

M E M O R A N D U M

TO: Barbara Phillips, Massachusetts PERAC

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

DATE: November 1, 2007

RE: Form 1099-R Reporting and Federal Tax Withholding for \$3,000 Retiree Medical Benefit Exclusion

This memorandum provides guidance regarding the appropriate Form 1099-R reporting and federal tax withholding for pension distributions used under the \$3,000 retiree medical exclusion for eligible public safety officers under Section 845(c) of the Pension Protection Act of 2006 ("PPA").

IRS GUIDANCE

The Internal Revenue Service ("IRS") recently issued revised Instructions for Forms 1099-R for 2007 ("2007 Instructions"). The 2007 Instructions provide some limited guidance on how a pension plan should handle the reporting of payments from the plan for qualified insurance premiums:

- First, the 2007 Instructions provide as a "TIP" that:
[t]here is no special reporting for qualified charitable distributions described in section 408(d)(8), for qualified HSA funding distributions described in section 408(d)(9), or for the payment of qualified health and long-term care insurance premiums for retired public safety officers described in section 402(l).

(Emphasis added.)

- Under the "What's New" section, noting the addition to the 2007 Instructions of the TIP described above, the 2007 Instructions state:

TIP has been added on page R-1 to indicate that there is no special reporting for ... payments of qualified health and long-term care insurance premiums for retired public safety officers. Recipients of those distributions claim the associated tax benefit on their own income tax returns. However, trustees and issuers may use Distribution Code 2 to indicate an exception to the additional tax on early distributions for payments of qualified health and longterm care insurance premiums for retired public safety officers. See the Guide to Distribution Codes on page R-11.

(Emphasis added.)

- Finally, in the description of Distribution Code 2 (Early distribution, exception applies) for Box 7, a bullet point has been added for use of Code 2 if the employee has not reached age 59½ and the distribution is "a distribution from a governmental plan for the payment of health or long-term care insurance premiums for a retired public safety officer under section 402(1)."

In addition to the 2007 Instructions, the IRS has informally responded to several

questions regarding the Form 1099-R reporting as follows (response in italics):

1. Should the 2007 1099-R (Box 2a) taxable amount reflect the reduction of taxable income by any qualified medical deductions taken pre-tax for safety members (up to \$3,000.00 under PPA)?

No.

2. Are there any new boxes on the 2007 1099-R form?

No. See the 2007 form at <http://www.irs.gov/pub/irs-pdf/f1099r.pdf>.

3. If not, are any of the 1099-R boxes to include PPA related deductions?

No.

4. Will there be a line on the 1040 form for the retiree to put their total YTD medical premium payment amount?

No. Instead, the retiree must reduce the taxable amount on line 16b by the amount of the exclusion and enter "PSO" next to that line.

5. Will this be how the retiree will report that they are due a deduction up to \$3,000.00?

Yes, the above method will indicate that the exclusion (deduction) was claimed.

6. Would the retirement fund need to provide the up to \$3,000.00 deduction amount to the safety payees?

No, there is no requirement to do so, although it would be helpful.

7. Would they need to provide the YTD medical premium amount to the safety payees?

No, there is no requirement to do so, although it would be helpful.

8. Are there any new forms that will be associated with these new deductions for safety retirees?

No.

DISCUSSION

Form 1099-R Reporting. As an initial matter, we would note that we think the 2007 Instructions have been written to provide that there is no special reporting on the part of a pension plan for the \$3,000 payments (that responsibility lies on the member), and use of the Distribution Code 2 for the \$3,000 is permissive, not mandatory. Thus, we think it would be permissible to simply include the \$3,000 as part of the gross distribution in Box 1 and the taxable distribution in Box 2, and do nothing further with regard to the Form 1099-R.

However, if desired, we think that it would be helpful to provide some additional information to affected members to assist them in taking advantage of the available exclusion, subject to the IRS guidance described above. We think that the following approach would be consistent with existing guidance, while providing some helpful information to members:

- The \$3,000 amount should be reported both in Box 1 and Box 2a (we do not think that the IRS guidance permits excluding any portion of the \$3,000 amount from the taxable amount reported in Box 2a).
- If the eligible retiree is under age 59½, Code 2 should be used. (Please note: If some portion of the distribution would not be eligible for Code 2, then two separate 1099-Rs would be issued.)
- On the Form 1099-R, there should be room in a field for a separate note. We think it would be helpful to provide information to the eligible retiree of the amount of the distribution directly used to pay medical premiums, such as "\$_____ of pension used for medical premiums." Alternatively, an insert could be provided with the mailing of the Form 1099-R indicating the amount of the pension distribution directly used to pay medical premiums, and noting that up to \$3,000 may be excluded from gross income for eligible retired public safety officers.

Withholding of Deductions. The method used for deducting health premiums from pension payments would not change – deductions would still be made on a post-tax basis. As discussed above, the retiree will need to claim the non-taxable treatment on his or her income tax return. Of course, a retiree may file an amended Form W-4P to adjust his or her income tax withholding, but there would be no retroactive adjustment.

We hope that this explanation is helpful. We have limited this memorandum to a discussion of the Form 1099-R reporting and federal tax withholding issues relating to the \$3,000 exclusion, and we have not discussed the substantive requirements for eligibility for this income tax exclusion. Please let us know if you have any other specific questions which we could assist you with.

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