XII. PLANNING FOR IRAS, QUALIFIED PLANS AND OTHER RETIREMENT BENEFITS

A. Introduction

The amount of wealth amassed in workplace retirement plans and IRAs is staggering. An understanding of the types of retirement plans, their distinguishing characteristics, their tax treatment and the available distribution options during life and at death is essential for all attorneys. This Chapter will review a number of important concepts relating to employee benefit plans, and how to integrate them into your client's estate plan. Included will be discussion of the following topics:

- An overview of the common types of tax qualified and non-qualified employee benefit plans.
- A discussion of the different types of individual retirement plans, including Roth IRAs.
- An explanation of the importance of tax deferred savings.
- A review of the income tax rules that apply to both qualified and non-qualified employee benefit and individual retirement plans, including how contributions to and withdrawals from these plans are treated for federal income tax purposes.
- A description of the penalties that can apply when a taxpayer contributes too much, withdraws too soon, or fails to withdraw on time, from a qualified plan or IRA.
- A discussion of the income taxation of non-qualified plans.
- A detailed explanation of the rules for calculating minimum required distributions from qualified plans and IRAs.
- An overview of the estate and gift taxation of qualified plans and IRAs, including an explanation of the income tax deduction for federal estate taxes paid on such plans under Code § 691(c).
- Basic estate planning strategies and considerations for qualified plans and IRAs.
- Marital deduction issues that arise in connection with the post-death distribution of qualified plans and IRAs.
- Charitable giving strategies for qualified plans and IRAs.

This Chapter will primarily address benefits received from "qualified" retirement plans under Internal Revenue Code ("IRC") § 401(a), which include pension, profit sharing, 401(k) and self-employed (Keogh) plans; not-for-profit corporation, school and church sponsored plans under IRC § 403(b); individual retirement plans (IRAs) under IRC § 408(a); and simplified employee plans (SEPs) under IRC § 408(k).

B. Types of Retirement Plans

1. Qualified Plans and Non-Qualified Plans

Most employees are covered under employer sponsored retirement plans that are "qualified" retirement plans under IRC § 401(a). A qualified plan is one that provides favorable income tax benefits for the employer (income tax deduction for contributions to the plan), as well as for the employee (both contributions to the plan and earnings in the plan are not subject to income tax until they are withdrawn). However, in order to receive these tax benefits the plans must by design, funding and administration meet a complex set of federal statutory and regulatory requirements.

In contrast, a non-qualified plan is any other retirement plan or deferred compensation plan. Non-qualified plans are subject to much simpler federal regulation, along with less favorable income tax treatment. Non-qualified plans are created primarily for executives, highly compensated and select employees as a form of deferred compensation or supplemental retirement benefit.

2. Defined Benefit Plans and Defined Contribution Plans

An employer may establish and maintain one or more of several different types of plans as qualified employee benefit plans. Such plans are classified as either *defined benefit* plans or as *defined contribution* plans.

a. <u>Defined Benefit Plans</u>. A *defined benefit plan* is a plan designed primarily to provide income at retirement. Benefits are generally not available until the participant reaches a specified age, referred to as normal retirement age, and are usually paid in the form of an annuity. Some plans also provide an optional benefit at an earlier age (early retirement age). Treas. Reg. § 1.401-1(b)(1)(i). The employee's entitlement under the plan is calculated with reference to the benefit formula contained in the plan, and not with reference to the amount of contributions made, or earnings in, the plan. As a result, a defined benefit plan can accumulate assets in excess of those actually required to pay benefits under the plan (an "over-funded" plan), or may not have enough assets in the plan to pay all benefits (an "under- funded" plan).

A pension plan benefit formula must be designed so that an employee's retirement benefit is definitely determinable. The potential types of benefit formulas in a defined benefit plan are unlimited, but generally fall into four categories: fixed benefit, flat benefit, unit credit and cash balance.

- A *fixed benefit plan* provides a benefit that is a stated amount, such as $150 per month. The same benefit is paid to all participants, regardless of compensation.
- A *flat benefit plan* calculates a participant's normal retirement benefit as a percentage of the participant's compensation. A retirement benefit equal to 50% of the employee's average compensation would be a flat benefit.

- A *unit credit plan* usually provides a benefit that is a combination of length of service and the participant's annual average compensation. This is accomplished by multiplying the participant's compensation (as defined in the plan) times years of service.

