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Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to:

OP:E:EP:A:2

Date:

AUG 03 1999

In re: Request for ruling on behalf of

Taxpayer O =

This letter is in response to a letter, dated September 14, 1998, in which your authorized representative (pursuant to a Form 2848 on file with our office) requested a ruling on your behalf that a recalculation of payments, currently being distributed from an individual retirement account (IRA) owned by you, to include a cost-of-living feature and a one-time catch-up payment, would not be considered a modification of substantially equal periodic payments as described in section 72(t)(4) of the Internal Revenue Code (Code).

Facts

According to the facts as stated, you are retired and are the owner of an IRA (IRA 1) which was funded by a rollover of a lump sum distribution from a corporate retirement plan in which you had participated. You started taking distributions from this IRA in 1993. The annual distribution amount was calculated using methodology intended to produce substantially equal periodic payments as described in section 72(t)(2)(A)(iv) of the Code. Once an annual distribution amount was calculated, the same amount was distributed each subsequent year. Because the actual earnings on IRA 1 have exceeded the expected earnings and the account has more than doubled in amount, you would like to change the distribution method to include a yearly cost-of-living adjustment (COLA) of four percent, and to include the payment of a one-time catch-up payment equal to the cost-of-living adjustments which would have been paid in prior years from 1993. Thus, under the proposed methodology, the annual distribution amount for a year would be equal to 104 percent of the annual distribution amount for the prior year, with the first adjustment

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resulting in an annual distribution amount for 1994 equal to 104 percent of the 1993 annual distribution amount. A conference of right with your authorized representatives was held by telephone on April 7, 1999.

Ruling Requested

Based on these facts, you have requested the following rulings.

1. The proposed recalculation of the annual distribution amounts to be distributed from IRA 1 to include a four percent annual cost-of-living adjustment, and subsequent distribution of such amounts, will not by itself cause the payment stream to fail to be substantially equal periodic payments, and will not be considered a modification of substantially equal periodic payments under Code section 72(t)(4).

2. The one-time distribution of a catch-up payment, equal to the amount by which the annual distribution amounts for prior years, if adjusted for the four percent COLA, would exceed the annual distribution amounts for prior years, not adjusted for the COLA, will not be considered a modification of substantially equal periodic payments under Code section 72(t)(4).

Applicable Law

Section 408(d) of the Internal Revenue Code provides that amounts paid or distributed out of an individual retirement plan must be included in gross income by the payee or distributee in the manner provided under section 72 of the Code.

Section 72 of the Internal Revenue Code provides rules for determining how amounts received as annuities, endowments, or life insurance contracts and distributions from qualified plans are to be taxed.

Section 72(t) of the Internal Revenue Code was added to the Code by the Tax Reform Act of 1986 (TRA '86), effective generally for taxable years beginning after December 31, 1986. Section 72(t)(1) provides for the imposition of an additional 10 percent tax on early distributions from qualified plans, including IRAs. The additional tax is imposed on that portion of the distribution that is includible in gross income.

Section 72(t)(2)(A)(iv) of the Code provides that section 72(t)(1) 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 such employee and his beneficiary.

Section 72(t)(4) of the Code imposes the additional limitation on distributions excepted from the 10 percent tax by section 72(t)(2)(A)(iv) that if the series of payments is subsequently modified (other than by reason of death or disability) before the later of (1) the close of the 5-year period beginning with the date of the first payment, and (2) the employee's attainment of age 59 1/2, then the taxpayer's tax for the first taxable year in which such modification occurs shall be increased by an amount determined under regulations, equal to the tax which would have been imposed except for the section 72(t)(2)(A)(iv) exception, plus interest for the deferral period.

Section 1.72-9 of the Income Tax Regulations (Regulations) provides tables that are to be used in connection with computations under section 72 and the regulations thereunder. Included in this section are tables giving life expectancies for one life (Table V) and joint life and last survivor expectancies for two lives (Table VI).

Notice 89-25, 1989-1 C.B. 662, provided guidance, in the form of questions and answers, on certain provisions of the Tax Reform Act of 1986 (TRA '86). In the absence of regulations on section 72(t) of the Code, this notice provided guidance with respect to the exception to the tax on premature distributions provided under section 72(t)(2)(A)(iv). Q&A-12 of Notice 89-25 provides three methods for determining substantially equal periodic payments for purposes of section 72(t)(2)(A)(iv) of the Code. Two of these methods involve the use of an interest rate which must be an interest rate that does not exceed a reasonable interest rate on the date payments commence.

