PennState Dickinson Law

DICKINSON LAW REVIEW
PUBLISHED SINCE 1897

Volume 79
Issue 3 *Dickinson Law Review - Volume 79, 1974-1975*

3-1-1975

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Recommended Citation
Federal Income Tax Implications of Lump Sum Distributions Under Pennsylvania Employees Retirement System, 79 DICK. L. REV. (1975).
Available at: https://ideas.dickinsonlaw.psu.edu/dlra/vol79/iss3/2

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Federal Income Tax Implications of Lump Sum Distributions Under Pennsylvania Employes Retirement System †

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Editor's Note: This article updates the author's earlier discussion concerning the tax treatment of lump sum payments received by the deceased employee's designated beneficiary which is contained in Polisher, Federal Estate, Gift and Income Tax Implications of Certain Options Under the Pennsylvania Employes' Retirement System as affected by the Internal Revenue Code of 1954, as Amended, 77 Dick. L. Rev. 215 (1973). Mr. Polisher's current article discusses the significant changes which resulted from the enactment of the Employee Retirement Income Security Act of 1974.

After being drastically changed by the Tax Reform Act of 1969,[1] the income tax treatment of a lump sum payment received

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† Supplemental Advisory Opinion No. 1 to that of June 15, 1972, reflecting changes resulting from enactment of the Employee Retirement Income Security Act of 1974.

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The author gratefully acknowledges the assistance of Paul J. Schneider, Esquire, of the Philadelphia Bar, an associate of his firm.

1. *See* Polisher, *Federal Estate, Gift and Income Tax Implications of Certain Options Under the Pennsylvania Employes' Retirement System as Affected by the Internal Revenue Code of 1954, As Amended*, 77 DICK. L. REV. 215, 218 (1973).

by a deceased employee's designated beneficiary upon his death has again been substantially altered by the Employee Retirement Income Security Act of 1974 (ERISA).[2] These new rules apply to all lump sum distributions made to recipients during taxable years beginning subsequent to December 31, 1973.[3] As under prior law, that portion of any lump sum payment which represents a return of the employee's contributions is still completely excludable from taxable income.[4] In addition, the next $5,000 will also be excluded from the recipient's gross income.[5] It is only with respect to the remainder of the lump sum payment that the rules with regard to taxation have been changed.

Under the Tax Reform Act of 1969, the taxable portion of the lump sum payment that represented benefits accrued prior to 1970 and benefits accrued for years after 1969 not attributable to employer's contributions were taxable as long-term capital gain income[6] while the portion of the lump sum payment representing benefits accrued for years after 1969 attributable to the employer's contributions for such years were characterized as ordinary income, subject to either the regular 5 year[7] or a special 7 year income averaging provision.[8]

The Employee Retirement Income Security Act of 1974 has simplified the computation of the tax compared to that under the 1969 Tax Reform Act. The new rules require that the lump sum payment should be divided into two parts, a pre-1974 portion which

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2. INT. REV. CODE of 1954, § 402, as amended, Pub. L. No. 93-406, 88 Stat. 829 (1974), 8A U.S. CODE CONG. & AD. NEWS 1 (1974).

3. INT. REV. CODE of 1954, § 402(a)(1).

4. *Id.*

5. INT. REV. CODE of 1954, § 101(b). At this time, it is not entirely clear how the death benefit exclusion of IRC § 101(b) will be treated for purposes of computing the tax on a lump sum payment. The Conference Report stated that "no change is made respective to the $5,000.00 exclusion from gross income provided in § 101(b)(2)(B) of the Code for amounts paid by employers because of the death of the employee." In defining "total taxable amount" in IRC § 402(e)(4)(D), as amended by ERISA, however, the total distribution is to be reduced by the employee's contribution to the plan and the net unrealized appreciation in employer securities. There is no specific provision for reducing the total taxable amount by the death benefit exclusion. Under prior law, if the distribution was in the form of an annuity, the $5,000.00 death benefit exclusion was treated as an employee contribution. We believe that the same characterization should apply under the new provisions. This would result, in effect, in prorating the exclusion between the capital gain and ordinary income portions. Until the IRS issues regulations dealing with this question, however, this conclusion is subject to some uncertainty. *See* House Conference Report No. 93-1280, 93rd Cong. (1974); 8A U.S. CODE CONG. & ADMIN. NEWS 656 (1974).

