Chapter 9

Retirement Benefits

§ 9:1 Introduction

The income and estate tax rules governing employee retirement benefits, particularly under qualified plans have changed often over the last thirty years and, accordingly, different rules may apply for different individuals depending on their age and date of retirement. The variations produced by these changes dramatically affect distributions of retirement benefits at death or retirement of the employee. The Internal Revenue Code now is generally less favorable than prior law to employees vis-á-vis retirement benefits in several respects. Most notably, the rules governing ten-year averaging for lump-sum distributions from qualified plans (discussed more fully below) were first replaced by five-year averaging rules and then subsequently averaging for lump-sum distributions was eliminated entirely after 1999. In addition, the long-term capital gain treatment for certain lump-sum distributions was repealed. In each instance, however, the 1986 Tax Reform Act and subsequent legislation provided somewhat generous transitional and grandfathering rules, which allow certain individuals to continue to be taxed under the pre-1987 rules for years to come. The 1986 Code also contains significantly more stringent rules (and associated penalty taxes) with regard to premature distributions (that is, prior to age fifty-nine and one-half) on the one hand and excess deferrals (that is, generally after age seventy and one-half) on the other.

Although the tax rules applicable to the taxation of lump sum distributions are much less favorable, the rollover rules have been greatly liberalized. The rollover rules now allow distributions from qualified plans, IRAs, tax-sheltered annuities (403(b) plans) and certain 457 plans sponsored by governmental employers to generally be eligible for rollover to other qualified plans, IRAs, tax-sheltered annuities or certain 457 plans sponsored by governmental employers.

In addition, final and temporary Treasury Regulations serve to simplify and liberalize the rules for determining the minimum amounts that must be distributed annually from qualified plans, IRAs, 403(b) tax sheltered annuities and 457 deferred compensation plans generally after a participant attains age seventy and one-half, in order to avoid the penalty tax on excess deferrals.

Finally, the introduction of Roth accounts—both Roth IRAs and their more recent manifestation, Roth 401(k) accounts—have provided an additional opportunity for tax and estate planning. In the case of an employer plan that permits an employee to select between traditional deferrals and deferrals to a Roth account, individuals may need to consider a variety of factors, including those that pertain to the timing of distributions.

While these changes are significant, they do not diminish an essential point. In many families, employee benefits are the foundation of retirement hopes and a major source of income for surviving beneficiaries in the event of the employee's death, before or after retirement. Frequently, these benefits, together with the client's life insurance, are the main financial assets available at death. The appropriate organization of those assets may be the critical estate planning challenge. The estate planner has to be sensitive not only to how the general estate and income tax rules will affect a given individual, but to whether that individual is even subject to those rules.

§ 9:2 Estate Tax

At one time, benefits from qualified employee plans and Keogh plans enjoyed liberal exclusions from the deceased employee's gross estate. But over a period of years Congress washed away those exclusions. Today all death benefits from qualified employee plans, Keogh plans, and IRAs are includible in the decedent's gross estate.[1] The congressional attitude evidently is that the applicable exclusion amount and the marital deduction are substantial opportunities to lower or eliminate federal estate tax, and they should be resorted to by the employee to keep his benefits from being taxed, without the extra advantage of a special exclusion for this asset. Indeed, under the Economic Growth Tax Relief Reconciliation Act (EGTRRA), the applicable exclusion amount increased gradually to $3,500,000 in 2009. The $3,500,000 exemption amount will go far in insulating retirement benefits from estate taxation.

Under the Code, a surviving spouse cannot be deprived, without the spouse's written consent, of participation in an employee's benefit from a qualified pension plan in the form of a joint and survivor annuity, whereby payments would be made to the employee beginning at retirement and at the employee's death the payments (or a predetermined percentage thereof) would shift over to the surviving spouse for her lifetime.[2] If the employee dies before retirement, the spouse's annuity would start at the point in time that would have been the late employee's earliest retirement date. Such an annuity would qualify for the marital deduction.[3]

In a qualified profit-sharing or stock-bonus plan (including, generally, a 401(k) plan and an ESOP), a participant can elect a lump-sum distribution or installment payments without the spouse's consent at retirement or termination of employment; however, the spouse must be deemed to be the participant's beneficiary in the event of a death distribution, unless the spouse has consented in writing to the designation of another person as beneficiary.

The adviser must work out an appropriate plan for the payment of the retirement benefits. The first step is to determine what those benefits are, and next to learn the client's wishes as to the handling of

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1. I.R.C. § 2039.
2. I.R.C. §§ 401(a)(11), 417.
3. I.R.C. § 2056(b)(7)(C).

those benefits should he die before retirement. The client and the adviser must bear in mind the rights of the surviving spouse to participate in a joint and survivor annuity.[4] If the client wishes some other arrangement for the spouse, her consent must be obtained in an appropriate manner. If the alternative that the client has in mind is an outright distribution to the surviving spouse, and if that is permitted by the retirement plan, the spouse is almost sure to consent. But if the employee has in mind making the benefit payable in some other direction, away from the surviving spouse, obtaining her consent could be a formidable task.

If the employee is not married, or if the spouse will give consent, a payment to the employee's estate or to a trust created by the employee may be an ideal choice from an estate tax perspective. That would permit the commingling of the benefits with other assets that the employee has. State law should be examined to see if payment to the estate would deprive the employee of any advantage, such as protection from the claims of creditors or some exclusion from state death tax. But more has to be considered, because as discussed later, an important factor which must be taken into account in selecting the beneficiary is the beneficiary's opportunity to defer the recognition of income.

In corporate plans, part of the employer contribution is sometimes used to buy insurance on the employee's life. At retirement, the cash value of the policy is normally high, and that cash helps to finance the retirement distribution. If death comes before retirement, the face amount of the policy will be payable as a death benefit. Some commentators have contended that it is possible to extricate the insurance benefit from the rest of the retirement account, transfer the rights of ownership to the insurance benefit so that the employee has no attachment to it or incidents of ownership in the insurance, and safeguard the insurance from estate tax under all sections of the Code. Whether or not the contention is sound, the disadvantage of embarking on this adventure is that the employee, by parting with all rights to deal with the insurance part of his account, will be giving up his control, which includes the right to name the beneficiary of the insurance. That could be a significant right to surrender, as events could occur in the life of the employee that would make him wish to have the ability to name the beneficiary of that insurance.

The gift tax consequences of the designation of a recipient of employee benefits are harmless under general principles, so long as the employee may revoke his beneficiary designation. An irrevocable designation would lead to a gift, which would be of no immediate consequence if it were in favor of the employee's spouse, because it

4. *Supra* note 2.

would be eligible for the marital deduction.[5] The non-employee spouse's consent to waive the right to participate in a joint and survivor annuity does not constitute a taxable gift by the employee's spouse.[6]

At one time, there were special estate and gift tax rules applicable to benefits of an employee subject to community property laws. If the spouse of the employee predeceased that employee, notwithstanding the fact that the employee was a participant in his employer's plan, the community property interest the spouse had in those earnings was not part of the spouse's gross estate.[7] There was a companion gift tax provision. If the benefit was payable at the employee's death to someone other than the surviving spouse, that spouse would not be deemed to have made a gift of the interest in the benefit under the community property laws. These community property rules were repealed by the 1986 legislation. Inclusion in the spouse's gross estate and a gift by the spouse in the respective situations would therefore follow.

§ 9:3 Income Tax Rules for Distribution of Your Retirement Benefit

The income tax rules relating to the treatment of benefit distributions from qualified retirement plans have been greatly simplified in recent years. At the outset, the determination of which rules may apply depends upon the form of payment, and any elections made by the employee and the beneficiary. Generally, as discussed below, the greatest planning tool available is the rollover. However, certain participants born prior to January 1, 1936 may still be able to take advantage of the favorable income tax treatment under pre-1987 law.

The potential tax advantages and planning alternatives for distributions that qualify as eligible rollover distributions (generally lump-sum distributions and periodic payments that extend for less than ten years) are greater than for annuities, installments, or other periodic payments that extend for ten years or more. For that reason, we shall focus our attention first upon the income tax consequences of eligible rollover distributions. However, at the risk of belaboring the obvious, it must be emphasized that a lump-sum distribution or other form of eligible rollover distribution is an option only if the plan provides for it. Whether a particular plan offers distribution options that qualify as eligible rollover distributions is a question of plan design to be determined by the plan sponsor, and while virtually all individual

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5. I.R.C. § 2523(f)(6).
6. I.R.C. § 2503(f).
7. I.R.C. § 2039(d), repealed for estates of decedents dying after 1984.

account plans (including 401(k), profit-sharing, stock-bonus, and money-purchase pension plans) offer lump-sum distributions as an option or as the standard form of payment, that is not necessarily the case with defined benefit pension plans. As a general matter, defined benefit pension plans of large employers are less likely, and defined benefit pension plans of small employers are more likely, to offer lump-sum options, but there are countless exceptions to that rule of thumb. Of course, if the plan participant is also the owner, or one of the controlling owners, of the business, he may have it within his power to assure that distribution options that qualify as eligible rollover distributions are available.

A second potential limitation on the availability of eligible rollover distributions arises as a result of the Retirement Equity Act of 1984, which provides that a married participant in a pension plan (whether a defined benefit pension plan or a money-purchase pension plan) must receive his retirement benefit in the form of a qualified joint and survivor annuity payable over the lives of the retired participant and his spouse, unless the spouse consents, in a written election that is notarized or witnessed by a plan representative, to the payment of the benefit in any other form, including a lump-sum distribution.[8] A spouse's consent for a distribution in a form other than a joint and survivor annuity at retirement or termination of employment is generally not required for profit-sharing plans (including 401(k) plans) or stock bonus plans; however, the spouse must be the presumptive beneficiary of any death benefit under the profit-sharing or stock bonus plan, unless the spouse consents in writing to an alternative beneficiary selection, in order for the plan not to be subject to the general qualified joint and survivor annuity rules.[9]

§ 9:3.1 *Rollovers*

[A] Rollovers by Participant or Surviving Spouse

A distribution that constitutes an eligible rollover distribution made to the plan participant, or the participant's surviving spouse or alternate payee may be directly transferred (direct rollover) or, in most instances, also indirectly rolled over by means of a distribution followed by a contribution within sixty days to another eligible retirement plan.[10] Generally, the amount rolled over will not be taxed in the year rolled over but rather will be taxed in the year it is subsequently distributed from the recipient plan (if not then rolled over to another eligible retirement plan). However, if the distribution is

8. I.R.C. §§ 401(a)(11), 417.
9. I.R.C. § 401(a)(11)(B).
10. I.R.C. § 402(c)(3).

being rolled over to a Roth IRA, the distribution being rolled over must be included in gross income in the year rolled over unless the distribution was taxed when it was contributed to the distributing plan or IRA (i.e., if the distribution is from a qualified plan's Roth account).

