2. Administrative Compliance 16
3. Taxation 16

D. Tax Treatment for Members and Alternate Payees 16

1. Taxation 16
2. Basis Recovery....17
3. Rollover Rights 17
4. Early Distribution Tax 17
5. Form 1099-R Reporting....17
6. Duty-Related Benefits to Alternate Payees....17

V. ROLLOVER RULES 19

A. Eligible Rollover Distributions 19

B. Eligible Retirement Plan 20

1. Direct Rollovers – Member and Spouse 20
2. Indirect Rollovers....21
3. Non-Spouse Beneficiary 21

VI. WITHHOLDING REQUIREMENTS – GENERAL RULES....21

A. General Withholding: Nonperiodic Distributions....21

B. General Withholding: Periodic Distributions 21

C. Withholding from Eligible Rollover Distributions 21

D. Administrative Responsibility for Withholding....22

VII. FORM 1099-R REPORTING REQUIREMENTS....22

A. Annual 1099-R Reporting Requirements....22

B. 1099-R Reporting Requirements for Boxes 1, 2a, and 5, Form 1099-R 22

C. 1099-R Reporting Requirements for Box 3, Form 1099-R 23

D. 1099-R Reporting Requirements for Box 4, Form 1099-4 23

E. 1099-R Reporting Requirements for Box 6, Form 1099-R 23

F. 1099-R Numerical Code Requirements for Box 7, Form 1099-R 23

G. 1099-R Alpha Codes Requirements for Box 7, Form 1099-R............................... 24

H. 1099-R Reporting Code Requirements for Boxes 9a and 9b, Form 1099-R 25

I. 1099-R Boxes 10-15 25

VIII. GENERAL INCOME TAX WITHHOLDING AND REPORTING RULES - FOR NON-RESIDENT ALIENS WITH TAXABLE INCOME 25

A. General Withholding for Non-Resident Aliens 26

B. Reporting Distributions to Nonresident Aliens.. 26

1. Reporting Distributions and Tax Withheld on Form 1042-S 26
2. Form 1042 Annual Return 27

IX. TAXATION AND REPORTING OF BENEFITS UNDER CH. 41, § 111f 27

MEMORANDUM

TO: Massachusetts Public Employee Retirement Administration Commission ("PERAC")

FROM: Ice Miller LLP (Mary Beth Braitman, Lisa Erb Harrison)

DATE: December 16, 2011

RE: Federal Taxation and Form 1099-R Reporting Requirements

I. INTRODUCTION

The purpose of this memorandum is to review and analyze the various income tax, withholding, and reporting requirements of the Internal Revenue Code ("Code"), including amendments made by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and the Pension Protection Act of 2006 ("PPA") that apply to distributions made by retirement systems under Chapter 32 of the Massachusetts General Laws. The Memorandum includes a general discussion of the income tax rules, basis recovery requirements, rollover rules, withholding requirements, and the coding and reporting requirements that apply to distributions under Chapter 32. Each of these subjects are presented separately below. In addition, we have attached a chart providing Form 1099-R reporting guidance with respect to the different benefits payable under Chapter 32.

II. SUMMARY OF FEDERAL TAXATION LAW

A. Code § 72 Taxation Rules.

1. General Income Tax Rules. The principal advantage of maintaining a tax-qualified retirement plan that satisfies the requirements under Code Section 401(a) involves the deferral of all income taxes on the amounts contributed by the employer to the plan. This tax deferral also applies to the income associated with the trusted assets and remains in effect until benefits are actually distributed to members and their beneficiaries. Code Section 402(a) controls the timing for the inclusion in taxable income of amounts distributed from qualified plans and contains specific exceptions and special rules regarding the income tax treatment for such distributions. Code Section 72 contains the principal provisions regarding the general income tax rules that apply to distributions from tax-qualified plans. Generally speaking, distributions from qualified retirement plans are taxed as ordinary income tax rates to the extent the distribution does not represent a return of the member's after-tax contributions (i.e., contributions that were included in the member's taxable income at the time the contributions were made). These after-tax contributions are referred to as the member's "tax basis" or "investment in the contract."

2. Historic Basis Recovery Rules. Distributions from qualified plans and tax sheltered annuity programs are subject to taxation under Code § 72 as annuities if the

distributions are payable at regular intervals over more than a one-year period measured from the annuity starting date. Code § 402(a); Treas. Reg. §§ 1.72-1(b)-(c) and 1.72-2(b)(2)-(3). The basic rule under Code § 72 is that the taxpayer is allowed to recover the member's tax basis (the aggregate amount of after tax contributions the member contributed to the fund) over the expected life of the benefit. Please note, however, that any member who has all contributions picked up by their employer and who has not purchased any additional service with after-tax dollars will not have a cost basis. Therefore, under these circumstances, the entire amount of all distributions paid to such members will be taxable. For those members who have made after-tax contributions (which were not picked up by their employer) or who purchased additional service credit with after-tax dollars, the portion of each annuity payment which is tax-free must be determined.

There are essentially three methods that affect pre-1998 benefit commencements -- (1) the General Rule, (2) the Simplified General Rule, and (3) the Simplified Method. We want to briefly note these because plans will likely have members with commencement dates where they are applying these methods.

a. General Rule. Under the General Rule, the overall value of the annuity is determined by reference to annuity tables contained in Treas. Reg. § 1.72-9 and reproduced in IRS Publication 939. The regulation contains several different annuity tables. Tables I through IV apply only to situations in which all investments were made prior to July of 1986. Tables V through VIII apply if any investment was made in July 1986 or later. Members with contributions both before and after June 30, 1986 may elect to use both the new and the old annuity tables to figure the proportionate expected return of their annuities. (Applying the old annuity tables for the pre-July 1986 contributions and the new tables for the post-June 1986 contributions.) The amount of each benefit that is applied to a member that is tax-free is determined by multiplying the member's "exclusion ratio" to each payment. The exclusion ratio is determined by dividing the member's total cost basis (i.e., the aggregate amount of after-tax contributions that were not picked-up by an employer) by the expected value of the member's total benefit as determined from the annuity tables.

Adjustments then are made to the exclusion ratio for special features such as refunds, which can occur either as a "pop-up" where there is a guarantee of the recovery of a member's contributions, or where there is a guarantee of a certain total stream of benefits. Treas. Reg. § 1.72-2(a). The methodology requires a reduction of the investment in the contract. There are also special rules for determining the expected return of a survivor annuity which pays a different benefit to the survivor. Where the survivor benefit is lower than the annuity for the primary annuitant, the annuity for the primary annuitant is treated as a life annuity and the difference between the two amounts is treated as a temporary life annuity, which is subtracted from the life annuity. If the situation is reversed, such that the benefit increases for the survivor, the lower amount is treated as the life annuity and the higher amount is treated as a temporary annuity; the two amounts are combined to determine the total return for the contract.

b. Simplified General Rule or "Safe Harbor". IRS Notice 88-118, 1988-2 C.B. 450, created a safe harbor for applying Code § 72(b). The safe harbor method is available as an alternative to the General Rule discussed above for taxpayers whose annuity payments began after July 1, 1986 and who met three criteria. The annuity payments had to (i) be paid over the life of the member or the joint lives of the member and his or her beneficiary; (ii) be from a qualified plan, an employee annuity, or a tax-sheltered annuity; and (iii) begin before the member attained age 75 or, if payments began after age 75, contain a guaranteed payment period of less than five years. (If payments begin after age 75 and the annuity payments are guaranteed for at least five years, the General Method must be used.) This safe harbor method contains simplified methods for calculating the exclusion ratio by allowing the use of alternative methods of calculating the expected number of payments and the total investment in the contract. This safe harbor became in part the basis for the Simplified Method described below.[1]

c. Simplified Method. The Small Business Job Protection Act ("SBJPA") amended Code § 72 to provide for the Simplified Method of basis recovery. The Simplified Method is available for taxpayers whose annuity starting date is after November 18, 1996 and before January 1, 1998. Under this method, no exclusion ratio is calculated. Rather, a taxpayer recovers his or her total cost basis in a prescribed number of installments based on his or her age. The resulting amount is the amount that is recovered from each payment. (However, the General Method must be used if payments begin after age 75 and the annuity contains a guaranteed period of at least five years.) The age of the primary annuitant is used to determine the assumed number of payments regardless of whether the member receives a single or joint life annuity, and there is no adjustment for a refund feature. If the taxpayer receives a lump sum in connection with the commencement of the annuity payments, the lump sum is taxed under Code § 72(e) and the investment in the contract is determined as if the payment was received before the annuity starting date (allowing a pro rata portion of basis to be recovered from the lump sum).

