DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CHIEF COUNSEL

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CC:TEGE:EB:QP2:[redacted]
GENIN-145345-03

[redacted]

Attention: [redacted]

Dear [redacted]:

Reference: Response to inquiry re: tax treatment and reporting of refund of excess retirement plan contribution.

Federal Agency A = [redacted]

Plan P = [redacted]

X Percent = [redacted]

This responds to your inquiry to Gary Wilcox, Deputy Chief Counsel (Technical), Internal Revenue Service, on behalf of Federal Agency A concerning the reporting and tax treatment of certain refunds (with interest) of retirement contributions made from its Plan P, a qualified defined benefit retirement plan. You asked us to answer several questions concerning this subject matter.

Since we do not have a request for a private letter ruling regarding your agency's plan filed in accordance with Revenue Procedure 2004-1, 2004-1 I.R.B. 1, we are unable to furnish a definitive ruling regarding your inquiries. However, we are pleased to furnish this general information letter to you concerning the reporting and taxation issues you raised, which we hope may be helpful to you and Agency A. Section 2.04 of

Revenue Procedure 2004-1 defines an "information letter" as a statement issued by the Internal Revenue Service that calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. This section also states that an information letter is advisory only and has no binding effect on the Service.

You report that Agency A maintains Plan P, a defined benefit plan which is treated as qualified under section 401(a) of the Internal Revenue Code. Section 805 of Plan P generally requires its participants to make mandatory contributions of X percent of their salaries to the Plan during their entire term of employment. The participants are fully subject to current income taxation of their X percent contributions. Section 806 of Plan P provides, in relevant part, that the annuity of a participant shall be equal to 2 percent of his or her basic salary for the highest three consecutive years of service multiplied by the number of years, not exceeding 35, of service credit obtained in accordance with the Plan; a Plan P participant accrues no additional benefit after working more than 35 years for Agency A.

Section 815(h) of Plan P provides that amounts deducted and withheld from the basic salary of a participant pursuant to its section 805 from the beginning of the first pay period after the participant has completed 35 years of service, computed under its section 816 (excluding service credit for unused sick leave under section 816(b)), together with interest on such excess amounts at the rate of 3 percent per year compounded annually from the date of deduction to the date of retirement or death, shall be applied toward any special contribution due under section 805(d), and any balance not so required shall be refunded in a lump sum to the participant after separation, or in case of the participant's death, to a beneficiary. Agency A characterizes these refund payments (not including the interest thereon) as "excess contributions."

Based on these facts and representations, your letter requests the Internal Revenue Service's response to the following five questions:

1. Is Agency A required to issue Forms 1099-R reporting the refunds of the "excess contributions"?

2. Should the excess contributions be reported (as employee contributions) in Box 5 of the Form 1099-R or as a gross distribution in Box 1. If reported as a gross distribution, should Agency A check the box indicating that the taxable amount is not determined?

3. What distribution code relating to the refund payments should be used in Box 7 of Form 1099-R?

4. Are the Plan P participants who receive refunds of their "excess contributions" and the related interest subject to the 10 percent additional income tax

imposed upon premature distributions under section 72(t) of the Internal Revenue Code? and,

5. How should the interest portion of the refund payments be properly taxed and reported?

Concerning the first question, employers such as Agency A must issue Forms 1099-R concerning the refunds of "excess contributions" and the associated interest paid with respect to such refunds pursuant to section 815(h) of Plan P due to the reporting requirements of sections 6041 and 6047 of the Internal Revenue Code. [1] The IRS has designated Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., as the proper information return for reporting such payments. Thus, Form1099-R is the proper form to be used in making the required reports of such refunds (and the related interest payments) to the participants who receive them.

Concerning the second question relating to reporting the distribution on Form 1099-R, the distribution should be included in Box 1 of the form. The distribution would also be reported in Box 5 (Employee contributions or insurance premiums) to the extent it represents amounts previously included in income as after-tax contributions. This would mean that the taxable portion of the distribution has been determined, and that the checkbox in Box 2b (Taxable amount not determined) should not be checked.

Concerning the third question about the appropriate code to insert in Box 7, generally, 7 (Normal distribution), will be the appropriate code to use for reporting the distribution of the refund of excess employee contributions.

Regarding the fourth question relating to the applicability of the early distribution penalty, separated Agency A employees are, with certain exceptions, subject to the 10 percent additional tax described in section 72(t)(1) of the Code on early distributions of excess contributions. However, we believe it would only rarely be applicable to Agency A's employees since they would be eligible for such refunds only after serving for at least 35 years and section 72(t)(2)(A)(v) provides an exception to the 10 percent penalty for such distributions "made to an employee after separation from service after attainment of age 55."