If a rollover distribution is directly transferred to another qualified retirement plan that accepts rollover distributions or to a traditional IRA, no income tax will be withheld from any part of the distribution that is directly transferred to the other plan. Alternatively, if any part of an eligible rollover distribution from a qualified plan (other than from a Roth account) is distributed to the participant or the participant's surviving spouse or alternate payee, generally 20% of the distribution will be withheld for income tax.[11] If the recipient wishes to then rollover the distribution and receive favorable tax treatment for the entire pre-tax amount of the distribution, the recipient will need to replace the amount withheld from other funds.

An eligible rollover distribution is defined as any distribution of any portion of the balance to the credit of an employee distributed from an "eligible retirement plan" which is not

(i) one of a series of substantially equal periodic payments made for life or life expectancy (or the joint lives or life expectancies of the participant and the participant's beneficiary) or for a period of ten or more years,

(ii) a required minimum distribution under section 401(a)(9), or

(iii) a hardship distribution.[12]

An "eligible retirement plan" is a qualified plan, IRA, an annuity described in section 403(a), a section 403(b) tax sheltered annuity or a section 457(b) plan maintained by a governmental employer.[13]

Beginning with January 1, 2008, a taxable distribution from any eligible retirement plan can be rolled over to a Roth IRA.[14] Prior to

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11. I.R.C. § 3405(c).
12. I.R.C. § 402(c)(4). In addition, certain corrective distributions, loans treated as distributions, dividends paid on employer securities and the cost of life insurance are not considered eligible rollover distributions.
13. I.R.C. § 402(c)(8)(B).
14. A rollover of a taxable distribution to a Roth IRA before January 1, 2010 can only be made if the participant's (or surviving spouse's) modified adjusted gross income for Roth IRA purposes is not more than $120,000 if single or $176,000 if married, for the year the distribution is made and, if the recipient is married, the recipient files a joint return. If the participant (or surviving spouse) wishes to rollover the distribution to a Roth IRA in 2009 and is not eligible, the distribution can be rolled over to a traditional IRA and then, after 2009, the traditional IRA can be converted into a Roth IRA.

2008, such rollovers could only be from a traditional, SEP or SIMPLE IRA. Rollovers to Roth IRAs from accounts which are pre-tax will generally result in income tax at the time of the rollover. The amount included in income tax will be equal to the amount that would have been included if the distribution was paid to the participant (or surviving spouse) directly rather than rolled over. The 10% additional tax for early distributions, however, will not apply to amounts rolled over to a Roth IRA.[15]

Distributions of after-tax contributions from a qualified plan may also be treated as an eligible rollover distribution. For purposes of after-tax contributions other than from a designated Roth account in an employer plan, an "eligible retirement plan" includes (i) an IRA or (ii) a qualified plan or section 403(b) plan (but not a governmental section 457(b) plan) that separately accounts for the after-tax distribution (and earnings) and receives the distribution in a direct rollover.[16] If a distribution includes both taxable and after-tax contributions, the rolled over amount is treated as first coming from the taxable part of the distribution.[17] A distribution from a designated Roth account in an employer plan may also be rolled over, however, such distributions may only be rolled over to either (i) a Roth IRA or (ii) a designated Roth account in a qualified plan or section 403(b) plan.[18]

[B] Rollovers by Nonspouse Beneficiary

A designated beneficiary, other than a surviving spouse, is able to take advantage of the rollover rules beginning with distributions after December 31, 2006.[19] In the case of a designated nonspouse beneficiary, a distribution from a qualified plan may be rolled over and treated as an eligible rollover distribution only if the distribution is directly transferred to an IRA (either a traditional IRA or a Roth IRA) that was established to receive the distribution on behalf of the nonspouse beneficiary.[20] The IRA will then be treated as an inherited IRA subject to the applicable distribution rules (discussed in further detail below). No other amounts can be rolled into or out of the inherited IRA.

15. I.R.C. § 408A(d)(A).
16. I.R.C. § 402(c)(2). The rollover rules for after-tax distributions (other than from a designated Roth account) were expanded effective for distributions after December 31, 2006 by permitting rollovers to 403(b) plans.
17. *Id.*
18. I.R.C. § 402A(c)(3); Treas. Reg. § 1.402A-1, Q&A5.
19. I.R.C. § 402(c)(11)(A), as added by Pub. L. No. 109-280.
20. *Id.*

§ 9:3.2 Lump Sum Distribution Rules Applicable to Grandfathered Participants

[A] Capital Gains and Averaging Rules

Prior to the Tax Reform Act of 1986, the recipient of a lump-sum distribution could look forward in many cases to electing between the highly advantageous ten-year averaging provisions applicable to such distributions or, in the case of the employee or his spouse, making a tax-free rollover to an IRA, thus further deferring taxation. In addition, if the employee had been a participant in the plan prior to 1974, the pre-1974 portion of his distribution could be taxed as long-term capital gain.[21] The 1986 legislation repealed the capital gain provision and substituted five-year averaging for ten-year averaging, subject to phase-out and grandfathering rules. The Small Business Job Protection Act of 1996 (the "Small Business Act of 1996") later repealed the special five-year averaging rules for distributions made after December 31, 1999.[22] However, the Tax Reform Act of 1986 provided generous transitional and grandfathering rules in connection with the change in the averaging provisions applicable to lump-sum distributions and the repeal of long-term capital gain treatment for the pre-1974 portion of a lump-sum distribution. The Act provided that any employee who attained age fifty before January 1, 1986, or an individual, estate or trust that receives a distribution with respect to such an employee, could elect to remain subject to the pre-1987 ten-year averaging and capital gain provisions and be taxed on the capital gain portion of the lump-sum distribution at a flat 20% rate in the year of distribution.[23] Thus, barring any future change by Congress, an employee who reached age fifty before 1986 could conceivably receive his lump-sum distribution at any time on or before his required beginning date (see below), and still enjoy the benefits of the pre-1987 rules. However, in order to take

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21. The capital gain portion of a lump-sum distribution is determined by multiplying the total taxable amount of the lump-sum distribution by a fraction, the numerator of which is the employee's years of active participation in the plan prior to 1974, and the denominator of which is all years of active participation in the plan. I.R.C. § 402(a)(2), prior to its repeal by the Tax Reform Act of 1986, § 1122(b)(1). The taxable amount of the post-1973 portion of a lump-sum distribution was treated as ordinary income, except that if the taxpayer were otherwise eligible he could elect special ten-year averaging in order to avoid the effects of bunching taxable income in one year's return. I.R.C. § 402(e)(1), prior to its amendment by Tax Reform Act of 1986, § 1122(a).
22. I.R.C. § 402(d), as amended by Small Business Act of 1996, § 1401(c)(1), effective for tax years beginning after December 31, 1999.
23. Tax Reform Act of 1986, § 1122(h)(3)(C), as amended by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), § 1011A(b)(14).

advantage of the pre-1987 capital gain provisions, the taxpayer must make an election, which will effectively preclude him from any capital gain or special averaging with respect to any subsequent lump-sum distribution. Accordingly, the taxpayer must carefully consider the effect such an election may have upon future distributions and the relative size and potential tax savings of each such distribution. For the estate planner the grandfather rules mean that, notwithstanding the general repeal of capital gain and averaging, a participant who was born on or before January 1, 1936 may continue to defer distribution without losing the benefits of the pre-1987 law.

In order to constitute a lump-sum distribution eligible for averaging treatment and capital gain taxation for income tax purposes, the distribution must be made from a qualified plan within one taxable year of the recipient, and must consist of the entire balance to the credit of the employee,[24] which becomes payable (i) on account of the employee's death, (ii) after the employee attains age fifty-nine and one-half, (iii) on account of the employee's separation from service (only for common-law employees), or (iv) after the employee has become disabled (only for self-employed individuals).[25]

In order to qualify as a lump-sum distribution eligible for averaging treatment and capital gains taxation, the distribution must be made from an employer-sponsored qualified pension, profit-sharing, or stock-bonus plan (including a 401(k) plan and employee stock ownership plan). Even though they share certain characteristics and tax

24. I.R.C. § 402(d)(4) redesignated § 402(e)(4) by Small Business Act of 1996 § 1401(b)(1). In order to constitute a complete distribution, the lump-sum distribution must represent the employee's entire interest in the plan. This includes any nondeductible employee contributions and any salary reduction elections made by the employee pursuant to a section 401(k) arrangement, but does not include any accumulated deductible employee contributions. If an employer maintains two or more pension plans, two or more profit-sharing plans, or two or more stock-bonus plans, they must be aggregated for purposes of determining whether there has been a complete distribution. Thus, if an employer maintains both a money-purchase pension plan and a defined benefit pension plan, a complete distribution from the money-purchase plan upon the employee's retirement, separation from service, or death will not be taxed as a lump-sum distribution unless a complete distribution is made from the defined benefit plan as well. Plans of different types need not be aggregated, so that a complete distribution from a profit-sharing plan, if otherwise eligible, will be taxed as a lump-sum distribution regardless of whether or not a complete distribution is also made from the same employer's pension plan. I.R.C. § 402(d)(4) redesignated § 402(e)(4) by the Small Business Act of 1996, § 1401(b)(i).

