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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200437038

U.I.L. 72.20-04

JUN 17 2004

SE:T:EP:RA:T2

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LEGEND:

Taxpayer A = *****************
Taxpayer B = *****************
Company M = *****************

Dear ********************:

This is in response to your letter dated August 25, 2003, as amended by correspondence dated November 12, 2003, submitted on your behalf by your authorized representative in which you request a ruling as to whether certain proposed methods of calculating distributions from an individual retirement account (IRA) owned by you will constitute a series of substantially equal periodic payments and will not be subject to the 10 percent additional tax imposed on premature distributions under section 72(t) of the Internal Revenue Code (Code). Your request for a ruling was supplemented by additional correspondence dated March 24, 2004.

The following facts and representations were made in support of your ruling request.

Taxpayer A is   years old. Taxpaver A is married to Taxpayer B and they file a joint Federal income tax return. As of   Taxpayer A retired and separated from service. As a result, Taxpayer A received several lump sum distributions from various qualified plans sponsored by his former employer. A portion of the distributions was directly transferred into a single rollover IRA with Company M. Taxpayer A is contemplating commencement of payments from his IRA in a series of substantially equal periodic payments.

Taxpayer A proposes the following methodology to calculate distributions from his IRA. The proposed methodology uses the account value and a life expectancy obtained from the single life expectancy table in section 1.401(a)(9)-9, Q&A-1 of the Income Tax Regulations (regulations). The proposed methodology relies upon a model of hypothetical purchases of zeroes made in the month preceding the first distribution from

the IRA. A zero is a non-interest bearing debt instrument of the U.S. Treasury ranging in maturity from 1 month to 25 years where the principal and interest components of the original debt instrument have been separated and sold independently of each other.

Taxpayer A proposes to build a ladder of zeroes containing 37 "rungs" or hypothetical purchases of zeroes to determine annual distribution requirements. These 37 "rungs" are based upon quotes received from an investment company (and involve extrapolation of the quotes for the periods after 25 years). The hypothetical purchases would be such that each zero is equal or nearly equal (to take into account the fact that zeroes are sold in $1,000 increments) in amount. In the example provided to us the annual payments would alternate between $59,000 and $60,000 (and thus would average about $59,500). The sum of the hypothetical purchase price for each zero would equal the account value of the IRA. You refer to this procedure as the "zero funding method".

Assuming that the Service rules favorable with respect to the above methodology, Taxpayer A further asks whether he can incorporate a cost-of living adjustment ("COLA") into all future year distributions. Taxpayer A proposes to uses either a fixed COLA, or a relative COLA. Assuming that the Service rules favorable with respect the above methodology, Taxpayer A asks whether such a methodology can be used on an annually recalculated basis.

Based on the foregoing, you request a ruling that the above described methodology, including the use of a COLA and annual recalculation, will result in an acceptable methodology for determining a series substantially equal payments under section 72(t)(2)(A)(iv) of the Code and will not be subject to the ten percent additional tax on premature distributions under section 72(t) of the Code.

Section 408(d)(1) of the Code provides that, except as otherwise provided, 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 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)(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 that 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 joint lives (or joint life expectancies) of such employee and his designated 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 the employee's attainment of age 59 ½, then the taxpayers tax for the first taxable year in which such modification occurs shall be increased by an amount determined under regulations, equal to the tax that would have been imposed except for the section 72(t)(2)(A)(iv) exception, plus interest for the deferral period.

Notice 89-25 was published on March 20, 1989, and 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 provides 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 of 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 assumption that must be an interest rate that does not exceed a reasonable interest rate on the date payments commence.

Revenue Ruling 2002-62, 2002-42 I.R.B. 710, which was published on October 21, 2002, modifies Q&A-12 of Notice 89-25. Rev. Rul. 2002-62 provides, among other things, that payments are considered to be substantially equal periodic payments within the meaning of section 72(t)(2)(A)(iv) if they are made in accordance with the required minimum distribution method, the fixed amortization method or the fixed annuitization method as described therein (the three methods described in Q&A-12 of Notice 89-25).

The required minimum distribution method determines the annual payment for each year by dividing the account balance for that year by the number from the chosen life expectancy table for that year. The fixed amortization method determines the annual payment for each year by amortizing in level amounts the account balance over a specified number of years determined using the chosen life expectancy table and the chosen interest rate. The fixed annuitization method determines the annual payment for each year by dividing the account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the taxpayer's age and continuing for the life of the taxpayer (or the joint lives of the individual and beneficiary). The annuity factor is derived using the mortality table in Appendix B of Revenue Ruling 2002-62, and using the chosen interest rate.

Section 2.02 of Revenue Ruling 2002-62 contains rules that apply to each of the three methods of calculating a series of substantially equal periodic payments. Section 2.02 provides, in general, that payments will constitute a series of substantially equal periodic payments if the payments are determined by using: (a) the uniform lifetime table in Appendix A of Revenue Ruling 2002-62, the single life expectancy table in section 1.401(a)(9)-9, Q&A-1 of the regulations, or the joint and last survivor table in section 1.401(a)(9)-9, Q&A-3 of the regulations, (b) an interest rate that is not more than 120

percent of the Federal mid-term rate, and (c) a reasonable manner of determining the account balance.

In this case, Taxpayer A's proposed methodology consists of an account valuation and a life expectancy obtained from the single life expectancy table in section 1.401(a)(9)-9 Q&A-1 of the regulations and implicitly uses a rate of interest that is determined by the market for zeroes. This is because the price paid today for a zero payable in a later year reflects the market's view of the appropriate interest rate (i.e., discount) to reflect the future payment of each $1,000 zero bond.

Given the account value, the life expectancy, and the annual payment, one can calculate the interest rate implicit in the derivation of the payment. For example, for a payment of $59,500 for 37 years and an account value of $1,000,000 (essentially your example), the interest rate is approximately 5.36 percent (assuming the first payment commencing immediately). In other words, if $1,000,000 was amortized in equal payments over 37 years at 5.36 percent interest (with the first payment made immediately) the payments would each be $59,500.

The interest rate inherent in the proposed methodology may very well exceed 120 percent of the Federal mid-term rate set forth in Revenue Ruling 2002-62. (For example, 120 percent of the applicable Federal mid-term rate for the months of January through June 2004 are as follows: January: 4.23 percent; February: 4.13 percent; March: 4.01 percent; April: 3.80 percent; May: 3.81 percent and June: 4.67 percent).

The concern that the Service would have under this method would be an interest rate that is too high. The higher the interest rate, the greater the payout. If the assumed interest rate is too high, the result would be payments that could not extend over the lifetime of the employee. In this case, because the rate of interest inherent in your proposed methodology may be higher than that permitted by Revenue Ruling 2002-62, the methodology implicitly uses an interest rate that will result in payments that would not extend over your lifetime.

Accordingly, we conclude that the proposed method (as modified) of determining periodic payments does not result in substantially equal periodic payments within the meaning of section 72(t)(2)(A)(iv) of the Code. Since we have concluded that the proposed methodology does not constitute a series of substantially equal periodic payments, your ruling with respect to using a COLA and annual recalculation, inasmuch as those rulings are based on an approval by the Service of Taxpayer A's proposed methodology, are considered moot.

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

A copy of this letter has been sent to your authorized representative in accordance with a power of attorney on file in this office.

200437038

If you have any questions, please contact ****************************SE:T:EP:RA:T2.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2

Enclosures:
- Deleted copy of ruling letter
- Notice of Intention to Disclose