  EXAMPLE: A *unit credit plan* contains a benefit formula that provides that the annual retirement benefit of each participant will equal 2% of compensation (average of all years) times years of service. If the employee's average compensation was $50,000 and the employee worked for 30 years, the annual retirement benefit would be $50,000 x 2% = $1,000, times 30 years of service = $30,000 annual benefit. The monthly benefit would be $30,000/12 months = $2,500 monthly benefit.

- A *cash balance plan* is a defined benefit plan that is made to look like a defined contribution plan. In a cash balance plan, the participant is given a hypothetical account that increases or decreases annually as a result of two types of credits: a compensation credit, based on the participant's compensation, and an interest credit, equal to a guaranteed rate that is stated in the plan.

Since the purpose of any defined benefit plan is to provide retirement security, the employer is subject to minimum funding rules that require the employer to make regular contributions to the plan. IRC § 412. Failure to make these contributions will subject the employer to a penalty. IRC § 4973.

b. Defined Contribution Plans. Plans that provide for individual participant account balances are classified as defined contribution plans. ERISA § 3(2)(A), 29 USC § 1002 (2)(A). With a defined contribution plan, the participant's benefit under the plan is based solely on the amount of contributions made for or by the participant, increased by reallocated forfeitures (if applicable), and increased or decreased by gains, losses, and expenses. It is not possible for a defined contribution plan to be over-funded or under-funded.

Since each participant's benefit is ultimately based on contributions, a defined contribution plan must maintain individual bookkeeping accounts for each participant. However, this separate individual account requirement is merely a bookkeeping requirement. It does not require a plan to actually physically segregate each participant's account. IRC § 414(i).

c. Pension, Profit Sharing and Stock Bonus Plans. Another way to distinguish among qualified plans is with reference to whether they are pension, profit sharing or stock bonus plans. Almost all defined benefit plans are pension plans. However, not all pension plans are defined benefit plans. A "money purchase pension plan," for example, is actually a defined contribution plan to which the employer contributes a defined or fixed percentage of the participating employee's compensation each year. It is called a money purchase pension plan because the employer must fund the plan each year, under the minimum funding rules of IRC §

412 (similar to defined benefit plans), and the amount in the participant's account at retirement is usually not distributed in a lump sum, but rather is used to purchase an annuity.

Most defined contribution plans are profit sharing plans. Profit sharing plans acquired their name from the regulations prior to 1986 when an employer could contribute to a profit sharing plan only if the employer had current or accumulated profits. Treas. Reg. § 1.401- 1(b)(1)(ii). This requirement was eliminated by the Tax Reform Act of 1986 ("TRA 1986"), P.L. 99-514. An employer may now make contributions to a profit sharing plan without regard to profits (IRC § 401(a)(27)(A)), and the plan does not have to require that a contribution be made each year, as long as contributions are "reoccurring and substantial." Treas. Reg. § 1.401- 1(b)(2).

3. Characteristics and Features of Qualified Plans

a. <u>Defined Benefit Plans</u>. Employer contributions to a defined benefit plan are actuarially determined each year. The employer receives an income tax deduction for all contributions made to the plan when contributed. IRC § 404(a) and § 403(a). The contributions and all earnings in the plan are not subject to income tax when received by the plan, and accumulate in the plan without current income tax. IRC § 501(a).

The maximum benefit that can be provided to a participant under a defined benefit plan is measured two ways: the percentage limitation and the dollar amount limitation. Under the percentage limitation, the retirement benefit may not exceed 100% of average compensation for the highest three consecutive years of employment. (For a self-employed person, compensation is limited to "net" self-employment income, *i.e.*, gross income less the contribution and one half of the deduction for the self-employment tax.) The dollar amount limitation is indexed at $195,000 per year (for 2010) for a retirement age of 65. For early retirement age, the amount is actuarially reduced.