25. I.R.C. § 401(e)(4)(A) redesignated § 402(e)(4)(D)(i) by the Small Business Job Protection Act of 1996 ("Small Business Act of 1996"), § 1491(b)(1).

advantages with qualified plans, such arrangements as IRAs, simplified employee pensions (SEPs), section 403(b) tax-sheltered annuities, and section 457 plans are not qualified plans for this purpose. Accordingly, distributions from such arrangements, for whatever reason, can never enjoy the potential capital gain or special averaging provisions.[26]

The ten-year averaging provisions do not enable the recipient to pay the tax that is due and owing on the distribution over more than one year. Rather, the ten-year averaging device is premised upon trying to determine the amount of tax due upon one-tenth of the post-1973 portion of the distribution and multiplying the result by ten.[27] The method of calculation assumes that the recipient is not married, has no dependents, and has no other income or deductions, other than the zero-bracket amount. The calculation is based on the rates in effect in 1986. The result is that the amount of tax payable on a given lump-sum distribution under ten-year averaging would be the same whether the recipient has no other taxable income or has millions of dollars in additional taxable income in the year of distribution.[28] If there were a single flat income tax rate, the averaging provision would be useless,

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26. I.R.C. §§ 402(c)(5), 403(b)(8), 408(d)(3).
27. There are several other adjustments which may apply. For example, lump-sum distributions of under $70,000 are reduced by the minimum distribution allowance (as defined in I.R.C. § 402(e)(1)(C) prior to its amendment by the Tax Reform Act of 1986, § 1122(a)) and lump-sum distributions made on account of death are reduced by the $5,000 death benefit exclusion (under I.R.C. § 101). On the other hand, the amount of any lump-sum distribution received during the previous five years for which a lump-sum election was made must be added to the value of the current lump-sum distribution (subject to a credit for the tax paid on that previous distribution). *See generally*, I.R.C. § 402(e) prior to its amendment by the Tax Reform Act of 1986, § 1122(a).
28. For example, the federal income tax under ten-year averaging using the 1986 rates was $14,756 on a $100,000 lump-sum distribution (a 14.7% rate) and $146,413 on a $500,000 lump-sum distribution (a 29.3% rate). Those results are in sharp contrast with the general marginal tax rates for 2009, which are 35% on taxable income over $372,950 using the rates applicable to married couples filing joint returns. For many individuals, the actual tax savings under ten-year averaging are so great that they can be even more advantageous than long-term capital gain rates. Accordingly, the recipient of a lump-sum distribution could make a special election to treat the entire taxable amount as if it had been earned after 1973, thereby subjecting it to the ten-year forward averaging provisions. This special election, once made, applies to all lump-sum distributions in the same year or any subsequent year. The special election to waive capital gains treatment cannot be made if the recipient previously received another lump sum distribution after 1975 any portion of which was taxed as capital gain. I.R.C. § 402(e)(4)(L) prior to its amendment by Tax Reform Act of 1986, § 1122(a).

but given a tax code that employs increasing marginal tax brackets, the potential tax saving under ten-year averaging is substantial.

In order to elect ten-year averaging, the recipient must make a written lump-sum election and have been a participant in the plan for five or more taxable years before the taxable year in which the distribution is made (unless the distribution is made on account of the employee's death).[29]

[B] Lump-Sum Elections (Pre-1987 Rules)

The lump-sum election was (and remains) a prerequisite to the special lump-sum averaging rules, but was not required for capital gain treatment, if applicable, unless the taxpayer was self-employed (including partners). Any election to invoke the pre-1987 tax rules under the grandfathering provisions of the Tax Reform Act of 1986 constitutes a lump-sum election made after 1986, and thus precludes the taxpayer from any subsequent lump-sum election with regard to another distribution. The grandfathering rules can be invoked by an election made by the taxpayer regardless of whether or not he has reached age fifty-nine and one-half at the time of the lump-sum distribution, but the election will use up the taxpayer's lifetime allowance.

The general prohibition against more than one lump-sum averaging election does not preclude a taxpayer from making a lump-sum averaging election with respect to his own retirement benefit and a separate lump-sum averaging election if the taxpayer is also a beneficiary of another person's death benefit from a qualified plan. Further, a death distribution may qualify for the capital gain treatment and ten-year averaging grandfather protection afforded lump-sum distributions of taxpayers who reached age fifty prior to 1986. Finally, eligibility for a lump-sum averaging election will be determined with respect to the decedent, not the beneficiary.[30]

[C] Taxable Amount of Lump-Sum Distributions (Pre-1987 Rules)

The concept of the taxable amount of a lump-sum distribution is critical.[31] It is the portion of the distribution after extracting the employee's nondeductible contributions (but not the earnings

29. If a lump-sum distribution made on account of the employee's death is payable to more than one beneficiary, each beneficiary that is an individual, trust, or estate could make a separate election whether or not to income-average.
30. I.R.C. § 402(d)(4)(D), prior to its repeal by Small Business Act of 1996, § 1401, effective for tax years beginning after December 31, 1999.
31. An entirely different income tax result will come about if the employee's benefits are paid in other than a lump sum, that is, in installments or an

thereon), the employee's accumulated deductible contributions from 1982–1986 (including the earnings thereon), and any net unrealized appreciation that may be attributable to any distributed securities of the employer corporation.[32] Employee pre-tax contributions under 401(k) plans are considered as employer contributions for this purpose and thus are includible in the taxable amount of the lump-sum distribution.

Say, for example, that an employee dies and a lump-sum distribution has been elected as the method of payment to the beneficiary. Assume the distribution includes shares of employer stock and that the value of the stock is substantially higher than the cost at which the employee benefit plan acquired the stock for the deceased employee's account. If those shares are sold by the qualified retirement trust and distributed, the recipient will be taxed on the distribution in accordance with the rules previously described.

If the shares of stock are distributed in kind to the beneficiary, the results are transformed. First, the appreciation in the stock above its acquisition cost is excluded from taxable income and therefore not subject to tax at the time of distribution. The beneficiary has gained a tax deferral on the appreciation but not on the cost value of the distributed shares. Second, when the beneficiary sells the stock, whether quickly or gradually, the sale will be treated as long-term capital gain to the extent of the appreciation while the stock was in the plan and (assuming that the appropriate holding period is observed) to the extent of post-distribution appreciation.[33] That treatment applies even if the stock is attributable to years of plan participation after 1973. Of course, the decision to take stock in a lump-sum distribution and the further decision to retain it for any length of time ought to be influenced by the quality of that stock as an investment and by the state of the market. Further, capital gain treatment will not necessarily be advantageous in the future. Recognizing that, the recipient may elect to include the appreciation as part of the total taxable amount of the lump-sum.[34]

There are other income tax facets to lump-sum distributions.[35] The inclusion of the lump-sum benefit in the gross estate will permit

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annuity. In that event, the payments are taxable as ordinary income when received, under section 72 of the Code. *See* I.R.C. § 402(a). If the plan is contributory, the beneficiary will recover the employee's nondeductible contributions free of income tax.

32. I.R.C. § 402(d)(4)(D) prior to its repeal by Small Business Act of 1996, § 1401.

33. Treas. Reg. § 1.402 (a)-1(b)(1).

34. I.R.C. § 402(e)(4)(B) prior to its repeal by Small Business Act of 1996.

35. Prior to its repeal by Small Business Act of 1996, § 1402(c), effective August 20, 1996, I.R.C. § 101(b) provided for the exclusion from gross income for the first $5,000 of a distribution paid because the employee died.

the recipient to claim an income tax deduction under section 691(c) for estate tax attributable to income in respect of a decedent if the employee's estate was subject to estate tax after all deductions and credits have been used.[36] There is a special rule in the Code to discourage taxpayers from seeking to soften the special averaging tax impact by using a series of trusts as the designated recipients of the lump-sum distribution. The special averaging tax on a lump-sum distribution cannot be reduced by splintering the distribution among two or more recipients, because the special averaging tax will be computed as if the distribution had been made to only one recipient and then allocated pro rata among the recipients.[37]

§ 9:3.3 *Income Tax Treatment of Employee Contributions to Qualified Plans*

The income tax treatment of distributions from qualified plans of employee contributions depends primarily on whether they were contributed on a pre-tax or after-tax basis. Pre-tax contributions include deductible contributions and after-tax contributions include nondeductible voluntary contributions.[38] To a lesser extent, the tax treatment depends upon the form of distribution, as discussed above.

Nondeductible employee contributions are not subject to income tax upon distribution. This is because the employee made the contributions out of after-tax dollars in the first place. If paid to the employee or the beneficiary in a lump sum, they are entirely excluded from taxable income. If the employee or beneficiary receives payouts in the form of an annuity or in installments, part of which are attributable to nondeductible employee contributions, an exclusion ratio will be calculated so that a pro rata portion of each periodic annuity

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36. Rev. Rul. 75-125, 1975-1 C.B. 254; Rev. Rul. 69-297, 1969-1 C.B. 131.

37. I.R.C. § 402(d)(4)(A) redesignated § 402(e)(4)(D)(i) by Small Business Act of 1996, § 1401. The Commissioner has extended that result to splitting the distribution among individual beneficiaries or among individuals and trusts. If that multiplicity of beneficiaries is attempted, the aggregate income tax on a lump-sum distribution will be roughly the same as if the distribution had gone to only one beneficiary. Assuming there is a multiplicity of beneficiaries, and assuming that they do not make the same election, the results seem to work equitably. The beneficiary seeking lump-sum treatment will pay the tax as if receiving a proportionate part of a total lump-sum distribution. If the distribution is not a lump sum, there is no statutory basis to preclude an employee from splitting pension or profit-sharing benefits among several individuals, or among several individuals and one trust, and thereby having the income tax consequences spread among them all. Tech. Info. Rel. 1426 (Dec. 15, 1975).

38. For purposes of this discussion, elective deferrals, whether pre-tax or after-tax, to 401(k) plans are considered employer contributions.

payment will be excluded from income.[39] The income tax treatment of earnings attributable to nondeductible employee contributions is the same as for employer contributions and earnings thereon, as described in the preceding sections. This is because the earnings were tax-sheltered as long as they remained in the plan. If the retired employee recovers his aggregate nondeductible contributions through the mechanism of the exclusion ratio, any subsequent payments will be treated as taxable income in their entirety.[40] Conversely, if the retired employee dies after commencement of his retirement benefit, but before he has fully recovered his nondeductible contributions through the exclusion ratio, the unrecovered amount is deductible on the person's last tax return.

The income tax treatment of a distribution of deductible employee contributions is quite different. The term "deductible employee contributions" refers to amounts that were contributed to IRA-like accounts forming part of a qualified plan. Such accounts, if permitted by the plan sponsor, have been frozen as a result of the Tax Reform Act of 1986. That is, such contributions are no longer deductible for years beginning on or after January 1, 1987, but such accounts can continue to be maintained in accordance with their terms. If the distribution of deductible employee contributions and earnings thereon is made on account of the employee's death, it will be taxed as ordinary income to the recipient. Such amounts are not subject to rollover by a beneficiary unless the beneficiary is the surviving spouse, who can roll them over to an individual retirement plan.[41] As discussed later, by designating an individual or certain forms of trusts as the beneficiary, there are opportunities to defer the income tax over the beneficiary's lifetime.