6. Tax Reform Act of 1969, Pub. L. No. 91-172, tit. V, § 515(a)(1), 83 Stat. 643 (repealed 1974).

7. Self Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, § 4(b), 76 Stat. 821 (repealed 1974).

8. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 645, *enacting* 26 U.S.C. § 72(n)(4) (repealed 1974).

continues to be taxable as long term capital gain income[9] and a post-1973 portion which is now taxable as ordinary income.[10]

At the risk of over-simplifying, the computation of the income tax on these two portions is made by taking the total lump sum payment and reducing it by the employee's contributions, and the $5,000 death benefit exclusion, if applicable. The result is the total taxable amount.[11] The "minimum distribution allowance" is then subtracted from the total taxable amount. This allowance is the lesser of $10,000 or 50% of the total taxable amount, reduced (but not below zero) by 20% of the portion of the total taxable amount which exceeds $20,000.[12] After deducting the minimum distribution allowance, if any, from the total taxable amount, the separate taxable income is obtained. This amount is then divided by 10 and a tax, determined by using the tax rates for unmarried individuals, assuming no other income and no deductions, is computed on this amount. The resulting tax is multiplied by 10 to obtain the initial separate tax.[13] The initial separate tax is then multiplied by a fraction, the numerator of which is the ordinary income portion of the total taxable amount and the denominator of which is the total taxable amount.[14] The ordinary income portion was, in turn, determined by multiplying the total taxable amount by a fraction, the numerator of which is the employee's total calendar years of active participation after 1973 and the denominator of which is the employee's total calendar years of active participation.[15] The capital gain portion of the distribution is then determined by subtracting the ordinary income portion from the total taxable amount.[16]

Once the capital gain and ordinary income portions of the lump sum payment are determined, the capital gain portion is added to

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9. INT. REV. CODE OF 1954, § 402(a)(2). A common law employee is entitled to capital gain treatment on the pre-1974 taxable portion of any lump sum distribution, whether or not the special ten year averaging method is elected with regard to the ordinary income portion, if any. INT. REV. CODE of 1954, § 402(a)(2)(B).

10. *Id.* § 402(e)(1).

11. *Id.* § 402(e)(4)(D).

12. *Id.* § 402(e)(1)(D). Thus, there will be no minimum distribution allowance if the total taxable amount is $70,000.00 or more.

13. *Id.* § 402(e)(1)(C).

14. *Id.* § 402(e)(1)(B).

15. *Id.* § 402(e)(4)(E). The Treasury Department will issue regulations describing circumstances under which employees may use plan years instead of calender years and providing a method for allocating fractions of years for employees who have both pre-1974 and post-1973 active participation.

16. An alternative manner is provided in the Code. *See* INT. REV. CODE of 1954, § 402(a)(2).

the recipient's gross income for the year of distribution and is treated like any other long term capital gain that he might have recognized during that year.[17] After determining the income tax due on the recipient's gross income, including the capital gain portion of the distribution, and using his regular tax table and deducting all allowable deductions and exemptions and utilizing the regular 5 year income averaging provision, if appropriate, the tax on the ordinary income portion is added to the tax on the recipient's other income to determine the total tax due for the year.