3. Current Basic Recovery Rule: Revised Simplified Method. The Revised Simplified Method was enacted by the Taxpayer Relief Act of 1997 ("TRA '97") and applies to taxpayers whose annuity starting date is after December 31, 1997. The amount of basis that is recovered each month is calculated in a manner similar to the Simplified Method and, for single life annuities, the same result is obtained. However, for joint annuitants, the Revised Simplified Method uses a larger expected number of payments in calculating the amount of basis to be recovered from each payment by basing this number on the combined ages of the annuitants. IRS Notice 98-2; Code § 72(d)(1)(B)(iv). The IRS guidance in Notice 98-2 addresses certain particular fact situations:

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[1] The Simplified General Rule is referenced in the handwritten notes on the sample Form 1099-Rs PERAC provided to Ice Miller. We do want to make sure that the appropriate recovery method is being used, based upon the applicable annuity starting date as discussed herein. The Revised Simplified Method would be correct for new benefit commencements.

- When two or more annuitants receive payments at the same time, each annuitant should exclude a pro-rata portion of the tax-free amount which is determined by dividing the amount of the annuitant's annuity payment by the total amount of the monthly payments to all annuitants receiving payments under the contract.

- When an annuity is not contingent on the life expectancy of any individual, the expected number of payments equals the number of monthly payments under the contract.

- The combined ages of the annuitants is the sum of the age of the primary annuitant (the oldest survivor when there is no primary annuitant) and the youngest survivor annuitant.

- The dollar amount determined as of the annuity starting date is excluded from each monthly annuity payment, even where the amount of the annuity payments change. Common examples include post-retirement COLAs or a change in a survivor annuity upon the death of one of the annuitants.

- Where annuity payments are not made on a monthly basis, appropriate adjustments must be made. For example, if a quarterly payment is made, the expected number of payments could be divided by 3.

NOTE: A Transition Rule applies to taxpayers with an annuity starting date after November 18, 1996 and before January 1, 1997. The Transition Rule allows these taxpayers to calculate the basis-recovery portion of the payments based on the pre-SBJPA rules, including the Safe Harbor Method. However, this Rule only applies to those payments received in 1996 or 1997. If this Transition Rule is applied for 1996 and 1997, a special Transition Method applies to payments received after 1997. Under the Transition Method, the taxable and tax-free portions must be redetermined as of January 1, 1998, although the taxpayer may elect to apply this Transition Method as of an earlier date. Upon redetermination, the expected number of future payments is the number calculated under the Revised Simplified Method as of the annuity starting date minus the number of payments actually received prior to redetermination. Likewise, the remaining investment in the contract is calculated to be the total investment in the contract minus the amount actually recovered tax-free prior to redetermination. The tax-free amount recovered from payments after redetermination is the remaining investment in the contract divided by the expected number of future payments.

4. <u>Annuity Starting Date</u>

For purposes of determining the applicable basis recovery amount, Code § 72(c)(4) defines "annuity starting date" in the case of any annuity contract as ". . . the first day of the first period for which an amount is received as an annuity under the contract; except that if such date was before January 1, 1954, then the annuity starting

date is January 1, 1954." The accompanying regulations provide that the "first day of the first period for which an amount is received as an annuity" is the later of:

- The date upon which the obligations under the contract became fixed, or
- The first day of the period (year, half year, quarter, month, or otherwise, depending on whether payments are to be made annually, semiannually, quarterly, monthly, or otherwise) which ends on the date of the first annuity payment.

See Treas. Reg. § 1.72-4(b)(1).

5. Duration of Basis Recovery

a. Benefits Commencing After December 31, 1986. Under each recovery rule for benefits commencing after December 31, 1986, the tax free portion is limited to the total actual cost basis of the taxpayer. If the taxpayer dies before having fully recovered his or her basis and there is no survivor annuity provision, a deduction for the amount of the unrecovered basis is allowed on his or her final tax return. If the taxpayer dies before having fully recovered his or her basis and there is a survivor annuity provision, the survivor will continue recovering the remaining basis. Code § 72(d)(1)(B)(ii); Code § 72(b)(3); Notice 98-2.

b. Benefits Commencing Before January 1, 1987. For annuities commencing prior to January 1, 1987, the portion of each annuity payment which is non-taxable remains the same for the duration of the annuity, even if more than the entire amount of the taxpayer's basis is recovered. IRS Publication 575, pg. 12 (2010). Conversely, if the taxpayer dies before recovering all of his or her basis, his or her estate is not allowed to deduct the remainder on his or her final tax return. Id.

6. Lump Sum Payments

The SBJPA includes a specific rule with respect to lump sum distributions paid in connection with the commencement of a monthly pension. Code Section 72(d)(1)(D) provides that, if a member receives a lump sum payment in connection with the commencement of a monthly pension, the lump sum payment is taxed under Code Section 72(e) and the member's basis in the pension will be calculated after taking into account the lump sum payment. Code Section 72(e)(2), which applies to nonannuity payments made before the annuity starting date, requires the payment to be included in gross income except to the extent allocable to the member's investment in the contract. Code Section 72(e)(8)(B) provides that the portion of the payment that is allocable to the member's investment in the contract equals the product of the entire amount of the distribution multiplied by a fraction, the numerator of which equals the member's basis/investment in the contract and the denominator equals the total value of the

member's vested benefit payable (including the lump sum and the value of all annuity payments).

7. Importance of Basis Recovery Calculation for 1099-R Reporting

In general, if a distribution consists of both taxable and nontaxable amounts, the payor (i.e., a qualified plan) must report the gross distributions and separately report the taxable amount and the employee contributions recovered tax free during the year. Rev. Proc. 92-86, § 3.01. This reporting is done on Form 1099-R. Code § 6047.

8. Premature Distribution Tax. Code Section 72(t) imposes an additional ten percent (10%) premature distribution tax on certain distributions that are paid to members. This tax is in addition to the ordinary or other applicable income tax that applies to the distributed amount.

a. Importance of Premature Distribution Tax for Form 1099-R. The recipient of the premature distribution, not the qualified plan, is liable for this tax. The member reports the early distribution tax on IRS Form 5329, which is then filed in conjunction with the member's regular income tax return. See IRS Form 5329 and the instructions thereto. However, a qualified plan must properly code premature distributions when preparing IRS Form 1099-R. We will cover this coding below.

b. Exceptions to the Premature Distribution Tax. The premature distribution tax does not apply to:

(1) distributions made after the date the member attains 59½;
(2) distributions made after the member's death;
(3) distributions attributable to the member's disability;[2]
(4) substantially equal periodic payments commencing after the member separates from service and payable over the life (or life expectancy) of the member or the joint life (or joint life expectancy) of the member and member's designated beneficiary;
(5) distributions made to a member who separates from service after attainment of age 55 (for a public safety employee in a governmental defined benefit plan, age 50);
(6) (if permitted by the plan) distributions used by the member to pay significant medical expenses (medical expenses which exceed 7.5% of the member's adjusted gross income);

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[2] We note that under the disability exclusion of Code Section 72(t)(2)(A)(iii), a disability is defined by reference to Code Section 72(m)(7). See also Form 1099-R Instructions (2011), references Code Section 72(m)(7) for use of code 3 in Box 7. The definition of disability under Code Section 72(m)(7) is similar (though not identical) to the Social Security definition under 42 U.S.C. § 1382c(a)(3)(A)-(B). Thus, some systems use a disability determination by Social Security as a basis for using code 3 in Box 7, while others use a code 3 for all disability determinations. If a system decides to limit the use of code 3 to disabilities meeting the Code or Social Security definition, a monthly benefit would could still be coded 2 in Box 7 under the substantially equal periodic payment exceptions.

(7) distributions to an alternate payee pursuant to a qualified domestic relations order. Code § § 72(t)(2) and 72(t)(3)(B);

(8) dividends paid with respect to stock of a corporation which are described in Code Section 404(k); and/or

(9) distributions made on account of a levy under Code Section 6331 on the qualified retirement plan.