§ 9:3.4 Roth IRAs

Roth IRAs were previously unavailable to many individuals because of limits on an individual's (or, together with his or her spouse) "modified adjusted gross income."[42] Beginning in 2010, individuals, regardless of their modified adjusted gross income, can either convert traditional IRAs into Roth IRAs, or where applicable (i.e., the individuals is eligible for an eligible rollover distribution), rollover

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39. I.R.C. § 72(b).
40. I.R.C. § 72(b). Prior to the Tax Reform Act of 1986, a retired employee could elect to receive his benefits tax-free until he had recovered his nondeductible contribution if such contributions did not exceed his first three years of benefit distributions. This three-year rule, which was found in I.R.C. § 72(d), was repealed by the Tax Reform Act of 1986, § 1122(c)(1), effective for benefits commencing after July 1, 1986.
41. I.R.C. § 402(c)(9).
42. I.R.C. § 408A(d)(3)(A), amended by Pub. L. No. 109-22 and Pub. L. No. 109-280, for tax years beginning after December 31, 2009.

amounts from qualified plans to Roth IRAs.[43] Whether conversion of a traditional IRA to a Roth IRA makes sense for any given individual depends on a variety of factors. For one, the individual needs to consider (and in some cases predict) the applicable tax rates for the year of conversion or rollover and the tax rates when the individual reaches retirement age. There is some measure of uncertainty here since while the rates will be known in the near future, tax rates over the longer horizon are largely speculative. If an individual believes that tax rates will increase over time, he might be more inclined to convert to a Roth IRA and avoid the anticipated tax increase in the future. Of course, individuals who are uncertain may also choose to hedge their bets by choosing a strategy that employs both traditional IRAs and Roth IRAs.

Unlike traditional IRAs, Roth IRAs are not subject to any "required beginning date" or "minimum distribution" schedule during the participant's lifetime.[44] If there are residual amounts in a Roth IRA account at death, such amounts pass to the beneficiaries of the Roth IRA at which point they become subject to the minimum distribution rules applicable to beneficiaries of traditional IRAs where the decedent died prior to his required beginning date.[45] The distributions, unlike distributions from traditional IRAs, will not be subject to income tax when paid provided they are qualified distributions.[46] As with traditional IRAs, a surviving spouse may also treat an inherited Roth IRA as his or her own so that distributions would not need to begin until the April 1st following the year in which the surviving spouse reaches age seventy and one-half.

A conversion of a traditional IRA to a Roth IRA (or a rollover of distributable amounts from a qualified plan or traditional IRA to a Roth IRA) will result in income tax for the year of conversion (or rollover). For any conversions or rollovers in 2010 of pre-tax accounts to a Roth IRA, individuals are able to elect to defer the tax ratably over two years in 2011 and 2012.[47]

§ 9:3.5 Income In Respect of a Decedent

A beneficiary's interest in a decedent's qualified plan or IRA is treated as income in respect of a decedent (IRD) under section 691. Therefore, it will be subject to income tax when distributed to the beneficiary, in accordance with the rules previously described; there is

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43. *Id.*
44. I.R.C. § 408A(c)(5).
45. Treas. Reg. § 1.4028A-6, Q&A13.
46. *Id.*
47. I.R.C. § 408A(d)(3)(E)(ii)(1).

no step-up in basis. As with other items of IRD, the beneficiary will be entitled to a deduction for the amount of estate tax, if any, allocable to the qualified plan or IRA.[48]

The deduction for estate tax will ordinarily apply in any case where there is a taxable estate. By the same token, where there is no taxable estate, such as where the combination of the allowable credit amount and the marital deduction entirely wipe out the estate tax, there cannot be a section 691(c) deduction. In taxable estates the interplay of the marital deduction and the section 691(c) deduction is interesting—but somewhat inequitable. The surviving spouse who receives the retirement benefits will be entitled to a section 691(c) deduction, even though the benefits qualify for the marital deduction and generate no estate tax liability.[49] In essence, the surviving spouse gets a section 691(c) deduction which equitably should belong to other IRD recipients.

Where an estate or trust is the recipient of the retirement benefits constituting the IRD, the allocation of the section 691(c) deduction becomes more complicated. If any amount "properly paid, credited or distributed" by the estate or trust to a beneficiary consists of IRD received by the estate or trust during the year, such portion of the IRD deemed "paid, credited or distributed" will be excluded from the taxable income of the estate or trust and deemed IRD to the beneficiary.[50] Under these circumstances, the section 691(c) deduction allocable to the item will be a deduction to the beneficiary rather than the estate or trust.[51]

A special rule also applies if the retirement plan interest is a lump sum payable from a qualified plan under section 691(c)(5) (which was repealed by the Small Business Act of 1996 effective for tax years beginning after December 31, 1999). This rule only applies when the special averaging rules apply. In that event, the total taxable amount of the lump sum distribution must be reduced by the amount of the deduction allowed for the estate tax.[52] This rule forces the beneficiary of a lump sum distribution to use the deduction for estate tax specifically against the lump sum which is likely to be taxed at relatively low rates under the averaging rules, rather than being able to use the deduction against ordinary income which may be taxed at a higher rate.

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48. I.R.C. § 691(c)(1)(A).
49. Findlay v. Comm'r, 332 F.2d 620 (2d Cir. 1964).
50. I.R.C. § 691(c)(1)(B).
51. *Id.*
52. I.R.C. § 691(c)(5) prior to its repeal by Small Business Act of 1996 § 1401(b)(a).

§ 9:3.6 Penalty Taxes on Premature Distributions and Failure to Make Minimum Distributions

The additional (penalty) taxes on (1) premature distributions (that is, prior to age fifty-nine and one-half) and (2) the failure to meet minimum distributions (that is, after a taxpayer's required beginning date), evidence a growing legislative trend toward penalizing taxpayers for taking what Congress regards as undue advantage of the favorable tax laws governing qualified plans and plan distributions.[53] The estate planner must take these provisions into account, as they will have an impact on the amount of qualified plan benefits that may be distributed during the taxpayer's lifetime and how much may be deferred until his death.

[A] Tax on Premature Distributions

Distributions made prior to age fifty-nine and one-half from any form of qualified plan, IRA, SEP or section 403(b) tax sheltered annuity are subject to a 10% additional tax.[54] Distributions from a Roth IRA that are not qualified distributions (as discussed in further detail below) are also subject to the 10% additional tax.

The premature distribution tax is subject to several important exceptions. It does not apply to distributions made on account of death or disability, and can be avoided by a rollover to an IRA or qualified plan.[55] The 10% additional tax also does not apply to distributions from IRAs or qualified plans that

(i) are made in approximately equal periodic amounts for life or the joint lives of the participant and his beneficiary or a period determined based upon the taxpayer's life expectancy or the joint life expectancy of the participant and his beneficiary,

(ii) are made for deductible medical expenses,

(iii) are made on account of an IRS levy on a qualified retirement plan;

(iv) are from an employee stock ownership plan for dividends on employer securities held by the plan; or

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53. I.R.C. §§ 72(t), 4974. These taxes are described as additional taxes, which has some significance for the manner in which they can be assessed, but for all intents and purposes, they are effectively penalty or excise taxes, insofar as they are imposed at a flat rate on the portion of the distribution, or failure to distribute, that violates the particular statutory provision, regardless of the taxpayer's other items of income or deductions for the year.

54. I.R.C. § 72(t)(2)(A).

55. *Id.*

(v) are from elective deferral accounts under 401(k) or 403(b) plans or similar arrangements that qualify as qualified reservist distributions.[56]

A few of the exceptions to the premature distribution tax apply to either qualified plans or IRAs, but not both. The additional tax does not apply to distributions from qualified plans that

(i) are made after separation from service in the year of or after attainment of age fifty-five or

(ii) are pursuant to a qualified domestic relations order.[57]

The premature distribution tax also does not apply to distributions from IRAs that

(i) are paid to individuals receiving unemployment compensation for payment of health insurance premiums,

(ii) are qualified higher education expenses, or

(iii) within 120 days of the distribution are used by the individual to pay qualified acquisition costs for a principal residence of the individual (or certain family members) where such individual is a first time homebuyer.[58]

Qualified distributions from Roth IRAs (including earnings on the rolled over amount), are not taxed on distribution. A "qualified distribution" is any distribution made after the five-year period beginning on the January 1st of the year in which the first contribution was made to the Roth IRA and which (i) is made after age fifty-nine and one-half, (ii) is made on account of death or disability or (iii) meets the exception for qualified first-time homebuyer distributions.[59] The five-year period for a Roth IRA inherited by a beneficiary or held by a surviving spouse who treats the decedent's Roth IRA as her own, includes the period it was held by the decedent.[60] A surviving spouse that has her own Roth IRA and also inherits a Roth IRA, can use the five-year period that ends with the earlier of the five-year period applicable to the decedent's Roth IRA or the one applicable to the surviving spouse's own Roth IRA.[61] Generally, any distribution from a Roth IRA that is not a qualified distribution will be subject to the 10% additional tax on early distributions only to the extent the distribution

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56. *Id.*; I.R.C. § 72(t)(2)(A), (B) and (G).
57. I.R.C. § 72(t)(2)(A) and (C).
58. I.R.C. § 72(t)(2)(D), (E) and (F).
59. I.R.C. § 408A(d).
60. Treas. Reg. § 1.408A-6 Q&A3.
61. Treas. Reg. § 1.408A-6 Q&A7.

is then includible in gross income. Thus the 10% additional tax is generally applicable only to earnings.[62] However, if an otherwise taxable amount is rolled over into a Roth IRA from an eligible retirement plan or converted from a traditional IRA and is distributed within five years, the 10% additional tax applies to such distribution as if the entire distribution was includible in gross income.[63]

The 10% penalty tax on premature distributions will not have a great deal of direct significance for the estate planner, since by its terms it does not apply to death distributions, and most individuals making lifetime distributions in anticipation of death are likely to be older than age fifty-nine and one-half. It does, however, have some indirect significance, insofar as it may encourage younger employees who terminate employment either to defer receipt of their distribution until a later age or roll over the distribution into an IRA or another qualified plan.

