# Changes in Lump-Sum Cash Withdrawals in Connection with the Start of Annuity Payments

## Previous PMRS Practice

Depending on the explicit provisions of specific retirement plans, PMRS members may or may not have both taxable and non-taxable moneys available for lump-sum distribution upon retirement. Such lump-sum distributions are often informally referred to as "option IV pay outs" but are defined by the Internal Revenue Service as "nonperiodic distributions."

Prior to February 2020, the non-taxable *payment* amount was determined to be equal to a member's *contribution* amount, i.e., if a member made $10,000 in post-tax contributions to the retirement plan, then the member could receive $10,000, non-taxed, as part of his or her lump-sum distribution. Any amount contributed by the member for any reason was included.

## Current PMRS Practice

For the purposes of determining member contributions for lump sum payments, PMRS does not include sums paid by a member to purchase service because those contributions have been converted to credited service in which the employee is 100% vested.

Moreover, IRS Publication 575 explains taxation of nonperiodic distributions from pension or annuity plans. According to the IRS, "Nonperiodic distributions are also known as amounts not received as an annuity. They include all payments other than periodic and correcting distributions" including "cash withdrawals" and "single-sum payments" in connection with the start of annuity payments.

The IRS states that a member who receives a nonperiodic distribution from a qualified retirement plan can only allocate part of it. Members may *exclude* from income the part that is allocated to the cost of the contract but must *include* the remainder in their gross income.

Publication 575 states that single-sum payments made on or after an annuity starting date in connection with the start of annuity payments must apply the following equation to determine taxability:

Amount Received x Cost of Contract/Account Balance = Tax-Free Amount


P.O.Box 1165 | Harrisburg, PA 17108 | 717.787.2065 | 1.800.622.7968 | F 717.783.8363
www.pmrs.state.pa.us | ra-staff@pa.gov

For purposes of PMRS members, "Cost of Contract" is the total amount of post-tax member contributions paid during employment, with the exception of sums paid by a member to purchase service, and "Account Balance" is the present value of the account calculated at the time of retirement.

**Impact on Members**

*What will change:*

1) The proportion deemed taxable vs. non-taxable at the time of distribution will be calculated and reported to the IRS based the guidance in IRS Publication 575.

   For example, if a member receives a lump sum payout of $50,000 with $10,000 of those dollars being the member's own previously-taxed contributions to the plan (the cost of the contract) and a total present value of the benefit (the account balance) of $100,000, the formula is:

   $50,000 x $10,000/$100,000 = $5,000

2) PMRS will no longer pay out any member contributions used to purchase service.

3) PMRS will no longer accept "Lump-Sum Distribution Supplement" forms (PMRB-6) dated prior to February 2020.

4) Lump-sum and retirement estimates prepared prior to January 8, 2020 may no longer be accurate. If in doubt, members should request new estimates prior to making retirement decisions.

**Rationale for Current Practice**

Should PMRS pay out member contributions used to purchase service, it would have the effect of allowing the employee to receive twice the benefit than has been funded.

Publication 575 sets forth the correct method for determining distribution of partially taxable payments. IRS Topics 410 and 411 discuss partially taxable payments and identify Publication 575 as the current and correct authority for calculating partially taxable payments. The current practice complies with Publication 575.