Generally speaking, these exceptions are self-explanatory. Our experience in this area, however, indicates that most questions relate to the exceptions applicable to substantially equal periodic payments, distributions payable after attaining age 55, and distributions under a federal tax levy. As a result, the remaining information in this subsection provides additional information regarding these three exceptions.

i. **Substantially Equal Periodic Payment Exception.** Code Section 72(t)(2)(iv) provides that the 10% premature distribution tax does not apply to a series of substantially equal periodic payments that are paid not less frequently than annually for the life or life expectancy of the member, or the joint lives or joint life expectancies of the member and his or her designated beneficiary. Code Section 72(t)(4) imposes a recapture tax if the series of equal payments is subsequently modified within five years of the date of the first payment or, if later, before the employee attains age 59½. Under the recapture provisions, the employee's tax in the year of the modification is increased by the amount of the 10% excise penalty that would have been imposed on all distributions to the member but for the exception under Code Section 72(t)(2)(A)(iv), plus interest from the time the first distribution was made.

ii. **Exception For Distributions Payable After Age 55.** Although Code Section 72(t)(2)(v) literally requires members to attain age 55[3] before separating from service to qualify for the exception from the premature distribution tax, guidance issued by the IRS permits a more favorable position to be followed for members who separate from service and attain 55 years of age later during the same calendar year. IRS Notice 87-13, Q&A-20 and IRS Publication 575 expand this exception so that the premature distribution tax does not apply to distributions made after the member separates from service if the separation occurs during or after the calendar year in which the member reached age 55. See also IRS Notice 2009-68, 2009-39 I.R.B. 423 (2009) (safe harbor rollover notice permitting this interpretation). This rule is also applicable to the public safety employee age 50 exception.

[3] The participant is not liable for 10% early withdrawal penalty only if, after he attains age 55, he withdraws funds from the employer's qualified plan. If the participant rolls the funds over to an IRA first and then withdraws from the IRA, he will be liable for the 10% tax unless one of the exceptions under Code § 72(t) applies.

iii. **Exception for Distributions on Account of IRS Levy.** The 10-percent tax on premature distributions will not apply to distributions made on account of an IRS levy on a taxpayer's qualified retirement plan. Code Section 72(t)(2)(A)(vii). However, the exception does not apply when the IRS has not levied upon the taxpayer's retirement plan and the taxpayer withdraws funds to pay taxes in order to avoid a levy or obtain a release of a levy on other interests. Committee Report No. 105-599.

B. Taxation of Disability Benefits.

1. Disability Benefits in the Nature of Workers' Compensation. Code Section 104(a)(l) provides that gross income does not include amounts received under workers' compensation acts as compensation for personal injuries or sickness. Treas. Reg. § 1.104-1(b) provides that Code Section 104(a)(1):

> excludes from gross income amounts which are received by an employee under a workmen's compensation act. . . or under a statute in the nature of a workmen's compensation act which provides compensation to employees for personal injuries or sickness incurred in the course of employment.

(emphasis added).

Treas. Reg. § 1.104-1(b) further provides that the Code Section 104(a)(1) exclusion does not apply to a retirement or pension annuity to the extent that it is determined by reference to the employee's age, length of service, or prior contributions.

The IRS has taken the position in several published revenue rulings that a statute which authorizes the payment of disability benefits to a class of employees who are injured in the line of duty or within the scope of employment qualifies as a statute in the "nature of a workmen's compensation act." See, e.g., Revenue Ruling 85-104, 1985-2 C.B. 52; Revenue Ruling 85-105, 1985-2 C.B. 53; Revenue Ruling 80-14, 1980-1 C.B. 33; Revenue Ruling 80-44, 1980-1 C.B. 34; Revenue Ruling 80-84, 1980-1 C.B. 35.

The United States Tax Court has followed the IRS' interpretation of Code Section 104(a)(1) and Treas. Reg. § 1.104-1(b) and has held that in order for a statute to be in the "nature" of a worker's compensation act, such statute must expressly provide "payments solely for personal injuries or sickness incurred in the course of employment." Clifford v. Com'r., 48 T.C.M. 524, 525 (1984) (emphasis ours). See also Kane v. U.S., 43 F.3d 1446,1449 (CA Fed. Cir. 1994) aff'g 28 Fed. Cl. 10 (1993); Benjamin v. Com'r, 66 T.C.M. 1488 (CCH)(1994); Weidmaier v. Com'r, 48 T.C.M. 1350 (CCH)(1984), aff'd 774 F.2d 109 (6th, Cir. 1985); Haar v. Com'r., 78 T.C. 864, aff'd per curium, 709 F.2d 1206 (8th Cir. 1952); Riley v. United States, 156 F. Supp. 751 (Claims Ct. 1957).

> Based on the foregoing analysis, the position of the IRS and the Federal Courts with respect to Code Section 104(a)(1) is clear: In order for a statute to be considered in the "nature" of a workmen's compensation act, such statute must expressly provide benefits to a class of employees which is restricted to those employees who are injured in the line of duty or within the scope of employment, and benefits cannot be measured by the same years and use the same formula as used to calculate regular retirement benefits.

2. Other Disability Benefits. For non-line-of-duty benefits, two situations must be considered -- pre-and post-retirement disability payments. Employer contributions to a retirement plan on behalf of employees to provide accident or health benefits, including disability payments, are specifically dealt with in Treas. Reg. § 1.72-15. These contributions are never treated as contributions for retirement benefits and are governed instead by the provisions of the Code relating to accident and health benefits, i.e., Code §§ 104 (governing retirement benefits in the nature of workman's compensation) and 105 (governing the taxability of amounts received for personal injuries and sickness). Treas. Reg. § 1.72-15(b). Employer contributions allocable to health and accident benefits do not become a part of the employee's basis for retirement benefits.[4] Treas. Reg. § 1.72-15(c). The position of the IRS, as communicated in Publication 575, is that basis recovery under a disability retirement annuity may not begin until the taxpayer reaches minimum retirement age, (i.e., the age at which the member could first begin to receive annuity or pension payments without being disabled). IRS Publication 575, pg. 5. Therefore, depending on the facts and circumstances applicable to each applicant for disability benefits, basis recovery would begin based on the member's earliest retirement date under the applicable statutory provisions.

> For benefits payable due to a disability not sustained in the course of employment, payments are treated as ordinary income until the individual reaches the earliest retirement age under the plan. These payments are subject to income tax and withholding, and the individual should complete a Form W-4P to make the appropriate withholding elections.
>
> After the individual reaches his earliest retirement age under the plan, the benefits are taxed under Code § 72, and basis is recoverable.

C. Taxation of Death Benefits.

1. $5,000 Death Benefit Exclusion. Benefits payable to the beneficiaries of members who died prior to August 21, 1996, were eligible for the special employer-provided death benefit exclusion under Code Section 101(b). This provision was repealed as part of the SBJPA, effective for deaths that occur after August 20, 1996.

2. Death Benefits in the Nature of Workers' Compensation. The Code Section 104(a)(1) exclusion described above will also apply to benefits for death in the line of duty. Treas. Reg. § 1-104-1(b). See, e.g., Rev. Rul. 80-44, 1980-1 C.B. 34. This

[4] Where all employee contributions have been picked up by the employer, basis recovery is not an issue.

most frequently arises where there is a line of duty death benefit that would not be payable in the event of a "regular" in-service death.

3. **Exclusion Under Code Section 101(h).** TRA '97 added to Code § 101(h) a federal income tax exclusion for certain death benefits for "public safety officers" killed in the line of duty.

a. The exclusion **applies**:

- If a survivor annuity is provided by a qualified (401(a)) plan to the spouse, former spouse, or a child of the officer.
- To the extent the annuity is attributable to the officer's service as a public safety officer.

b. The exclusion does **not apply** if:

- The death was caused by the intentional misconduct of the officer or by such officer's intention to bring about such officer's death.
- The officer was voluntarily intoxicated at the time of death.
- The officer was performing such officer's duties in a grossly negligent manner at the time of death.
- The payment is to an individual whose actions were a substantial contributing factor to the death of the officer.

c. Definition of "public safety officer"

A public safety officer includes an individual serving a public agency in an officer capacity, with or without compensation, as a law enforcement officer, a firefighter, a rescue squad, or an ambulance crew.

d. Effective Date

The exclusion originally applied to amounts received in tax years beginning after December 31, 1996, for officers dying after that date. TRA '97 § 1528(a); Code § 101(h). The Fallen Hero Survivor Benefit Fairness Act, enacted June 15, 2001, extends the favorable tax treatment described above in the case of public safety officers who were killed in the line of duty on or before December 31, 1996, for amounts received in tax years beginning after December 31, 2001.

D. Application of Taxation Rules to Chapter 32 Disability and Death Benefit Provisions. Below we have set forth the various disability and death benefit provisions under Chapter 32, along with our general analysis with respect to the appropriate tax treatment of these benefits. A private letter ruling request is being prepared for filing to confirm the appropriate tax treatment of these benefits.