[B] Minimum Distributions and Required Beginning Date

Qualified plans, section 403(b) tax sheltered annuities, 457 plans and IRAs are subject to minimum distribution rules designed to prevent the unlimited deferral of benefit distributions in order to avoid taxes. Except with respect to Roth IRAs, the minimum distribution rules apply both to lifetime distributions to the employee (or the traditional IRA holder) and to distributions made to his spouse or other beneficiary after death.[64] The minimum distribution rules only apply to distributions from a Roth IRA after the Roth IRA holder's death. In the case of a failure to make distributions from a qualified plan, section 403(b) tax sheltered annuity, 457 plan or IRA that would

62. Treas. Reg. § 1.408A-6 Q&A4. The effect of the 10% additional tax for nonqualified distributions from a Roth IRA is mitigated by the ordering rules that apply to distributions. I.R.C. § 408A(d)(4). These ordering rules provide that earnings are the last amounts to be distributed from a Roth IRA. Therefore, it is possible that certain nonqualified distributions can be made before the 10% additional tax will apply.

63. I.R.C. § 408A(d)(3)(F); Notice 2008-30, 2008-12 I.R.B. 638.

64. Pursuant to the Worker, Retiree, and Employer Recovery Act of 2008 required minimum distributions from retirement plans and IRAs were waived for 2009. *See also* Notice 2009-9, 2209-5 I.R.B. 419 and Notice 2009-82, 2009-41 I.R.B. 491. If a required minimum distribution is made with respect to 2009, the participant may be eligible to rollover the distribution. The waiver does not apply to any 2008 required minimum distribution, even if they are being paid in 2009 (i.e., retired employees and IRA owners who turned seventy and one-half in 2008). Also, as a result of the waiver, beneficiaries who are receiving distributions over a five-year period can effectively take the distributions over a six-year period.

meet the minimum distribution rules, a 50% additional (penalty) tax is imposed on the shortfall unless waived by the Internal Revenue Service, for reasonable cause.[65]

The minimum distribution rules require distributions from a qualified plan or traditional IRA to commence no later than an individual's "required beginning date." The definition of "required beginning date" has changed over time. Prior to the Tax Reform Act of 1986, "required beginning date" was defined as the April 1st following the year in which the employee reached age seventy and one-half or retired, whichever was later, except with regard to distributions from IRAs or distributions from qualified plans to 5% owners, where it meant the April 1st following the year in which the individual reached age seventy and one-half regardless of the year of retirement.[66] This was changed effective for years beginning after 1988 and prior to 1997, when "required beginning date" was defined as the April 1st following the year in which any participant attained age seventy and one-half, without regard to his actual date of retirement.[67] For years beginning after December 31, 1996, the definition of "required beginning date" reverted back to the pre-1989 (that is, minimum distributions must commence no later than the April 1st following the year in which the employee reaches age seventy and one-half or retires, whichever is later except with regard to distributions from traditional IRAs and distributions from qualified plans payable to 5% owners, in

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65. I.R.C. § 4974(a). The failure must be due to reasonable error and the taxpayer must establish that reasonable steps are being taken to remedy the situation. I.R.C. § 4974(d). The 50% additional tax for a failure to make minimum distributions was generally extended to qualified plans, section 403(b) tax sheltered annuities and section 457 qualified plans, effective January 1, 1989.
66. Section 1852(a)(4)(A) of the Tax Reform Act of 1986 amended I.R.C. § 401(a)(9)(C) to extend the rule with regard to 5% owners to any individual who is or was a 5% owner at any time during the five-year period prior to age seventy and one-half.
67. I.R.C. § 401(a)(9) as amended by the Tax Reform Act of 1986, as in effect prior to the Small Business Act of 1996. Any individual who attained age seventy and one-half before January 1, 1988 (other than an individual who is or was a 5% owner during the plan year ending in the year he reached 66 1/2 or in the subsequent year), was permitted to continue to defer commencement of distributions until the April 1st following the year of his retirement to the extent allowed under the law as in effect prior to the Tax Reform Act of 1986. In addition, any individual who made a special written election pursuant to the terms of the Tax Equity and Fiscal Responsibilities Act of 1982 (TEFRA § 242(b)(2)), could continue to defer commencement pursuant to the terms of such election. Tax Reform Act of 1986, § 1121. I.R.C. § 401(a)(9)(C), as amended by Small Business Act of 1996, § 1404(a).

which case distributions must begin no later than the April 1st following the year in which the individual reaches age seventy and one-half, regardless of the year of retirement).[68]

Once a distribution begins, it must be made no less rapidly than an annuity for the life of the individual or a joint life annuity for the individual and his designated beneficiary, or over a period no greater than the life expectancy of the individual or the joint life expectancy of the individual and his beneficiary. The required minimum distributions rules that apply in the event of the participant or IRA holder's death, whether prior to or after his required beginning date, are discussed in further detail below.

Many individuals with substantial financial resources would just as soon defer distributions from a qualified plan, IRA, or other tax favored arrangement indefinitely, in order to maximize the value of the plan's tax exemption. Indeed, that is precisely the reason Congress imposed the minimum distribution rules in the first place. However, the minimum distribution rules still allow for a considerable period of deferral even after age seventy and one-half and retirement. A joint life expectancy of an employee at age seventy and one-half and his spouse will frequently exceed twenty years. The impact of the minimum distribution rules is discussed below in connection with selecting the beneficiary.

§ 9:4 Selecting the Beneficiary

The selection of a beneficiary for the employee's qualified retirement arrangements becomes critical because it impacts each of the foregoing tax considerations and must be coordinated with the rest of the client's estate plan. It is at this juncture that the estate tax and income tax planning considerations come together. Take the starkest of circumstances. If the rich benefit which the client has toiled a lifetime to accumulate in his qualified plan is simply paid to his estate upon death without the availability of the marital deduction under the Will, the benefit will be subject to both estate tax and income tax in short order and the combined tax rates may exceed 70%. When applied together, these taxes can devastate retirement benefits at death leaving little left for the family.

To ameliorate these harsh results, careful estate and income tax planning is required to preserve what can be saved for the family. On the estate tax side of the equation, in many cases, the objective should be to make a beneficiary designation which will qualify the benefit for

68. I.R.C. § 401(a)(9)(C). Under the current rules, an individual is a 5% owner if he is 5% owner during the plan year ending in the calendar year in which he attains age seventy and one-half. *Id.*

the marital deduction whenever feasible to postpone the estate tax until the death of the surviving spouse. On the income tax side of the equation, in respect of any pre-tax retirement benefits, the optimum objective is to designate the beneficiary or beneficiaries who will have the opportunity to defer the income taxation of the benefit for the longest period possible.

Notwithstanding certain countervailing factors, income tax deferral of pre-tax amounts in qualified plans or IRAs is often the goal of the employee and the estate planner. This assumes that the estate and the employee's beneficiaries have other assets from which to pay the estate taxes, if any, and from which to meet other needs. Because income tax awaits distributions from qualified plans or traditional IRAs (but not Roth accounts or Roth IRAs), deferring their use produces savings. Further, due to the tax-exempt nature of the qualified plan or traditional IRA, it is tax-effective to preserve them, so that they should be the last source of immediate cash needs, not the first.

Of course, there may be overriding personal or financial circumstances which make it impossible to take advantage of maximum deferral opportunities. For example, there may be no other sources from which to pay the estate taxes attributable to the plan benefit, or the benefit may be needed to pay the taxes attributable to other illiquid estate assets such as stock in a closely-held business, or the beneficiary may not be in a financial position to defer receipt of the benefit and otherwise cover bills and expenses. In these cases, there may be no choice but to pay the benefit to the participant's estate or for the designated beneficiary to take down the benefit rapidly and to forego the opportunity to defer income taxation. The limitations on income tax deferral will be found, for the most part, in the minimum distribution rules under section 401(a)(9) of the Code and the related Treasury Regulations.

The IRS has issued several rounds of guidance on required minimum distributions. Proposed Regulations were first issued in July 1987 (the "1987 Proposed Regulations"). In 2001, the IRS issued new proposed regulations (the "2001 Proposed Regulations"). Final Regulations (except for Treas. Reg. § 1.401(a)(9)-6T, which was issued in temporary form) were issued on January 1, 2003 (the "Final Regulations").[69] The Final Regulations apply to required minimum distributions beginning on or after January 1, 2003.

Under the 1987 Proposed Regulations it was important to focus on the fact that there were really two sets of rules, one governing the minimum distribution requirements of an employee or a traditional

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69. The last installment of the Final Regulations was actually published on June 15, 2004 (on defined benefit plans and annuity contracts); however, the effective date of this installment was retroactive to 2003.

IRA holder who reaches his required beginning date and begins to receive benefits prior to death, and a second set of rules which define the minimum distribution requirements following the death of an employee or IRA holder who dies prior to his required beginning date. Under the Final Regulations, the two sets of rules are very similar, with only minor differences. However, to the extent there are differences, the estate planner must be prepared to deal with both sets of rules, since he will not know in advance of the employee's retirement which will come into play first.

Required minimum distributions made to the individual during his lifetime are based on a uniform table of distribution periods which applies regardless of the identity of any named beneficiary and whether the traditional IRA owner or plan participant is treated as not having a beneficiary because the beneficiary is not an individual.[70] However, an exception applies when a spouse is the sole beneficiary. In such case, minimum distributions can be based on the actual joint life expectancy of the individual and spouse determined using their ages in each year for which a distribution is made,

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70. Treas. Reg. § 1.401(a)(9)-5, Q&A-4. Prior to the issuance of the 2001 Proposed Regulations, the choice of the named beneficiary under the qualified plan or IRA impacted the amount of the annual minimum distributions which has to be paid during the individual's lifetime as well as on the length of the period over which the balance in the qualified plan or IRA had to be paid to the beneficiary after the individual's death. Under the 1987 Proposed Regulations, the beneficiary was determined as of the employee's required beginning date. However, if the employee died prior to his required beginning date, the beneficiary was determined as of the employee's date of death. The joint life expectancy used for minimum distribution purposes was that of the participant and the designated beneficiary, based on the age they each attain in the first year for which a minimum distribution had to be made (that is, the year in which the individual reached his required beginning date). If more than one beneficiary was named, the designated beneficiary for minimum distribution purposes was the primary (rather than contingent) beneficiary with the shortest life expectancy. Thereafter, if the named beneficiary changed because the designated beneficiary whose life expectancy was being used to determine distributions died after the required beginning date and a contingent beneficiary becomes entitled to benefits, the original primary beneficiary's life expectancy continued to be used to compute minimum distributions. Also, if the named beneficiary changed because the individual changed the designation, the original beneficiary's life expectancy continued to be used, unless the new primary beneficiary's life expectancy was shorter than the original beneficiary's life expectancy. Under the 1987 Proposed Regulations, if the beneficiary was not an individual (that is, a charity, the estate or a trust), the individual was treated as not having a beneficiary and minimum distributions generally had to be calculated based on the individual's single life expectancy.

if it results in a longer distribution period than the applicable period under the uniform table.[71]

Under the Final Regulations, the beneficiary for determining post-death required distributions is determined as of the September 30 of the year following the year in which the individual died.[72] There is even the potential for post-mortem planning during the period from date of death to September 30 of the following year by eliminating potential beneficiaries by distributing their share of the benefit in full or by a beneficiary disclaiming the benefits in accordance with section 2518 of the Code. This may, however, be a potential trap for the unwary because although a potential beneficiary will have more than a year to disclaim for minimum distribution purposes, the disclaimer must be made within nine months of the decedent's death to be a qualified disclaimer under section 2518 of the Code. In addition, state law may require that a disclaimer be made prior to an earlier date to be an effective disclaimer.[73] Interestingly, the Service has ruled that a qualified disclaimer of an IRA can be made even after the beneficiary has taken a required minimum distribution.[74] However, there can be no qualified disclaimer of the required minimum distribution amount itself, and the income allocable to it, since the beneficiary had already accepted the required minimum distribution amount and is deemed to have accepted the income allocable to it.