Rationale

Section 72(t)(1) of the Code provides for the imposition of an additional 10 percent tax on early distributions from qualified plans, including IRAs, which is imposed on that portion of the distribution that is includible in gross income. An exception to the additional 10 percent tax is provided under section 72(t)(2)(A)(iv) for distributions that are part of a series of substantially equal periodic payments. Q&A-12 of

Notice 89-25 provides three methods for determining substantially equal periodic payments for purposes of section 72(t)(2)(A)(iv).

Section 72(t)(4) of the Code provides that if a series of payments, exempted from the additional tax imposed under section 72(t)(1) by the exception provided in section 72(t)(2)(A)(iv), is subsequently modified (other than by reason of death or disability) before the later of (1) the close of the 5-year period beginning with the date of the first payment, and (2) the employee's attainment of age 59 1/2, then the taxpayer's tax for the first taxable year in which such modification occurs is increased by an amount equal to the tax (as determined under regulations) which would have been imposed except for the section 72(t)(2)(A)(iv) exception, plus interest for the deferral period.

Taxpayer O started receiving distributions from IRA 1 in 1993. Taxpayer O's authorized representative has stated that these distributions were intended to be substantially equal periodic payments which were not subject to the additional tax imposed under Code section 72(t)(1) because of the exception provided under section 72(t)(2)(A)(iv). The same annual distribution amount has been distributed from IRA 1 each year since 1993. Taxpayer O will attain age 59 1/2 in 2002.

Under the change proposed by Taxpayer O, the methodology used to calculate the annual distribution amount for IRA 1 will be modified before the later of (1) the close of the 5-year period beginning with the date of the first payment, and (2) the employee's attainment of age 59 1/2. The original methodology provided for a one-time calculation of an annual distribution amount, with the same amount to be distributed in subsequent years. The original methodology did not provide for annual increases in the annual distribution amount. Under the proposed methodology, the annual distribution amount will change each year, with the annual distribution amount for a year equal to 104 percent of the prior year annual distribution amount. Thus, under this methodology, the annual distribution amount for 1994 would equal 104 percent of the 1993 annual distribution amount. Under the proposed methodology, the COLA increases in the annual distribution amount that would have been distributed in prior years would be distributed as a one-time catch-up payment. This catch-up payment would equal the amount by which the prior payments, when adjusted annually for COLAs, exceed the prior payments, not adjusted annually for COLAs.

Both the change in the annual distribution amount and the distribution of a catch-up payment are not changes due to death or disability. Accordingly, under the rules of Code section

72(t)(4), either of these proposed changes in payments that were substantially equal periodic payments would be a modification.

Following a modification (as described in section 72(t)(4)(A)) of substantially equal periodic payments, the taxpayer receiving such payments would have their tax for the first taxable year in which such modification occurs increased by an amount, determined under regulations, equal to the tax which would have been imposed, except for the section 72(t)(2)(A)(iv) exception, plus interest for the deferral period.

Section 72(t)(4)(B) defines the deferral period as the period beginning with the taxable year in which (without regard to section 72(t)(2)(A)(iv)) the distribution would have been includible in gross income and ending with the taxable year in which the modification described in section 72(t)(4)(A) occurs. If the exception under section 72(t)(2)(A)(iv) had not applied to the distributions made during the deferral period, then the tax which would have been applied under section 72(t)(1) would have been equal to 10 percent of the distributions made during that period to the extent such amounts were includible in gross income. Assuming that all of the distributions under the prior methodology were includible in income, the increase in Taxpayer O's tax (for the first taxable year in which the modification occurs) would be calculated as 10 percent of the total amount which has been distributed using the exception, plus interest for the deferral period. For purposes of calculating interest for the deferral period, the underpayment rate determined under section 6621 of the Code would be considered a reasonable rate. This rate, determined for each calendar quarter, is generally published in the Internal Revenue Bulletin the month before a calendar quarter begins.

Holdings

1. Accordingly, we conclude that the proposed recalculation of the annual distribution amount to include an annual four percent COLA from the year distributions commenced, if made to a series of annual substantially equal periodic payments (calculated using one of the methods described in Notice 89-25, and providing that the same annual distribution amount would be distributed each year), would result in a modification of such payments under the rules of Code section 72(t)(4).

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2. The distribution of a one-time catch-up payment equal to the amount by which the annual distribution amounts for prior years, if adjusted for COLAs, would exceed the annual distribution amounts for prior years, not adjusted for COLAs, would result in a modification of substantially equal periodic payments under the rules of Code section 72(t)(4).

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

Sincerely yours,

Martin L. Pippins

Martin L. Pippins
Acting Chief, Actuarial Branch 2