1. Section 6, Ordinary Disability. Section 6 provides a non-duty related monthly allowance equal to the normal retirement benefit under Section 5 for a member payable upon attaining age 55, based upon the member's service at the time of disability. The allowance may not exceed four-fifths of: (i) the average annual rate of the member's regular compensation during any period of three consecutive years of highest compensation, and (ii) the average annual rate of regular compensation received by the member during the period his last three years of creditable service preceding retirement, whichever is greater. This allowance may be paid under the normal retirement payment options of Sections 12.

For members who are veterans, the allowance is the amount of the regular life annuity under Section 12(2)(a)(i), which is the actuarial equivalent of the value of the member's accumulated deductions, and a yearly pension equal to half the average annual rate of the member's compensation, or, if the member is at least 55, the pension is no less than the amount the member would be entitled to receive upon normal retirement under Section 5.

Because these benefits are not paid under a statute that provides for duty-related benefits, they would be treated as taxable income, with basis recovery available upon attaining age 55.

2. Section 7, Accidental Disability. Section 7 provides a duty-related benefit equal to: (i) an annual annuity equal to the amount of the regular life annuity under Section 12(2)(a)(i), which is the actuarial equivalent of the value of the member's accumulated deductions; and (ii) an annual pension equal to 72% of the annual rate of the member's regular compensation on the date the member became disabled or the annual rate of the member's regular compensation for the 12 months prior to his retirement, whichever is greater. The retirement allowance may be paid under one of the normal retirement payment options of Section 12. If the member was not a member in service on or before January 1, 1988 or has not been continuously a member in service since that date, the total yearly amount of the sum of the pension and the annuity may not exceed 75% of the annual rate of the member's regular compensation.

In addition, an annual pension in the amount of $450 (subject to cost of living increases) is payable for any surviving unmarried child of a member receiving accidental disability who is under age 18 or, if over that age and under age 22, is a full-time student at an accredited educational institution, or who was over this age limit and physically or mentally incapacitated from earning on the date of the member's retirement.

A member who is a veteran receives an additional retirement allowance of $15 for each year of service, not to exceed $300.

The member's annual pension benefit should be treated as a benefit payable under a statute in the nature of a worker's compensation act, and therefore the annual pension equal to 72% of compensation would be nontaxable. However, the annuity attributable to the member's accumulated deductions should be taxable, because it is based on the member's prior contributions, subject to basis recovery being available at age 55.

The annual dependent allowance should also be treated as non-taxable, as it is paid as part of the duty-related benefit.

The additional benefit for a veteran is based upon years of service and, thus, should be taxable, subject to basis recovery at age 55. As discussed in our May 18, 2011 letter, we think that the survivor benefit that would be payable in the event an accidental disability retiree elects Option C should also be treated as non-taxable, to the extent it is attributable to the 72% pension portion, as a continuation of the member's duty-related disability benefit. Because this has not been the approach previously taken, then this position will be set forth in the private letter ruling request to confirm tax treatment.

3. Section 12, Regular Death Benefit for Active Members. Section 12(2)(d) permits a member to name beneficiaries for an active death situation. Section 12B provides if a member in service who dies with at least two full years of creditable service with a spouse of at least one year and eligible children, an additional allowance of $120/month for first child and $90/month for each additional child (with overall limits) is payable. This section also provides for children's payments without a spouse. These benefits would be taxable as they are not limited to duty related deaths.

4. Section 9, Accidental Death Benefits. If a member in service dies as a result of a duty-related injury, the member's dependent beneficiary or beneficiaries are entitled to receive: (1) the amount of any accumulated total deductions to the member's credit, and (2) an accidental death benefit allowance equal to 72% of the member's annual rate of compensation at the time of the injury or annual rate of compensation for the 12 month period he last received compensation immediately before his death, whichever is greater.

The accidental death benefit allowance would be excludable from taxable income as being paid under a statute in the nature of a worker's compensation act.

However, as the amount of accumulated deductions is based on the member's prior contributions, we think that lump sum payment would be treated as taxable, subject to basis recovery and any rollover treatment elected by the recipient. This payment would also not qualify for the Code Section 101(h) exclusion because it is not an annuity.

5. Section 100, Firefighter and Police Officer Accidental Death Benefits. If a firefighter or police officer covered under this section dies as a result of a duty-related injury, an annual pension is paid to the surviving spouse in an amount equal to the amount of salary which the firefighter or police officer would have received had he continued in service. If the member was a member of a contributory retirement system, any accumulated total deductions to the member's credit are also payable to the member's

surviving beneficiary or beneficiaries. The benefits payable to the surviving spouse are paid in the same manner as Section 9 accidental death benefits if the member was a member of a contributory retirement system.

The accidental death benefit allowance would be excludable from taxable income as being paid under a statute in the nature of a worker's compensation act, as well as under Code Section 101(h) if the member meets the definition of a public safety officer and none of the exceptions apply.

However, as the amount of accumulated deductions is based on the member's prior contributions, we think that lump sum payment would be treated as taxable, subject to basis recovery and any rollover treatment elected by the recipient. This would also not qualify for the Code Section 101(h) exclusion because it is not an annuity.

6. Section 101, Death of Disabilitant Who was on Accidental Disability. Section 101 provides for a spouse's death benefit of $6,000 or $9,000 (if participating employer has provided for $9,000). This benefit is paid instead of any other survivor benefit. This benefit is payable in the case of an eligible member on accidental disability or a member on ordinary disability who could not select a spouse's survivor benefit. This spouse's benefit, if paid to an accidental disabilitant as described under 2 above, would be excludable from taxable income as being paid as a continuation of the disabilitant's benefit under a statute in the nature of a worker's compensation act. This will be covered in the private letter ruling request. If paid to an ordinary disabilitant's spouse, it would be treated as taxable income, subject to basis recovery.

III. SPECIAL LUMP SUM DISTRIBUTION RULES

A. Introduction. As noted earlier, generally speaking, distributions from qualified retirement plans are taxed as ordinary income tax rates to the extent the distribution does not represent a return of tax basis. Special tax rules exist, however, for distributions that constitute "lump sum distributions" as defined in the Code. See Code § 402(d)(4)(B).[5] Depending on the facts and circumstances, the recipient of a "lump sum distribution" generally has several options regarding the income tax treatment associated with the distribution. The recipient may:

- rollover all or part of the distribution,
- treat the entire taxable portion of the distribution as ordinary income,
- elect forward income averaging (if applicable),
- report the portion of the distribution attributable to pre-1974 participation in the plan as a capital gain (if applicable) and report the amount attributable to post 1973 participation as ordinary income, or

[5] The citations to Code § 402(d) in this section are prior to the amendment of that Code Section by the SBJPA. A transition rule under Section 1401(c)(2) of the SBJPA preserved these Code provisions for individuals who remained eligible for these special rules under Section 1122(h)(3) or (h)(5) of TRA '86.

- report the portion of the distribution attributable to pre-1974 participation as capital gains and use the forward income averaging rules for the post-1973 portion of the distribution (if applicable).

The recipient of the distribution is ultimately responsible for the income taxes associated with the distribution. As a result, the recipient, not the qualified plan, must accept responsibility for properly calculating and determining the best method for computing the applicable amount of income tax on a lump sum distribution. The special income tax rules described in this section require the recipient to make an affirmative election to apply these rules. To make this election, the recipient must complete and file IRS Form 4972 and attach it to his or her federal income tax return for the tax year in which the distribution is paid. The instructions to IRS Form 4972 and IRS Pub. 575 provide additional information regarding the mechanics and details regarding these rules.

To qualify for forward income averaging and capital gains treatment, the distribution must constitute a "lump sum distribution." For this purpose, a "lump sum distribution" means a distribution paid within a single tax year that represents the payment of the member's entire balance from all of the employer's tax qualified pension plans. Code § 402(d)(4).[6] In addition, the distribution must be paid on account of death, after the member attains age 59½, or on account of separation from service. Code § 402(d)(4)(A). Certain limitations also apply. For example, the recipient is only permitted to make one election to apply the special tax rules for distributions payable after the member attains age 59½. Code § 402(d)(4)(B). In addition, under certain circumstances, amounts that would appear to otherwise qualify as a "lump sum distribution" will not be eligible for the special tax treatment. For example, unless the distribution is payable after the member's death, the member must have five or more years of participation in the plan to qualify for the forward income averaging and/or capital gains rules. Code § 402(d)(4)(F); Prop. Treas. Reg. § 1.402(e)-2(e)(3). Similarly, if the recipient elects to rollover a portion of the distribution, the remaining amount that is not rolled over will be ineligible for treatment as a "lump sum distribution." Code § 402(d)(4)(K). Finally, select portions of the distribution will not be included in the "lump sum distribution." For example, amounts distributed from a qualified plan if a previous distribution from the same plan (or the plan combined therewith for purposes of the lump sum distribution rules) was rolled over tax free to another qualified plan or IRA, are not treated as "lump sum distributions." See Code § 402(d)(4)(K).