Special rules apply when an employee's benefit under a plan is divided into separate accounts. If the separate accounts have different beneficiaries, the accounts need not be aggregated and the life expectancy for each account is determined separately.[75] Under the Final Regulations, the separate accounts can be established following the employee's death. In order to take advantage of the required minimum distributions rules based on the age of each beneficiary, the separate accounts must be established by the end of the year following the year of the individual's death,[76] providing additional post-mortem planning opportunities.

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71. *Id.* Actual life expectancy will provide a longer distribution period if the spouse is more than ten years younger than the individual. Treas. Reg. § 1.401(a)(9)-9. Under the 1987 Proposed Regulations, if the plan or IRA document permitted, the individual could elect to have his and/or his spouse's life expectancy recalculated annually for the purpose of computing minimum distributions. The Final Regulations (and the 2001 Proposed Regulations) eliminated recalculation elections by building recalculation into the uniform table of distribution periods.
72. Treas. Reg. § 1.401(a)(9)-4, Q&A-4.
73. *See, e.g.*, N.Y. E.P.T.L. § 2-1.11(b)(2) (McKinney's 2004).
74. Rev. Rul. 2005-36, 2005-26 I.R.B. 1368.
75. Treas. Reg. § 1.401(a)(9)-8, Q&A-2&3.
76. Treas. Reg. § 1.401(a)(9)-8, Q&A-2.

Generally, a trust cannot be designated beneficiary for purposes of required minimum distributions. There is a special rule, however, which permits an irrevocable trust to be a designated beneficiary where the ultimate beneficiary or beneficiaries can be identified. The rule provides that if a trust is named as the beneficiary and:

(i) the trust is a valid trust under state law (or would be but for the fact there is no corpus),

(ii) the trust is irrevocable or becomes irrevocable upon the death of the individual,

(iii) the beneficiaries of the trust are identifiable from the trust instrument, and

(iv) the trust document is provided to the plan,

then the beneficiaries of the trust will be treated as the designated beneficiaries of the plan or IRA for purposes of the minimum distribution rules, thereby enabling the life expectancy of the trust beneficiaries to be used for that purpose.[77]

Under the Final Regulations, the requirements of (i) through (iv) must be satisfied by October 31 of the calendar year immediately following the calendar year in which the individual died.[78] As discussed below, it is this special rule that permits the designation of a QTIP, applicable credit amount trust or a trust for a child or grandchild to be utilized while preserving tax deferral opportunities. Clearly, the Final Regulations provide greater flexibility in meeting the client's planning objectives. If a trust is the named beneficiary but the four requirements noted above are not met, the individual will be treated as not having a designated beneficiary for minimum distribution purposes.

It should be emphasized that a beneficiary designation that is ineffective for minimum distribution purposes is still valid for determining who is entitled to the death benefit proceeds.

If the employee or IRA holder wishes to name his or her spouse as the beneficiary (either directly or as the beneficiary of a QTIP trust), then the joint lives or life expectancies of the employee and the spouse will determine the period over which benefits can be paid.[79] If the spouse is named as the direct beneficiary and the employee predeceases the spouse and the form of benefit payments under the qualified plan or IRA includes a lump sum payment of the remaining benefits, the spouse can elect to rollover the benefits into his or her own IRA, in

77. Treas. Reg. § 1.401(a)(9)-4, Q&A-5.

78. Treas. Reg. § 1.401(a)(9)-4, Q&A-6. Under the 1987 Proposed Regulations the requirements of (i) through (iv) had to be satisfied as of the employee's required beginning date. 1987 Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A D-5.

79. Treas. Reg. § 1.401(a)(9), Q&A-4.

which case further distributions will not be required until the spouse has reached his or her own required beginning date. At the spouse's subsequent death, the potential for still further income tax deferral will depend upon whom the surviving spouse designated as his or her beneficiary.

If the employee is not married, or wishes to name children or grandchildren as his designated beneficiary for other reasons, even greater income tax deferral is possible. Under the Final Regulations, after the employee's death, distributions can continue to a nonspouse beneficiary over the longer of the employee's remaining life expectancy determined as of the employee's date of death or the beneficiary's life expectancy determined as of the beneficiary's birthday in the year following the year of the employee's death.[80]

If an individual dies before minimum distribution payments have commenced, all of the individual's benefits must be distributed by the end of the fifth year following the year of death, unless the individual has a designated beneficiary under the plan or IRA and the benefit is paid out over the beneficiary's life or life expectancy beginning within one year of the individual's death.[81] Under certain circumstances an individual may be treated as having no beneficiary. The opportunity to defer the payment and thereby the income taxation of the benefit over the lifetime of a designated beneficiary—particularly a youthful beneficiary—should not be overlooked. Compare a widower client who makes his benefit payable to his estate with a similarly situated client who makes it payable to his adult children who are in their early thirties, or better yet to trusts for his minor grandchildren who are still in elementary school. In the first case where the benefit is payable to the estate, the benefit must be fully distributed and, therefore, subject to income tax by the end of the fifth year following the client's death. No deferral beyond the five-year period is permitted. It is for this reason that it is generally undesirable to designate an estate as the beneficiary of qualified benefits unless there are other compelling reasons to do so, such as pressing liquidity requirements. The second client positioned his children (or trustees) to stretch the income taxation of the benefit for upwards of fifty years. There is no significant disadvantage to positioning the beneficiaries to take advantage of the maximum income tax deferral because the beneficiary—whether it is an individual or trust—always has the right to withdraw more than the minimum distribution amounts. If more than one beneficiary is named, to avoid having the shortest life expectancy apply to the entire benefit, separate accounts can be set up with different designated beneficiaries. Keep in mind, however, that if a trust with more than

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80. Treas. Reg. § 1.401(a)(9)-5, Q&A-5.
81. Treas. Reg. § 1.401(a)(9)-3, Q&A-1(a).

one beneficiary is named, the life expectancy of the oldest beneficiary must be used.

If an individual dies after minimum distribution payments have commenced, the remaining benefits must be distributed as rapidly as under the payment method used by the individual prior to his death.[82] In such case, the remaining payments can be paid over the longer of the designated beneficiary's life expectancy or the employee's remaining life expectancy.[83]

Generally, the best deferral opportunity exists where the client is married. If the spouse is the named beneficiary, the spouse can defer commencement of distributions until the end of the calendar year in which the deceased individual would have attained age seventy and one-half if payments had not yet commenced to the participant, or, regardless of whether payments already commenced, the spouse may rollover the benefit to the spouse's own IRA and receive distributions over the life of the spouse or the joint life expectancy of the spouse and the spouse's beneficiary, commencing on the April 1st following the date the spouse reaches age seventy and one-half.[84]

Naming a spouse as the beneficiary of a qualified plan or IRA will usually provide for a significant period of deferral of income tax under the minimum distribution rules and special spousal rollover rules, as well as deferral of estate tax because the benefits will qualify for the unlimited marital deduction. If the spouse elects to rollover the distribution, the spouse, in turn, will have the same opportunity in selecting the beneficiary of her IRA or other eligible retirement plan to defer the income taxation of the benefit following her death over the lives of the designated beneficiaries, such as her children, grandchildren or trusts for their benefit.[85]

Moreover, if the individual does not want the spouse to control the "principal" portion of distributions from a plan or IRA, such as in the case of a second marriage, most of the tax benefits, other than the opportunity to rollover the benefit to a spousal IRA, can be achieved by making the benefits payable to a QTIP trust for the spouse's benefit.

In considering whether to name the spouse or a QTIP trust as beneficiary, there is a tradeoff. If the spouse is named as the direct

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82. I.R.C. § 401(a)(9)(B)(i).
83. Treas. Reg. § 1.401(a)(9)-5, Q&A-5. The life expectancy of the designated beneficiary is determined using the age of the beneficiary as of the beneficiary's birthday in the calendar year following the year of the employee's death and the employee's remaining life expectancy is determined based on the employee's age as of the employee's birthday in the calendar year of the employee's death.
84. I.R.C. § 401(a)(9)(B); Treas. Reg. § 1.401(a)(9)-3, Q&A-2.
85. Generation-skipping tax implications should be considered if grandchildren (or trusts for their benefit) are designated as beneficiaries.

beneficiary, he or she can roll the benefits over into his or her own IRA or other eligible retirement plan, name a new beneficiary, and obtain a longer stretch-out of the income taxation of the benefit both during the spouse's lifetime and after the spouse's death. Therefore, if the client, who is the IRA owner or plan participant, is willing to permit his or her spouse to control the retirement benefits, the client should consider naming the spouse as the beneficiary.

If a QTIP trust is named as the beneficiary, the arrangement must provide that the annual distributions from the qualified plan or IRA will satisfy both the minimum distribution rules and the "all the income from the property" requirement under the QTIP trust rules. A payment option will satisfy both requirements if it provides that post-death distributions from a qualified plan or IRA will be in an amount equal to the greater of (i) the amount distributable under the minimum distribution method in effect or (ii) the net income of the IRA (or account balance under a qualified plan), to be paid each year to a QTIP trust. In many cases, this formula payment option may not be available under a qualified plan. In such case, the retirement and estate plan can still be effectuated by the individual receiving a distribution of his qualified plan benefit prior to his required beginning date (if the plan permits) and rolling the distribution over into an IRA that can accommodate this formula payment option.