The normal form of benefit from a defined benefit plan must be a Qualified Joint and Survivor Annuity. Other forms of distribution are available with spousal consent. Distributions are generally taxed as ordinary income under IRC § 72. However, those participants born before 1936 may be able to elect favorable income tax treatment in the form of 10-year forward averaging or capital gains treatment. Distributions also may be rolled over to an IRA or another workplace retirement plan at retirement (if the plan allows lump sum distributions). IRC § 402 and § 403.

b. <u>Defined Contribution Plans</u>. In a defined contribution money purchase pension plan, the employer contributes a fixed percentage of the employee's compensation each year (under the minimum funding rules in IRC § 412). In a defined contribution profit sharing plan, the employer determines the amount the employer wishes to contribute to the plan in a gross dollar amount, usually on an annual basis (but possibly more frequently). Contributions are then allocated to each participant's account based on each participant's compensation in relation to that of all compensation of participants in the plan. In each case, the employer receives an income tax deduction in an amount equal to the contribution. IRC § 404(a). Contributions are not currently taxed to the employee (IRC § 402(a) and 403(a)), and both contributions and earnings accumulate in the plan without current income tax. IRC § 501(a).

The maximum annual contribution is 25% of covered payroll, not to exceed 100% of the individual participant's compensation up to $49,000 for 2010. The maximum compensation recognized in 2010 is $245,000, and for those who are self-employed, compensation is limited to "net" self-employment income (gross income less the contribution and one half of the deduction allowed for self-employment tax).

Distributions are not allowed from money purchase plans while the participant is employed ("in-service withdrawals")(Internal Revenue Service ("IRS") Memorandum of the District Director of the Los Angeles Key District dated August 10, 1995). In service withdrawals may be allowed from profit sharing plans, however. A profit sharing plan may allow distributions after a fixed number of years, the attainment of a stated age, or upon the occurrence of stated events such as layoffs, illness or disability. Treas. Reg. § 1.401-1(6)(1)(ii).

When distributions are made they are generally taxed as ordinary income under IRC § 72. However, participants born before 1936 may be able to elect favorable income tax treatment in the form of 10-year forward averaging or capital gains treatment. Distributions also may be rolled over to another workplace retirement plan or IRA. IRC § 402 and § 403.

c. **Stock Bonus Plans**. The requirements of a stock bonus plan are identical to those of a profit sharing plan with two major exceptions. First, benefits under a stock bonus plan may be distributed in cash or stock of the employer maintaining the plan. Second, the plan may, but is not required to, invest primarily in the employer's stock.

d. **Employer Stock Ownership Plans (ESOPs)**. An ESOP is first and foremost a qualified stock bonus plan. But there are some important basic differences. The primary difference is that an ESOP must be primarily invested in stock of the employer company. Income tax treatment (to the employer and to the employee) of contributions to and earnings in an ESOP is the same as any other profit sharing plan.

An ESOP has a number of unique characteristics. An ESOP is exempt from many of the prohibited transaction rules applicable to most qualified plans, such as the normal prohibition against borrowing funds to purchase securities from a shareholder or the plan sponsor. The plan sponsor in turn may guaranty the loan. For these transactions to be deemed exempt from the penalties normally imposed on prohibited transactions, they must be entered into for the primary benefit of the participants and their beneficiaries. Treas. Reg. § 54.4975-7(b)(3).

Unlike any other qualified plans, an ESOP may serve as a financing tool for the employer. The intricacies of the leveraged ESOP are beyond the scope of this Chapter. But the concept is straightforward. Under a leveraged ESOP, the plan borrows money from a commercial lender to purchase the stock owned by a shareholder of the plan sponsor. The loan is secured by the stock and is guaranteed by the sponsor. Contributions to the ESOP are in amounts sufficient to amortize the loan. The ESOP uses the contributions to the plan to repay the loan and, as the loan is repaid, shares of stock are released from the loan collateral and allocated to participant accounts. IRC § 404(a)(9).

An individual who sells a substantial amount of stock to an ESOP may be able to defer recognition of the gain on the sale by investing the proceeds in qualified replacement securities. IRC § 1042.

e. <u>401(k) Plans</u>. In 1978, IRC § 401(k) was added to the Internal Revenue Code, creating what is known as a "cash or deferred arrangement," or, more commonly, 401(k) plans. A 401(k) plan is a qualified profit sharing plan that includes an option for participants to direct the employer to put money in the plan in lieu of paying the employee taxable cash compensation. A 401(k) plan can be an independent plan, or it can be part of a profit sharing or stock bonus plan. A 401(k) plan can accept both employee and employer contributions, or it can be funded entirely through salary deferrals.

Since a 401(k) plan allows employees to choose deferrals or cash, a disproportionate benefit could be provided under the plan for highly compensated employees, who have more income to save. Consequently, the law requires that the plan comply with certain contribution limitations for highly compensated employees, as compared to all other employees covered by the plan. These limitations are commonly referred to as the ADP test, or average deferred percentage test, and the ACP test, or actual contribution percentage test. IRC § 401(k)(3), § 401(a), § 401(m)(2), and § 410(b).