B. 10 Year Averaging. If the member was born before 1936 (i.e., the member was 50 years of age or older on 1/1/86), the recipient of a "lump sum distribution" can choose to use ten-year forward income averaging to figure the income tax owed on the distribution. TRA '86, § 1122(h)(5).[7] See, e.g. IRS Pub. 575, pg. 20. The election and computation of the ten-year forward averaging tax is made by the recipient of the distribution on IRS Form 4972.

[6] For this purpose, distributions from different types of tax-qualified plans of the employer are treated separately. See Code § 402(d)(4)(C). For example, distributions made from the employer's tax-qualified pension plan are treated separately from the distributions made from the employer's tax-qualified defined contribution plan.

[7] This grandfathered transition rule was not affected by the SBJPA. In fact, the SBJPA included provisions that specifically state that the repeal of the five-year forward income averaging rules does not prohibit an eligible

C. Capital Gains Treatment. The Tax Reform Act of 1986 included two transition rules for capital gains treatment of "lump-sum distributions" from qualified retirement plans. A limited transition rule applied for distributions made before 1992. Under this rule, a percentage of the portion of the lump sum distribution attributable to the member's pre-1974 participation in the plan was treated as a "regular" long-term capital gain which could be offset by capital losses. See TRA '86, § 1122(h)(4). This transition rule was phased-out over a period of five years, beginning in 1987. As a result, this election has not been available for distributions paid after December 31, 1991.

For members who were born before 1936 (i.e., the member was 50 years of age or older on 1/1/86), the recipient of a "lump sum distribution" can elect to have the portion of the distribution that is attributable to pre-1974 participation in the plan treated as a capital gain taxed at a special flat rate of twenty percent. See TRA '86, § 1122(h)(3). This election can be combined with the ten-year forward income averaging rules for the remaining portion of the distribution (i.e., the portion of the distribution attributable to post-1973 participation in the plan). See, e.g. IRS Pub. 575, pgs. 19-20. Once again, the recipient of the distribution must affirmatively elect to apply these special tax rules by completing IRS Form 4972.

To enable eligible recipients to execute such an election, however, a qualified plan must properly report the portion of the distribution that is attributable to pre-1974 participation in the plan. This portion of the distribution should be reported in Box 3 on IRS Form 1099-R. See 1099-R Instructions, pgs. R-6, R-7. For this purpose, the amount attributable to pre-1974 participation is computed by multiplying the total taxable amount of the lump sum distribution by a fraction, the numerator of which is the number of months that the member actively participated in the plan prior to 1974 and the denominator for the fraction is the total months that the member actively participated in the plan. When computing the months of active participation, the Instructions to Form 1099-R specify that for years prior to 1974, twelve months are counted for any year or a portion of a year in which the member participated in the plan; and for years after 1973, one month is counted for any portion of a month in which the member participated in the plan.

IV. REPORTING ON QUALIFIED DOMESTIC RELATIONS ORDERS

A. Definitions under the Code. Code Section 414(p) defines the terms qualified domestic relations order ("QDRO") and "domestic relations order" ("DRO"). Code Section 414(p) provides that it does not apply unless Code Section 401(a)(13) applies. Code Section 401(a)(13) does not apply to governmental plans. However, Code Section 414(p) permits a governmental plan to avail itself of the QDRO taxation rules if the governmental plan makes a payment or distribution subject to the certain conditions.

B. Governmental Plans Conditions. The payment or distribution must be made pursuant to a DRO, which is defined as:

> Any judgment, decree, or order (including approval of a property settlement agreement) which —

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individual from electing the grandfathered ten-year forward income averaging and/or capital gains transition treatment offered under TRA '86, §§ 1122(h)(3) and (5)). SBJPA, § 1401(c)(2).

- relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant, and

- is made pursuant to a State domestic relations law (including a community property law).

The DRO must create or recognize "the existence of an alternate payee's right to . . . receive all or a portion of the benefits payable with respect to a participant under the plan."

The plan may only make payments under a DRO to an alternate payee, who is defined as

> Any spouse, former spouse, child or other dependent of a participant who is recognized by a domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to such participant.

C. Importance of QDRO Status. It is important for a payment made by a qualified governmental plan to a non-member to have QDRO status for a number of reasons.

1. Qualification. The first is that a plan "shall not be treated as failing to meet [the requirements of 401(a)] solely by reason of payments to an alternative payee" under a QDRO. Code Section 414(p)(10). This is very significant. From a general pension law standpoint, for example, if a payment has QDRO status, that should alleviate concerns about the exclusive benefit rule and the basic requirements that a retirement plan should be established to pay pension benefits.

2. Administrative Compliance. Secondly, from a benefits administration viewpoint, QDRO status carries with it certain specific treatments under the Code. For example, there are specific provisions governing adherence to the distribution requirements of Code Section 401(a)(9) for a QDRO.

3. Taxation. As described below, QDRO status also determines the tax treatment of distributions.

D. Tax Treatment for Members and Alternate Payees. If the benefit meets the above conditions, how should tax be reported on the payments to members and alternate payees?

1. Taxation. <u>If the alternate payee is a former spouse</u>, Code Section 402(e)(1)(A) applies, such that the alternate payee is treated as the "distributee" and provides that <u>the amount paid is includible in the former spouse's gross income</u> for purposes of Code Sections 72 and 402(a). This is a <u>required tax treatment</u>. The spousal alternate payee is also considered the distributee for withholding purposes — both for general withholding and for special withholding on eligible rollover distributions. If a DRO provides for payments <u>to non-spousal alternate payees, the distribution would be</u>

included in the member's gross income. Thus, the tax "follows the money" in the case of a spouse, but not for non-spouses.

2. Basis Recovery. In the case when the DRO applies to benefits with an annuity starting date after 11/18/96, the basis recovery rules that apply to these benefit payments are rules established by Code Section 72, as amended by SBJPA and TRA '97 (if after 12/31/97). In these cases the Simplified Method would apply to the monthly payments of an alternate payee. The allocation of basis between the member and former spouse (the alternate payee) should be determined on a pro rata basis, using the present value of all payments made from the plan. Code Section 72(m)(10). This pro rata allocation would also be applicable to lump sum payments. See Publication 575.

3. Rollover Rights. An alternate payee who is a former spouse has the same rollover rights as the member.

4. Early Distribution Tax. The 10% early distribution tax does not apply to payments to an alternate payee under a QDRO regardless of the age of the member or the alternate payee. Code Section 72(t)(2)(C).

5. Form 1099-R Reporting. From a tax reporting standpoint, separate (member v. alternate payee) 1099-R's should be issued each year. The 1099-R Instructions (p. 8) provide:

> Distributions to an alternate payee who is a spouse or former spouse of the employee under a QDRO are reportable on Form 1099-R using the name and TIN of the alternate payee. If the alternate payee under a QDRO is a nonspouse, enter the name and TIN of the employee.

6. Duty-Related Benefits to Alternate Payees. The question raised in the case of an accidental disability retirement under Chapter 32, Section 7, that is partially paid to the member and partially paid to an alternate payee under a QDRO is whether the non-taxable treatment of the duty-related disability benefit also applies to the portion of the benefit that is paid to the alternate payee.

We are not aware of any specific guidance with respect to the tax treatment for that portion of a distribution paid to an alternate payee where the distribution would be excluded from the participant's income because it is paid under a workers' compensation statute, or a statute in the nature of a workers' compensation statute.

With respect to a nonspouse alternate payee under a QDRO, the benefit payable would be taxed to the participant instead of the alternate payee. See IRS Notice 89-25, 1989-1 C.B. 662, Q&A-3. Thus, the payment of a portion of an accidental disability retirement allowance under Chapter 32, Section 7 to a non-spouse alternate payee would be treated as non-taxable to the participant in the same manner as the portion of the accidental disability retirement allowance paid directly to the member (i.e., "LOD payment").

The more difficult situation is where the spouse or former spouse is the alternate payee. There are arguments that lead to the conclusion that the LOD payment is taxable to the alternate payee spouse and arguments that lead to the opposite conclusion.