While, of course, the preferable approach is for the client to make an affirmative decision whether to name his spouse or a QTIP trust as the designated beneficiary, in some instances where, by inadvertence, the benefits are payable to the client's estate, there may be post-mortem opportunities to qualify the benefits for a spousal rollover. The Internal Revenue Service has become more liberal in permitting the spouse to rollover retirement benefits when such benefits pass to the spouse outright under the Will as part of the residuary bequest and the spouse is the sole executor.[86]

§ 9:5 Funding the Applicable Credit Amount Trust with Retirement Benefits

For many clients, qualified plan benefits may constitute the dominant assets of the estate and it may be necessary to fund all or a portion of the applicable exclusion amount trust with such benefits. As is the case with the QTIP, it is possible to preserve the opportunity to defer the income taxation of the benefit over the life expectancy of the beneficiary of the trust, whether the beneficiary is the participant's

86. *E.g.*, Priv. Ltr. Ruls. 200151054 (Dec. 21, 2001), 200106047 (Feb. 9, 2001), and 200032045 (Aug. 11, 2000); Bruce D. Steiner, *Postmortem Strategies to Shift Retirement Plan Assets to the Spouse*, 24 EST. PLAN. 369 (1997).

spouse or a child or more remote issue. If there is more than one beneficiary of the trust, the life expectancy of the oldest beneficiary must be used. This raises some interesting questions. In order to determine the oldest beneficiary of the trust, or for that matter of any other trust (such as a QTIP trust), which is designated as beneficiary, it is necessary to identify the beneficiaries of the trust. The regulations provide that a contingent beneficiary is generally considered a beneficiary.[87] However, a "mere successor beneficiary" is not considered a beneficiary for these purposes. A person who has a contingent right beyond being a mere successor beneficiary is considered a beneficiary. For example, a person to whom income and principal may be sprinkled would be considered a beneficiary.[88] Remainder beneficiaries also are to be taken into account.[89] Thorny questions arise as to whether remote contingent beneficiaries or permissible appointees under a power of appointment are to be considered beneficiaries.[90] Remote contingent beneficiaries have been deemed to be beneficiaries by the service in some circumstances, but not in others. In Private Letter Ruling 200438044, the Service permitted the taxpayer to use a "snapshot" approach to determine which beneficiaries should be considered for purposes of the minimum distribution rules. Under the circumstances presented, the taxpayer was permitted to restrict consideration of the beneficiaries to the life beneficiary of the trust and the remainder beneficiaries who would take the trust assets outright if the life beneficiary died immediately after the taxpayer. Because each of the remainder beneficiaries had an unrestricted right at the death of the income beneficiary to a portion of the trust remainder (including the taxpayer's interest in the IRA), the Service determined that it was not necessary to consider the remote contingent beneficiaries. While this ruling sheds some light on who must be considered when determining the "designated beneficiaries" for purposes of the minimum distribution rules, the parameters remain murky. Furthermore, the Private Letter Ruling cannot be relied upon for precedent. Until these issues are resolved, the safest course would be for the trust to avoid including any contingent beneficiaries or permissible appointees who are older than the designated primary beneficiary.[91]

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87. Treas. Reg. § 1.401(a)(9)-4, Q&A-5 and § 1.401(a)(9)-5, Q&A-7.
88. Treas. Reg. § 1.401(a)(9)-5, Q&A-7(c).
89. Treas. Reg. § 1.401(a)(9)-5, Q&A-7(c)(3), Example 1.
90. *See* Priv. Ltr. Rul. 200228025 (July 12, 2002), where remote contingent beneficiaries were considered to be beneficiaries, and Priv. Ltr. Rul. 200040035 (Oct. 6, 2000), where they were not.
91. Similarly, the trust should not include contingent beneficiaries or permissible appointees which are not individuals (such as charities), since only

Although it is possible to defer the income taxation of the benefit over the life expectancy of the "oldest beneficiary" of the applicable credit amount trust, the trust is not an ideal beneficiary designation from an estate tax planning perspective. This is because the income taxes which will be payable upon the minimum distributions will deplete trust assets which otherwise will be exempt from estate taxation upon the death of the participant's surviving spouse. Nevertheless, if there are insufficient other assets with which to fund the applicable credit amount trust, there may not be a better alternative. Finally, it is important to keep in mind that in formulating the provisions establishing the applicable credit amount trust each share must be stated as a fractional and not a pecuniary share, otherwise the deferral opportunity will be lost. This is because of the general rule that satisfaction of a pecuniary bequest accelerates recognition of income in respect of a decedent.

§ 9:6 Use of Retirement Benefits for Charity

If the client is charitably inclined, there are opportunities to substantially reduce or possibly eliminate the heavy estate and income taxes on plan benefits by designating a public charity or private foundation as the beneficiary. It is important to keep in mind that, except for a limited benefit available only in 2006 and 2007 under the Pension Protection Act of 2006 and in 2008 and 2009 under the Emergency Economic Stabilization Act of 2008, more fully described below, designating a charity as the beneficiary of retirement plan benefits generally will not provide any tax savings during the participant's lifetime. If the participant were to withdraw or transfer the entire plan or IRA balance to a charity or a charitable remainder trust during his lifetime, the income tax on the benefit would be immediately payable. In any event, under the ERISA rules, the participant may not assign his or her benefit under a qualified plan during his or her lifetime. Therefore designating a charity as a beneficiary of plan benefits will only save taxes that would otherwise fall due after the participant's death.

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individuals can be deemed "designated beneficiaries." Generally speaking, if a person who is not an individual is designated as a beneficiary, the employee will be treated as having no designated beneficiary for purposes of the minimum distribution rules, *even if there are also individuals who are designated as beneficiaries. See* Treas. Reg. § 1.401(a)(9)-4, A-3. For a discussion of the issues that may arise when designating a trust as a beneficiary, see Bruce D. Steiner, *Trusts as Beneficiaries of Retirement Benefits*, 29 TAX MGT EST., GIFTS & TR. J. 108 (2004).

The limited exception to that rule carved out under the Pension Protection Act of 2006[92] and renewed under the Emergency Economic Stabilization Act of 2008[93] applies to taxpayers aged seventy and one-half or older. Such individuals may exclude from gross income up to $100,000 a year for distributions made to qualified charities (the definition of which excludes private foundations, donor-advised funds and supporting organizations) from an IRA or Roth IRA during years 2006 through 2009.

Where the client is predisposed to making outright charitable bequests upon his death, the advisor should consider recommending that these bequests be funded in whole or in part from an IRA or other qualified plan benefit rather than from other sources. This approach will not only provide a charitable deduction for estate tax purposes, but it also will provide dual income tax savings.[94] First, other assets which are not pregnant with income tax can be allocated to individual beneficiaries. Second, the charitable recipient is exempt from income tax. The repeal of the penalty tax on excess accumulations makes this approach even more advantageous as the 15% penalty tax on excess accumulations at death which was in effect from January 1, 1989, through December 31, 1996, could not be wiped out even if the plan proceeds went directly to a charity or a charitable remainder trust. Care must be taken not to use plan benefits to satisfy a specific pecuniary bequest under the client's Will to a charitable organization, because the satisfaction of the bequest will cause the estate to recognize current taxable income equivalent to the plan benefits used for this purpose. Instead, the charity should be designated directly on a beneficiary designation form as the beneficiary of a specific amount or the entire plan benefit, or of a separate account, or of a percentage of the entire benefit.[95] If charitable contributions are a primary goal of an individual's IRA, it may not be wisest to convert an existing traditional IRA because in so doing, the individual may cause a layer of tax that would not otherwise be necessary.

The idea of designating a charity as the outright recipient of plan benefits following the participant's death is likely to be used to provide moderate bequests to charities or more substantial benefits where the

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92. H.R. 4; Pub. L. No. 109-208.
93. H.R. 1424; Pub. L. No. 110-343.
94. In the case of charitable foundations, the income tax clearance applies if there is no unrelated business income.
95. A note of caution: If charity is the designated beneficiary of a specific amount or of a percentage of the entire benefit, the benefit must be paid to or a separate account established for the charity prior to September 30 of the year following the individual's death. *See* note 66, *supra. See also* note 84.1, *supra*, and NATALIE B. CHOATE, LIFE AND DEATH PLANNING FOR RETIREMENT BENEFITS, §§ 7.2.03 and 7.2.06 (5th ed., 2003 Revised).

client is not concerned about providing for a surviving spouse or issue. In most cases, however, the client may not wish to cut the family off entirely from pension benefits unless there are sufficient other assets from which to amply provide for them. For the client who is charitably inclined, it is possible to combine benefits for family and charity and in so doing to enhance the financial benefits for the family. The vehicle through which this may be accomplished is the charitable remainder trust.

The potential tax savings giving rise to the enhanced benefits are two-fold. By naming a charitable remainder trust as the beneficiary, the estate will receive a partial estate tax charitable deduction equal to the actuarial value of the remainder interest passing to charity. The precise size of the charitable deduction will depend upon the term of the trust, payout percentage and type (unitrust or annuity) of the charitable remainder trust. Additionally, because the charitable remainder trust is a tax-exempt entity, the entire benefit can be spared from income tax at the death of the participant and invested more productively without diminution by income taxes. The estate and income tax savings, in turn, will provide a larger corpus from which to pay an annuity or unitrust interest to designated family members. Moreover, the special rules which govern income taxation of a charitable remainder trust will take over, with the result that the individual beneficiary of the annuity or unitrust interest will pay income tax on an annual basis as the payment is received, based upon the special tier rules for charitable remainder trusts. Of course, to reap these benefits, upon termination of the charitable remainder trust, the pension benefits which initially formed the corpus will pass out of the family to the ultimate charitable beneficiary. Therefore, this plan is for only those clients who are truly charitably inclined.

§ 9:7 Payment of Estate Taxes Attributable to Retirement Benefits

The final point which must be addressed with the client and should not be overlooked is the source of the payment of the federal and state estate taxes attributable to the plan benefits. This is of critical importance if the beneficiaries of the plan benefits are different from the residuary beneficiaries under the Will. If the tax clause is carelessly drawn and in a general manner provides that all estate taxes with respect to property passing under and outside of the Will are to be paid out of the residuary estate, the wrong beneficiaries will bear the exceedingly painful estate taxes attributable to the retirement benefits. If properly addressed with the client, under these circumstances, most clients would rather direct that the estate taxes with respect to property passing outside the Will be apportioned so that the recipients of the retirement benefits will be responsible for their shares of the taxes. However, if funds have to be taken down to pay estate taxes, the take down will lead to income tax on those funds, thereby causing a circular problem. More funds are needed to pay estate taxes because of the income tax cost that intervenes.