Section 72(t)(1) provides that if any taxpayer receives any amount from a qualified retirement plan, the taxpayer's tax for the year when he receives such amount shall be increased by 10 percent of such amount which is includible in gross income.

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1 In essence, sections 6041 and 6047 of the Internal Revenue Code require an employer maintaining a plan, from which designated distributions may be made, to make returns and reports regarding such plan and the remuneration paid to the individual participants and beneficiaries to each recipient who receives at least $10 of distributions in a year from such plan.

Section 72(t)(2)(A) provides several exceptions to the general section 72(t)(1) rule. Among the exceptions are (i) distributions which are made on or after the date on which the employee attains age 59½, (ii) made to a beneficiary or the participant's estate after the participant's death, (iii) made after an employee's becoming disabled, (iv) 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 designated beneficiary, and (v) made to the employee after separation from service after attainment of age 55.

Notice 87-13, 1987-1 C.B. 432, Q&A 20, provides, in relevant part, that a distribution to an employee from a qualified plan will be treated as within section 72(t)(2)(A)(5) if (1) it is made after the employee has separated from service for the employer maintaining the plan and (2) such separation from service occurred during or after the calendar year in which the employee attained age 55.

Concerning the fifth question regarding the proper reporting and tax treatment of the interest payments, the interest portion of a Plan P participant's "excess contribution" refund made pursuant to section 815(h) of Plan P is includible in the distributee's gross income in the year it is distributed, pursuant to sections 72 and 402(a) of the Code.

Agency A should report direct rollovers, using distribution Code G (relating to direct rollover and rollover contribution) in Box 7 of Form 1099-R. The interest portion of the refunds that is not rolled over should be reported on Form 1099-R, using code 1 (early distribution, no known exception) or 2 (early distribution, exception applies), or 7 (normal distribution) as appropriate. Since the interest payment is an "eligible rollover distribution", any amount of the interest portion that is not directly rolled over is subject to income tax withholding at a 20% rate. The participant may choose to receive such distribution and personally roll it over to an IRA. If the plan participant was born before 1936, the distribution may also qualify for preferential tax treatment as a lump sum distribution. To show potential qualification for this special treatment, you should use Code A in Box 7 of Form 1099-R. The following examples illustrate how to deal with and report an eligible rollover distribution of the interest.

Example 1: The participant receives a $10,500 distribution, consisting of a $10,000 refund of his contribution and $500 of interest and Agency A rolls the interest over in a direct rollover to another eligible retirement plan. The participant would receive two Forms 1099-R. The first Form 1099-R reports the $10,000 refund, with this figure entered in Boxes 1 and 5 of this form; no entry would be made on this form's Boxes 2a or 2b; and distribution code "7" would be inserted in its Box 7. The second Form 1099-R, reporting the interest portion, would be completed by entering 500 in Box 1, 0 (zero) in Box 2 and distribution code G in box 7.

Example 2: Assume the same facts as in *Example 1*, except that the interest is not rolled over. The first Form 1099-R, reporting the refund of the after-tax contribution, would be completed the same way as described in *Example 1*. The second Form 1099-R, reporting the interest payment, would be completed with entries of 500 in Boxes 1 and 2a and 100 (pertaining to the withheld income tax) in Box 4. Box 7 would include a distribution code of 1 or 2 (if the participant had not yet reached age 59½), code 7 (if the participant had reached age 59½), and code A if the participant was born before 1936.

The above-described 20 percent withholding for eligible rollover distributions that are not rolled over is required under section 3405(c) and § 31.3405(c)-1, Q&A 1 and 2 of the Treasury Regulations. Section 3405(e)(1)(A) defines a “designated distribution” as any payment or distribution from an employer deferred compensation plan, an individual retirement plan or a commercial annuity. Under section 3405(e)(1)(B)(ii), the term “designated distribution” does not include the portion of a distribution or payment which it is reasonable to believe is not includible in gross income.

Section 6047(d) provides, in relevant part, that the IRS shall, by forms or regulations, require an employer or plan administrator maintaining a plan from which designated distributions may be made to make returns regarding such plan to its participants and beneficiaries and to the IRS. Furthermore, no return shall be required with respect to distributions to any person during any year unless such distributions aggregate $10 or more. Section 35.3405-1T, Q&A E-9 provides that these reporting requirements are satisfied if Form 1099 is filed with respect to each payee, absent other forms and regulations.

We hope the general information supplied above has been helpful. If you need further assistance, either with the technical information furnished in this letter or with submitting a request for a private letter ruling in accordance with Revenue Procedure 2004-1, please contact me or [redacted] at [redacted]

Sincerely,

Robert D. Patchell
Branch Chief, Qualified Plans 2
Office of Associate Chief Counsel
(Tax Exempt/Government Entities)