First, the arguments that lead to the conclusion that the LOD payment is taxable to the alternate payee spouse:

- The general principle is that a spouse or former spouse who is an alternate payee is treated as the distributee. It could be argued that the spouse or former spouse, as distributee, is not entitled to the distribution pursuant to the line of duty disability statute, but, rather, under the QDRO, and that there is no basis for the spouse or former spouse, as distributee, to exclude the distribution from income.

- Treasury Regulation § 1.104-1(a) provides that the exclusion applies to amounts "received by an employee" under a statute in the nature of a workers' compensation act. This appears to limit the favorable tax treatment to the employee.

- Treasury Regulation § 1.104-1(b) provides that "Section 104(a)(1) also applies to compensation which is paid under a workmen's compensation act to the survivor or survivors of a deceased employee." This could be read as only providing for a survivor benefit to be treated as excludible.

Second, the arguments that lead to the conclusion that the LOD payment is nontaxable to the alternate payee spouse:

- Code Section 104 is an exception to Code Section 61(a), which includes in gross income not only compensation but "income from whatever source derived" including alimony, annuities, pensions, etc. Code Section 104 provides an exemption from gross income for "amounts received under workmen's compensation acts as compensation for personal injuries or sickness." The Code does not require that the employee receive the income.

- Certain revenue rulings that have been issued extend the exclusion under Code Section 104 to payments to survivors. Rev. Rul. 80-14, Rev. Rul. 80-44, Rev. Rul. 80-84. Thus, the IRS has already approved, as a policy matter, that a pension plan may provide for the continuance of the non-taxable disability benefit to survivors. For example, Rev. Rul. 80-14 provides the following:

  > If a disabled firefighter dies while receiving duty disability benefits, the states of M authorized payment of a percentage of those benefits to the surviving spouse. The spouse's payments are merely a continuation of the excludable disability benefits received by the decedent and are part of the benefit package granted to an employee as compensation for the employee's occupational disability.

This statement would support the position that, if the alternate payee's interest is the continuation of the excludable benefit, then the alternate payee's interest should be excludable as well.

- Code Section 101(h) provides that annuity payments from a pension plan are nontaxable to the former spouse if the public safety officer dies in the line of duty. This indicates a Congressional policy to treat former spouses as eligible for nontaxable treatment.

The issue of the tax treatment of accidental disability retirement benefits paid to an alternate payee under a QDRO has been included in the private letter ruling request in order to confirm the appropriate taxation and reporting treatment.

V. ROLLOVER RULES

The rollover rules hinge on the definition of "eligible rollover distributions." Code § 402(c) and Treas. Reg. § 1.402(c)-2 Q&A-2. Under EGTRRA and the Pension Protection Act of 2006, substantial changes and flexibility have been added to the rollover rules. Under current law, both employees and surviving spouses of employees (as well as spousal alternate payees under DROs), have the same rollover options, while non-spouse beneficiaries have more limited rollover rights as described below.

A. Eligible Rollover Distributions. Code Section 402(c) provides that any "eligible rollover distribution" from a qualified trust described in Code Section 401(a) may be rolled over to an "eligible retirement plan" (see definition of "eligible retirement plan" below) within 60 days. Code § 402(c)(3). As in the past, the amount of any distribution that is actually rolled over to an eligible retirement plan is not included in the recipient's taxable income. Code § 402(c)(1).

An "eligible rollover distribution" means any distribution to an employee or surviving spouse of an employee of all or any portion of the balance to the credit of the employee in a qualified plan, except for the following:

- Any distribution that is one of a series of substantially equal periodic payments made (not less frequently than annually) over any one of the following periods: the life of the employee (or the joint lives of the employee and the employee's designated beneficiary), the life expectancy of the employee (or the joint life and last survivor expectancy of the employee and the employee's designated beneficiary), or a specified period of ten years or more;[8]

- Any distribution to the extent the distribution is required by the minimum distribution requirements of Code Section 401(a)(9);

[8] The determination of whether a distribution is one of a series of substantially equal periodic payments and, therefore, not an eligible rollover distribution, is generally made at the time payments begin without regard to contingencies or modifications that have not occurred. Treas. Reg. § 1.402(c)-2 Q&A-5. In addition, certain Social Security supplements described in Code Section 411(a)(9) are disregarded. Id. Thus, joint and survivor annuity distributions, Social Security offsets, and disability benefit payments generally will be considered to be a part of a series of equal periodic payments that are excepted from the definition of eligible rollover distributions.

- Any hardship distributions described in Code Section 401(k)(2)(b)(i)(IV); and
- Additional items designated by the Commissioner in revenue rulings, notices, and other guidance of general applicability. Those that already have been designated include dividends on employer securities, plan loans, taxable cost of life insurance coverage, and corrective distributions for 401(k) plans.

Code §§ 402(c)(4) and 403(b)(8)(B); Treas. Reg. §§ 1.402(c)-2, Q&A-3 and 1.403(b)-2, Q&A-2(a).

Special rules relating to the portion of a distribution that is non-taxable (i.e., after-tax basis), and rules relating to non-spouse beneficiary rollover rights, are discussed below.

B. Eligible Retirement Plan. The revised rollover rules under Code Section 402(c) allow a member and a member's surviving spouse (or spousal alternate payee) and, in more limited circumstances, a non-spouse beneficiary to execute a rollover to an "eligible retirement plan." The definition of the term "eligible retirement plan" varies depending on the facts and circumstances of the rollover and the recipient.

1. Direct Rollovers – Member and Spouse. A direct rollover occurs whenever a member or the member's spouse elects to have an eligible rollover distribution paid directly to an eligible retirement plan. Under current law, for an employee or surviving spouse (or alternate spousal payee) an eligible retirement plan with respect to amounts that would otherwise be included in gross income if they were not rolled over includes:

- an individual retirement account described in Code Section 408(a) or an individual retirement annuity (other than an endowment contract) described in Code Section 408(b) ("IRA");
- a Roth IRA;
- a qualified plan, including a qualified plan trust described in Code Section 401(a) or an annuity plan described in Code Section 403(a);
- a 403(b) plan, or
- a governmental 457(b) plan.

For any amounts that include after-tax basis recovery, such amounts may also be rolled over to an IRA or a Roth IRA, or to a qualified plan (defined benefit or defined contribution) or 403(b) plan (so long as the employer plan separately accounts for the after-tax amounts). After-tax amounts cannot be rolled over to a governmental 457(b) plan.

It is important to note that in the case of a Roth IRA rollover, the non-taxable portion of the rollover must be reported as taxable income; however, it is not subject to the 10% early distribution penalty.

2. Indirect Rollovers. An "indirect" rollover occurs when a recipient of an eligible rollover distribution elects to personally receive the distribution (rather than have the distribution paid directly to an eligible retirement plan) and subsequently transfers all or part of the distributed amount to an eligible retirement plan within 60 days after receiving the distribution. Under the indirect rollover rules, an eligible retirement plan includes an IRA, Roth IRA, a qualified plan (defined benefit or defined contribution), a 403(b) plan or a 457(b) plan. Code § 402(c)(8)(B); Treas. Reg. § 1.402(c)-2 Q&A-2. However, because the distribution was paid to the recipient, the plan is required to withhold 20% and it will be reported as a distribution to the recipient on Form 1099-R.

EGTRRA provided a hardship exception to the requirement that rollovers be made within 60 days of distribution. Under this exception, the IRS will be permitted to waive the 60-day requirement if the failure to do so would be against equity or good conscience. Examples of such waivers may include cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement (e.g., death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error). Code § 402(c)(3)(B).

3. Non-Spouse Beneficiary. If the recipient of the distribution is a non-spouse beneficiary, the only rollover option is a direct rollover to an inherited IRA (which may be a traditional IRA or a Roth IRA). An indirect rollover is not available.

VI. WITHHOLDING REQUIREMENTS – GENERAL RULES

Benefit distributions from a qualified plan are subject to the withholding requirements under Code Section 3405. Code Section 3405(f) provides that distributions subject to the requirements under Code Section 3405 are treated as wages under Code Section 3402, irrespective of whether or not the recipient elects withholding. Code § 3405(e).

A. General Withholding: Nonperiodic Distributions. For nonperiodic distributions that do not qualify for rollover treatment, the payor is required to withhold an amount equal to ten percent (10%) from all these distributions, unless the payee elects not to have the withholding apply. Code § 3405(b).

B. General Withholding: Periodic Distributions. Periodic distributions are also subject to the voluntary withholding rules under Code Section 3405. However, if a recipient of a periodic distribution fails to make an election under a properly completed Form W-4P, the plan administrator must withhold as if the recipient were married and had claimed three (3) withholding exemptions. Code § 3405(a)(4).