To add insult to injury, in determining the estate tax value of retirement accounts, an estate cannot claim a discount to reflect the income taxes that would be payable by beneficiaries on distributions from the accounts.[96] Furthermore, the Service has issued a Technical Advice Memorandum concluding that an estate may not claim an estate tax deduction under section 2053 for income taxes it paid on amounts the estate was forced to withdraw to pay estate taxes.[97]

Furthermore, the estate tax clause must be coordinated with the payment options available under the plan to the designated beneficiary. It is possible that under the terms of the plan the benefits may not be payable in a lump sum following the death of the participant, yet the beneficiary entitled to the benefit still may be legally responsible to pay the federal estate taxes nine months after the participant's death and the state death taxes may be due even sooner. In this case, the beneficiary would have to use other resources to pay the tax. The bottom line is that the beneficiary designation, the tax clause under the Will and the available payment options to the beneficiary all must be considered and coordinated.

The foregoing is a bare sketch of the major points of the tax rules. Refinements are possible. The essential point, however, is that the tax consequences for post-death payments vary according to the form of distribution chosen. Working out the possibilities while the client is alive is almost mind-boggling, for the possible alternatives would include (but hardly be limited to) different projections for the client's gross estate, whether or not the spouse will survive and therefore make possible a marital deduction, different choice of recipients for the distributions and levels of outside income for those recipients, and varying lengths of time for installment payouts.

§ 9:8 Retirement

An employee's options on retirement are restricted not only by law but also by the terms of the plan. May he collect his retirement benefit outright? If so, the employee must weigh the income tax rules, including the possible lump-sum tax advantages for those who attained age fifty prior to 1986, and the advantages of rolling over the distribution to an eligible retirement plan.

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96. *See* Estate of Smith v. United States, 300 F. Supp. 2d 474 (S.D. Texas 2004).
97. Tech. Adv. Mem. 200444021 (Oct. 29, 2004).

If the employee is disinclined to accelerate taxable income, the employee may select an annuity payout that will continue after death for the surviving spouse or another secondary beneficiary. This choice is not available in many defined contribution plans. It was eliminated from many such plans when ERISA became effective, in order to avoid the need to comply with rules concerning qualified joint and survivor annuities that seem burdensome to plan administrators.

In order to provide an annuity form of payment, a rollover of a distribution into an IRA may be a convenient solution in the absence of a joint and survivor annuity option in a plan, as the rollover can be placed with an insurance company and an annuity contract entered into.

A retiring employee may be uninterested in receiving either a lump-sum distribution or an annuity payout. Such an employee may rollover his distribution to an IRA.[98] The distribution rolled over will not be subject to tax at the time of the rollover (unless rolled over to a Roth IRA, if eligible), but only when amounts are actually distributed. Among the consequences of the rollover for individuals who were at least age fifty in 1986, is the surrender by the employee of the possibility of a lump-sum tax treatment of any later distribution from the IRA, unless there is another rollover to a qualified plan when the employee takes up new employment. Thus, neither capital gain treatment nor lump-sum averaging would be available when the payout starts from the IRA.

§ 9:9 Nonqualified Plans

While qualified employee benefits get the most attention because of their widespread existence, other employee benefits should not escape unnoticed. In some employment contracts, payments are provided that will begin when the employee's regular working period ends. If the contract includes post-mortem payments to a beneficiary, such as the employee's wife, a crucial question is whether the value of those payments will be included in the employee's gross estate.

Section 2039, designed to reach post-mortem benefits under such contracts, must be considered. Cases have held that if the contract provides only a salary to the employee and a post-mortem payment to the beneficiary, the value of those payments will not be in the gross estate under section 2039 because of the short reach of that statutory provision.[99]

98. I.R.C. § 402(d)(5).

99. Estate of Fusz v. Comm'r, 46 TC. 214 (1966), *acq.*, 1967-2 C.B. 2, *accord* Rev. Rul. 67-371, 1967-2 C.B. 329; Rev. Rul. 77-183, 1977-1 C.B. 274; *cf.* Estate of Bahen v. United States, 305 F.2d 827 (Ct. Cl. 1962); Estate of Schelberg v. Comm'r, 612 F.2d 25 (2d Cir. 1979); Estate of Van Wye v. United States, 686 F.2d 425 (6th Cir. 1982).

For section 2039 to apply, the employee himself must have been entitled to some contractual right beyond salary, whether it be retirement benefits, disability payments, or the like.

Some attention has been paid to the question of whether various plans and benefits established by an employer for an employee are to be aggregated in considering whether an income right to a surviving beneficiary of the employee will be included in the employee's gross estate at the time of death. The law is unsettled. It has been determined by the Second Circuit that fractionalizing various benefits into a survivor's income plan, which picks up at death, and a disability plan, which would provide benefits for the employee, will be sufficient to save the survivor's income benefits from the decedent's gross estate.[100] In that case, the disability benefits were deemed to be similar to salary or wage continuation payments. The Sixth Circuit agreed with that conclusion.[101] Other courts, however, have not been persuaded.[102]

The Commissioner has ruled that benefits under a qualified pension or profit-sharing plan will not be considered together with contractual rights enjoyed by an employee's beneficiary for payments after death in determining whether the value of the rights is to be included in the decedent's gross estate.[103]

Other sections of the Code, such as 2037 and 2038, may be used by the Commissioner to force post-mortem payments into the gross estate,[104] but they are apt to be avoidable by the client. For example, the decedent's inability to change the contract or the beneficiary of the post-mortem payments has been held to be sufficient to avoid section 2038.[105]

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100. Estate of Schelberg v. Comm'r, 612 F.2d 25 (2d Cir. 1979).
101. Estate of Van Wye v. United States, 686 F.2d 425 (6th Cir. 1982). *See also* Estate of Siegel v. Comm'r, 74 T.C. 613 (1980).
102. *See* Looney v. United States, 569 F. Supp. 1569 (M.D. Ga. 1983). The court stated that for the employee in *Looney* to receive benefits under the disability plan, the employee would have had to have become totally and permanently disabled, thus effectively making the payments "post-employment" benefits. *Id.* at 1574. The court did not deem it relevant that the decedent had not been receiving any disability payments at the time of his death. *Id.* at 1570.
103. Rev. Rul. 76-380, 1976-2 C.B. 270; *but see* Rev. Rul. 88-85, 1988-2 C.B. 333, which renders the prior ruling obsolete to the extent it referred to I.R.C. § 2039(c), (d), (e), (f), or (g) for periods for which the 1984 and 1986 Tax Reform Acts repealed those sections.
104. *See, e.g.*, Estate of Siegel v. Comm'r, 74 T.C. 613 (1980).
105. Rev. Rul. 76-304, 1976-2 C.B. 269. *See also* Estate of Bogley v. United States, 514 F.2d 1027 (Ct. Cl. 1975); Rev. Rul. 78-15, 1978-1 C.B. 289; Kramer v. United States, 406 F.2d 1363 (Ct. Cl. 1969).

If the decedent was the sole or dominant stockholder of a closely held corporation, there could be problems in the assertion that the contractual rights accruing under the survivor's income agreement could not have been amended or modified, or the beneficiary of that agreement could not have been changed. If the Commissioner successfully asserted that the deceased employee had the ability to modify the contract or change the beneficiary because of the domination of the corporation, then section 2038 would sweep the postmortem payments into the gross estate.

An important consideration is how exploitable the gap in section 2039 is. An employee who works for a large company, or for a family business or closely held corporation under someone else's control, is unlikely to be content in contracting only for salary and post-mortem benefits. He will almost surely be concerned about retirement or other benefits, and seek provision for them in his employment agreement.

On the other hand, if the employee is a principal in the business, there is more opportunity to write a stripped-down agreement with the corporation that provides only for salary and post-mortem payments. Formal retirement may be allowed to rest with the employee's future decision. If he decides to work forever, no one else may have the authority or desire to tell him he is too old to continue. If he decides to cease actively working, he can allow the business to continue under someone else's day-to-day care while he draws salary as chairman of the board and tries to master the intricacies of sand traps and contoured greens. The owner-employee situation may offer opportunities to mold an agreement that avoids inclusion of the post-mortem benefits in the gross estate.

In chapter 11 there is a discussion of business interests and the often-perplexing problem of how income can be provided for a surviving spouse after the death of the primary wage earner. An employment contract that includes post-mortem payments may help. Even if the contract cannot be drawn in the particular case under terms that will keep the value of the payments out of the gross estate, the very fact that there will be post-mortem payments to the widow may be of extreme importance.

The payments can qualify for the marital deduction by avoiding any third-party interest subsequent to the widow's, thereby frustrating the terminable-interest rule. With the aid of the marital deduction, the estate tax impact might be tolerable. In the view of the survivors who will carry on the business, those post-mortem payments may permit the business to operate in an orderly fashion.

A note of caution is wise. These contracts may be viewed by the IRS as conferring benefits that are subject to gift tax. In a 1981 Revenue Ruling, the IRS took the position that when an employee agrees to render services with a death benefit to be paid to the employee's spouse, the contractual arrangement amounts to a gift because of the benefits conferred upon the surviving spouse.[106] The question arises as to how the gift is to be valued in the light of the conditions in the contract. For example, the amount of the widow's benefit would be fixed at some indefinite date in the future, because it would depend upon the salary that the employee may be earning at the time of his death. Further, the benefit would only be paid if the employee was providing services at his death and was then married. The IRS contended that the transfer becomes a completed gift in the calendar quarter in which the employee dies, and at that point the amount of the gift can be measured. This is a tortured position. An observer is moved to comment that the position was arrived at after the IRS perceived the shortcomings in its estate tax efforts. The assertion that the making of such a contract is a transfer that ripens into a gift at the time of death is a poor disguise for an estate tax claim.

In *DiMarco v. Commissioner*,[107] the Tax Court rejected the Commissioner's view in a case involving an account not voluntarily created by the employee. The Service acquiesced in part in the result in DiMarco leaving open the possibility of asserting a gift in somewhat different circumstances.

The IRS's gift tax position is not built upon a sound foundation. But taxpayers and their advisers are on clear notice that these contracts will attract IRS attention.

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106. Rev. Rul. 81-31, 1981-1 C.B. 475, *rev'd by* Rev. Rul. 92-68, 1992-2 C.B. 257.

107. DiMarco v. Comm'r, 87 T.C. 653 (1986).