The right to use the new ten year averaging tax computation must be specifically elected and is still dependent upon the employee having been a participant in the plan for at least five taxable years prior to the taxable year of distribution[18] and the receipt of the entire amount credited to his account[19] within one taxable year of receipt by reason of retirement, death, disability or having attained fifty-nine and one-half years of age.[20] Depending upon the circumstances of the distribution, this election may be made by an individual, his estate or a trust. In the case of a distribution to multiple trusts, the election must be made by the employee or the personal representative of the deceased employee[21] and the tax computation is made as if the entire lump sum distribution was paid to one individual. The total tax liability is then apportioned among the multiple trusts in proportion to the amounts received by each trust. Once an election has been made with respect to any employee who is fifty-nine and one-half years of age or older, no further elections may be made for any other lump sum distributions with respect to such employee.[22] Moreover, if any person receives more

17. *Id.*

18. INT. REV. CODE of 1954, § 402(e) (4) (H).

19. In determining whether the entire amount credited to an employee's account under the plan has been distributed, all trusts which are part of a plan must be aggregated and all plans of the same category, i.e. pension, profit sharing or stock bonus plans, must be aggregated. INT. REV. CODE of 1954, § 402(e) (4) (G). Nonqualified trusts and annuities are not taken into account.

20. The latter event was added by ERISA and assuming the existence of an appropriate plan provision, would allow a judge to work on a semi-retired basis and still receive a lump sum distribution without jeopardizing the ability to utilize the beneficial tax treatment afforded to such distributions.

21. INT. REV. CODE of 1954, § 402(e) (4) (B). The Internal Revenue Service has provided Form 4972 for use in computing the tax on the ordinary income portion of a lump sum distribution. This form must be filed as part of the recipient's tax return in order to elect the special ten year averaging method.

22. *Id.* § 402(e) (4) (B). A beneficiary may make the election under § 402(e) (4) (B) subsequent to age fifty-nine and one-half with respect to a lump sum distribution of his or her own interest in a plan, and make a later, or have made an earlier, separate election with respect to a distribution received as a beneficiary of another employee, whether such distribution is made from the same or a separate plan. However, the six year aggregation rule would apply to each such distribution. INT. REV. CODE of 1954, § 402(e) (2).

than one lump sum payment within six years of each other, beginning with 1974, they will be aggregated for purposes of calculating the tax rate of the separate tax on the current distribution.[23]

Author's Note: *Since the preparation of this article, the Commissioner of Internal Revenue issued proposed Regulations with respect to the taxation of lump sum distributions under Section 402 of the Internal Revenue Code of 1954, as amended by the Employee Retirement Income Security Act of 1974. In general, the proposed Regulations support the analysis of the income tax treatment of lump sum distributions as set forth in this article. The only exception is found in proposed Reg. § 1.402(e)-2(d)(B)(iii), which takes the position that if a distribution is made to more than one individual, it shall not be treated as a lump sum distribution unless the entire amount paid or distributed is included in the income of the employee in respect of whom the payment or distribution has been made.*

23. The effect of this aggregation is to elevate the current distribution to a higher tax bracket. In determining whether lump sum payments have to be aggregated, one determines if there has been any lump sum payment in the five years preceding the year in which the current lump sum payment is being received. If there were other lump sum payments received during that period, the elevation of tax brackets is accomplished by treating both the prior and current distribubtions as one distribution and computing the tax that would be due on that total amount. The resulting tax computation on the ordinary income portion is then reduced by the separate tax on the ordinary income portion already imposed with respect to the earlier distribution or distributions. The remainder is the tax due on the ordinary income portion of the current distribution. The actuarial value of any annuity contract received during the six year period is taken into account in taxing a later lump sum distribution even though the annuity itself is not then subject to tax as part of the lump sum distribution. A separate tax attributable to the annuity is computed, using the lowest tax brackets applicable to the taxable portion of its value, and subtracted from the aggregate separate tax on the taxable income portion of the distribution. See INT. REV. CODE of 1954, § 402(e)(2).

A recipient may not evade the aggregation requirement by directing that distribution be made to a grantor trust, or to any trusts under which the recipient is a beneficiary, since the recipient will be treated as having received the distribution in each such case. If a recipient has failed to make the election to take advantage of the special ten year averaging tax computation with respect to an otherwise qualified lump sum distribution, he will not be required to aggregate the distribution with a subsequent lump sum distribution.