C. Withholding from Eligible Rollover Distributions. If a participant, the surviving spouse of a participant, or a non-spouse beneficiary receives an eligible rollover distribution, rather than electing to have it paid directly to an eligible retirement plan pursuant to a direct rollover, the payor of the distribution is required to withhold an amount equal to twenty

percent (20%) of the taxable portion of such distribution. Id.; Treas. Reg. § § 31.3405(c)-1 Q&A-1; 1.402(c)-2 Q&A-1(b)(3); and 1.403(b)-2 Q&A-2(b). This amount is required to be withheld even if the distribution is ultimately rolled over within sixty (60) days. Furthermore, payees cannot elect to forego withholding with respect to these distributions. Treas. Reg. § 31.3405(c)-I Q&A-2.

It should be noted that this 20% withholding requirement only applies to eligible rollover distributions that are not transferred pursuant to a direct rollover. Thus, the 20% withholding requirement does not apply to distributions that fall outside the definition of an eligible rollover distribution, such as a distribution required under Code Section 401(a)(9) or to distributions included in a series of substantially equal periodic payments for life, based on life expectancy, or payable over a specified period of ten years or more. If an eligible rollover distribution is "divided" and part is directly rolled over, the 20% withholding applies only to the taxable part that is not directly rolled over. Treas. Reg. § 31.3405(c)-1 Q&A-6.

D. Administrative Responsibility for Withholding. The plan administrator of a qualified plan has the responsibility for maintaining records and making required reports with respect to amounts withheld from distributions from qualified plans. If the administrator fails to do these things, the employer maintaining the plan is responsible. Treas. Reg. § 31.3405(c)-1 Q&A-15. All eligible rollover distributions must be reported on Form 1099-R in accordance with applicable requirements. Treas. Reg. § 31-3405(c)-1 Q&A-16. The receiving plan has no obligation to report the receipt of an eligible rollover distribution. Treas. Reg. § 31.3405(c)-1 Q&A-17(b).

VII. FORM 1099-R REPORTING REQUIREMENTS

A. Annual 1099-R Reporting Requirements. In addition to filing IRS Form 945, Annual Withholding Return, and depositing amounts withheld from benefit payments, a qualified plan is also required to issue a Form 1099-R to each recipient of a distribution from the plan. The only exception involves payments to non-resident aliens, which is covered in Section VIII below. Code § 6047(d); Instructions for IRS Forms 1099-R and 5498 (2011) ("1099-R Instructions"); General Instructions for Certain Information Returns (2011) ("General 1099-R Instructions"). No 1099-R report is required with respect to distributions to any person which, in the aggregate, are less than $10 for the year. Code § 6047(d)(1).

A copy of Form 1099-R must be sent to the recipient by January 31, 2012. See General 1099-R Instructions, p. 9. In addition, a copy of each Form 1099-R that is sent to a recipient must be sent to the IRS. Copies of these informational returns must be filed with the IRS, along with Form 1096 (for paper forms), by February 28, 2012 (for paper forms) or April 2, 2012 (if filing electronically). General 1099-R Instructions, p. 3. If you are filing more than 250 information returns, you must file electronically, though the IRS encourages filing electronically in all circumstances. General 1099-R Instructions, p. 4.

B. 1099-R Reporting Requirements for Boxes 1, 2a, and 5, Form 1099-R. If a distribution consists of taxable and nontaxable amounts, the payor must report the gross distribution in Box l on IRS Form 1099-R, the taxable amount in Box 2a, and the nontaxable

amount (basis recovery) in Box 5 (do not show in Box 5 amounts recovered in prior years). See Rev. Proc. 92-86 (governing 1099-R reporting for distributions made after December 31, 1992).

If the payor is unable to reasonably obtain the data needed to determine the taxable amount, Box 2a and Box 5 should be left blank, and Box 2b "taxable amount not determined" should be marked. However, the payor should make every effort to determine the taxable amount. See Rev. Proc. 92-86 ("[T]he payor must report the amount of employee contributions that are recovered tax-free based on the method the payor uses to compute taxable amount.") Thus, for governmental plans, Box 2b should either never be marked or if should be marked only for those who have been in pay status for a number of years, i.e., before July 1, 1986.

Box 2b should also be marked, if applicable, for Total Distribution if the entire balance of the member's benefit is being distributed, or, if periodic payments are made, mark this box in the final year of payment.

C. 1099-R Reporting Requirements for Box 3, Form 1099-R. Box 3 is used for reporting lump sum amounts for capital gain election. This box should not be completed for a direct rollover.

D. 1099-R Reporting Requirements for Box 4, Form 1099-4. Box 4 is used to report the amount of federal income tax withheld from the gross distribution reported in Box 1.

E. 1099-R Reporting Requirements for Box 6, Form 1099-R. We mention Box 6 only for the sake of completeness. We do not believe that you will ever have amounts to report as "Net unrealized appreciation in Employer's securities." As a result, Box 6 should be left blank.

F. 1099-R Numerical Code Requirements for Box 7, Form 1099-R. Numeric and alpha codes should be entered in Box 7 depending on the nature and circumstances surrounding the distribution.

"1"	**Early (Premature) Distribution, No Known Exception.** Numeric code 1 is used only if the member has not reached 59½, and only if none of the exceptions under Code § 72(t) are known to apply.
"2"	**Early (Premature) Distribution, Exception Applies (As Defined in Code § 72(t)).** Numeric code 2 should be used only if the member has not reached age 59½ to indicate that an exception under Code § 72(t) applies (such as a distribution to satisfy an IRS tax levy, a distribution after separation from service in or after the year the member reaches age 55 (or 50 for public safety employees), or for substantially equal lifetime periodic payments payable after a separation from service. However, code 3 or 4 (whichever applies) should be used, instead of code 2, for any early distribution due to disability or death.

"3"	**<u>Disability</u>**. Numeric code 3 should be used for disability. Code § 72(m)(7). In the case of ordinary disability, use code 3 for benefit distributions until the member attains his or her earliest retirement age (at which point either code 2 or code 7, depending on when the member reaches age 59½, would apply).
"4"	**<u>Death</u>.** Numeric code 4 should be used to indicate payment to a decedent's beneficiary, including payments to an estate or trust.
"7"	**<u>Normal Distribution</u>.** Numeric code 7 should be used for all distributions to members who are at least 59½ years of age.
"5," "6," "8," and "9"	**<u>Special Codes</u>.** These codes reflect prohibited transactions, tax-free exchanges of insurance contracts, distributions to correct excess contributions or taxable deferrals, and premiums paid for insurance protection. Accordingly, except in a very unusual circumstance, these numeric codes generally should not apply to distributions from a qualified defined benefit plan.

The 1099-R Instructions involving the use of the numeric codes specifically state that only three combinations of numeric codes are permitted: codes 8 and 1, 8 and 2, and 8 and 4. If any two other numeric codes are applicable, the payor must file more than one Form 1099-R. For example, the Instructions state that if a part of a distribution is premature (<u>i.e.</u>, code 1) and part is not (<u>i.e.</u>, code 7), one Form 1099-R <u>must</u> be filed for the part to which code 1 applies and another Form 1099-R must be filed for the part that is a normal distribution, code 7. In addition, if part of a distribution is an "eligible rollover distribution," and the other part is not, two separate 1099-Rs must be filed with the appropriate codes for each distribution reflected in Box 7. A similar procedure must be used for disability benefit distributions paid to a member during the year the member attains his or her earliest retirement age. Under the disability benefit scenario, the numeric code would switch from code 3 to either code 2 or code 7 (depending on whether the member's earliest retirement age is before or after age 59½).

G. **<u>1099-R Alpha Codes Requirements for Box 7, Form 1099-R</u>.** IRS Announcement 89-151 and the 1099-R Instructions do not specifically require an alpha code. Furthermore, the Instructions state that "when applicable, you may enter a numeric and an alpha code." (Emphasis added). Accordingly, we believe an alpha code is only required if one of the alpha codes listed in the 1099-R Instructions applies to the distribution. In such a case, an alpha code should be used.

The alpha codes that apply to distributions from a qualified plan include the following:

"A"	**<u>Income Averaging</u>.** Alpha code A should be used to indicate that the distribution qualifies for 10-year forward income averaging under Code § 402(d). There are a variety of rules and restrictions that apply to the income averaging tax provisions. The recipient is not required to have used income averaging for this code to be used. This code should be used with a distribution code. Example: For a normal distribution which is eligible for forward income averaging, enter codes 7 and A.

"E"	**Distribution Under EPCRS.** Alpha code E should only be used when making a corrective distribution under the Employee Plans Compliance Resolution System. No other codes should be used with Code E.
"G"	**Direct Rollover.** Alpha code G should be used for all distributions that are paid in the form of a direct rollover, including to a Roth IRA (Code H does not apply to a direct rollover from a qualified plan to a Roth IRA). For a direct rollover for a surviving spouse, enter codes G and 4.
"B", "F", "H", "J", "L", "N", "P", "Q", "R", "S", "T", "U" or "W"	**Other Codes.** Other alpha codes should only be used if a specific legal determination by the plan's legal counsel has been made that these codes apply. Generally speaking, these alpha codes should not apply to distributions from a qualified governmental plan.

H. 1099-R Reporting Code Requirements for Boxes 9a and 9b, Form 1099-R.

a. Box 9a. For a total distribution made to more than one person, the percentage for the individual is entered in 9a. A plan is not required to complete this box for a direct rollover.

b. Box 9b. If the safe harbor method is used for basis recovery, this box should show the total employee contributions that can be recovered tax free in the year periodic payments begin. Box 9b is not required to be completed for annuities with a starting date after November 18, 1996. However, the IRS permits the reporting of total employee contributions, so long as amounts previously recovered tax-free are not included. For a total distribution, employee contributions are reported in Box 5, not 9b.

I. 1099-R Boxes 10-15. These boxes and Copies 1 and 2 are provided for the payor's convenience and need not be completed for the IRS. See 1099-R Instructions, pg. 36, for direction on using these boxes and copies.

VIII. GENERAL INCOME TAX WITHHOLDING AND REPORTING RULES — FOR NON-RESIDENT ALIENS WITH TAXABLE INCOME

Different withholding and reporting rules apply with respect to payments made to non-resident aliens (an alien is any individual who is not a U.S. citizen, and resident aliens are generally taxed in the same manner as a U.S. citizen). These withholding and reporting rules are very complex, so we have only highlighted some of the general issues involved to make you

aware of some of the differences from other payments from qualified plans. If you would like a more detailed analysis on these rules, we can provide that for you.

A. General Withholding for Non-Resident Aliens. The Code and Regulations impose a 30% tax (and withholding rate) on pension payments to nonresident aliens. The 30% must be withheld unless the withholding agent can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a U.S. person or a payee that is a foreign person that is the beneficial owner of the income and is entitled to a reduced rate of withholding. Code § 1441; Treas. Reg. § 1.1441-1(b)(1) and (b)(3)(iii)(C); IRS Publication 515, Withholding of Tax on Nonresident Aliens (2011). For payments under Chapter 32, these withholding provisions will apply absent qualification for the graduated withholding rates or a tax treaty exemption.

To establish qualification for graduated withholding rates or a tax treaty exemption, certain forms must be completed by the nonresident alien, but a retirement plan should provide or request certain forms in some circumstances. The Instructions for Requester of Forms W-8 provide that a withholding agent should request a Form W-8 from any person to whom you are making a payment that you presume or otherwise believe to be a foreign person. Thus, a Form W-8BEN (to claim a tax treaty exemption), a Form W-8ECI (to claim a graduated withholding), and a Form W-7 (TIN application for non-U.S. Citizens) should be provided to each nonresident alien who is expected to receive payments, whether or not such aliens are claiming an exemption, before making a payment. See Instructions for Requester of Forms W-8 (2006); Instructions for Form W-8BEN (2006), and Form W-8BEN (2006). Form W-9 could also be provided, to be completed if the person is not an alien. Any nonresident alien who claims an exemption from U.S. tax under an income tax treaty must obtain a TIN using Form W-7 (if he or she has not already done so) and include it on Form W-8BEN. See Treas. Reg. § 1.144-1(e)(4)(vii)(A); Instructions for Requester of Forms W-8, p. 2.

If the recipient of payments fails to properly claim a tax treaty exemption (i.e., fails to provide a properly completed Form W-8BEN), and fails to claim graduated withholding under a properly completed Form W-8ECI, the presumption rules set forth in the Treasury Regulations under Code § 1441 and outlined in the Instructions for Requester of Forms W-8 should be applied. Unless it may be presumed that the payment is being made to a U.S. person under those presumption rules, it must be assumed that the recipient is a foreign individual and withholding should be at the rate of 30%. Thus, income tax from any distribution to any nonresident alien should be withheld at a 30% gross rate ***until and unless*** a properly completed Form W-8BEN (or Form W-8ECI, if applicable) is received. If Form W-8BEN properly claiming an exemption under an income tax treaty is received, there would be no tax withholding (or withholding at a reduced rate, depending on the treaty provision); however, certain reporting requirements will still apply (as discussed below).

The IRS forms and their instructions are helpful in sorting through this.

B. Reporting Distributions to Nonresident Aliens

1. Reporting Distributions and Tax Withheld on Form 1042-S. Amounts paid to foreign persons, including nonresident aliens, and any tax withheld from such

payments must be reported to the IRS on Form 1042-S. See Instructions for Form 1042-S (2011) and Publication 515, p. 3, 30-31.

2. Form 1042 Annual Return. A withholding agent must file the annual withholding return for U.S. source income of foreign persons, Form 1042, if the agent has filed Form(s) 1042-S, whether or not any tax was withheld or required to be withheld. See Instructions to Form 1042 (2010).

IX. TAXATION AND REPORTING OF BENEFITS UNDER CH. 41, § 111F

Chapter 41, § 111F of M.G.L. provides for the payment of full salary to police officers and firefighters (who are not covered by workers' compensation) in the event of a job-related injury. Because this statute is in the nature of a workers' compensation act, the benefits are treated as non-taxable under federal law (Code Section 104(a)(1)). This is part of the PLR request. If the disability is temporary, the member may return to work when able. If the disability is permanent and total, the member may receive an accidental disability retirement.

The member receives creditable service for the period of time that payments are received under Section 111F, and such compensation is treated as "regular compensation"—thus, retirement contributions are taken, on a pre-tax basis, from such payments and become part of the member's annuity savings. At retirement, an annuity based upon the member's contributions is paid as part of the retirement allowance.

With respect to the annuity that is based upon these contributions, one position is that it would be treated as taxable under Code Section 72. While the payments when made under Section 111F are eligible for the income tax exclusion of Code Section 104(a)(1), once the contributions from such payments are paid to a qualified plan under Chapter 32 they become subject to the federal taxation rules applicable to qualified plans. Because the contributions are made to the qualified plan as pre-tax, they cannot be treated as basis recovery, and it does not appear that the annuity payable that is based on the contributions would qualify for any other taxation exemption applicable to qualified plans.[9]

Alternatively, there has been some opinion from different Chapter 32 systems that because the original payments were non-taxable they should not be taxed at any point, even when paid from the qualified plan. Essentially, this position would be that the payments under Section 111F retain their tax-exempt, workers' compensation treatment until ultimately paid to the member, even if they are contributed to the qualified plan. We think it would be appropriate to include this question to the PLR request to confirm the correct tax treatment with regard to the annuity that is based upon the contributions taken from Section 111F payments, and for retirement systems to continue their current practice until receipt of the ruling. We have included this in the PLR request.

With respect to the tax reporting of payments under Section 111F, because such payments are in the nature of workers' compensation, but are not paid from a qualified plan, we

[9] Even if paid as an accidental disability retirement, because the annuity is based upon the amount of the member's contributions it would not satisfy the Code Section 104(a)(1) exclusion requirements.

do not think that they would be reported on a Form 1099-R. However, when the annuity attributable to the contributions from such payments is paid from a Chapter 32 qualified plan, the annuity would be subject to the normal reporting requirements of Form 1099-R.[10]

Attachment: Massachusetts PERAC – Form 1099-R
Benefit Reporting Overview

CIRCULAR 230 DISCLOSURE: Except to the extent that this advice concerns the qualification of any qualified plan, to ensure compliance with recently-enacted U.S. Treasury Department Regulations, we are now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including any attachments, is not intended or written by us to be used, and cannot be used, by anyone for the purpose of avoiding federal tax penalties that may be imposed by the federal government or for promoting, marketing or recommending to another party any tax-related matters addressed herein.

[10] While "reportable disability payments made from a qualified plan must be reported on Form 1099-R," "amounts totally exempt from tax, such as workers' compensation" generally are not reported on Form 1099-R. 1099-R Instructions, p. 1.