In a 401(k) plan, the employee elects to defer a portion of salary or bonus. Amounts deferred are subject to FICA and FUTA taxes, but are not subject to current income tax. The employer may provide a voluntary matching contribution, which is tax deductible to the employer. IRC § 404(a). Contributions and earnings accumulate in the plan without current income tax, either to the employee or to the plan. IRC §§ 510(a), § 402(a) and § 403(a). Employers may make additional profit sharing contributions from year to year, as long as they are non-discriminatory.

The employee deferral limit is 100% of compensation up to a maximum of $16,500 in 2010. The contribution limit is indexed to the cost of living annually, rounded down to the nearest $500. A provision for "catch-up" contributions for individuals 50 years of age or older was added to IRC
§ 414(v), effective for years after 2001. An individual 50 years old or older will be able to elect additional deferrals of $5,500 in 2010. The amount of catch-up deferrals is indexed to the cost of living annually, rounded down to the nearest $500.

f. <u>Other Types of Qualified Plans or Hybrid Plans</u>. Each of the following hybrid plans is a variation on a deferred contribution plan that has a unique allocation formula for the contributions that are made to the plan.

(1) <u>Target Benefit Plans</u>. This is a hybrid money purchase pension plan under which an employer establishes a targeted retirement benefit for each participant. However, the projected benefit is merely a target the plan uses to determine current contributions; it is not a guarantee.

(2) <u>Age Weighted Profit Sharing Plans</u>. Age weighted plans are no different from other types of profit sharing plans except that the contribution is allocated among

the participants based not only on each participant's compensation, but also on each participant's age.

(3) **New Comparability Plans**. New comparability plans are profit sharing plans structured to provide a more uniform allocation of contributions among members of a group (such as among all highly compensated employees or among all non-highly compensated employees). Thus, unlike an age-weighted plan, the plan's allocation of contributions will not be age based.

4. Plan Qualification Requirements: An Overview

A complete discussion of qualified plan requirements is beyond the scope of this text. The following is intended to review and summarize some of the most significant requirements for employee benefit plan qualification. Keep in mind that these are general rules only, to which many complex exceptions and limitations apply.

a. **Eligibility and Coverage**. A qualified employer plan may contain an eligibility requirement, which sets forth who may participate in the plan and when they may join. However, as a general rule, the law prohibits basing eligibility on a minimum age higher than 21 and minimum service of more than one year. Moreover, in operation, a qualified plan must benefit a certain proportion of non-highly-compensated employees in relation to highly compensated employees.

b. **Nondiscrimination in Benefits and Contributions**. Much of the law pertaining to qualified plans was written to ensure that the plan does not unduly or unfairly benefit a company's officers, directors or key executives at the expense of rank and file employees. Consequently, a plan must be designed so that it does not discriminate, either in benefits provided or in contributions made, in favor of highly compensated employees.

c. **Funding**. Qualified plans must be funded in advance of employee retirement. Normally this is accomplished through contributions to an irrevocable trust fund or under an insurance contract. The law also requires that a fiduciary -- a person or entity empowered to hold funds of another -- must control the fund for the sole benefit of the participants and their beneficiaries. This limits the control the employer has over the plan's funds, as was the intent.

d. **Vesting**. Vesting refers to the point at which an employee has a non-forfeitable and undeniable right to the benefit provided for the employee under the plan. Under current vesting rules, an employee must be fully vested at the normal retirement date specified in the plan and, in the event of termination prior to retirement, after a specified period of service. The purpose of the vesting rules is to make it difficult for an employer to deny benefits to employees by selective turnover, termination or other arbitrary acts.

The law has established two alternative vesting schedules. Five-year "cliff" vesting provides for no vesting during the first four years of service, and 100% vesting at five years. Three-year to seven-year vesting provides for a gradual vesting of the benefit, beginning the third year

of service with 20%, and increasing each year by 20%, with 100% vesting in the seventh year.

e. Limitations on Contributions and Benefits. The Internal Revenue Code limits the amount of benefit that can be received (under a defined benefit plan) or the amount of contribution that can be made (to a defined contribution plan). These limitations are stated above in the discussion of defined benefit plans and defined contribution plans.

f. Reporting and Disclosure. All qualified plans must meet certain reporting and disclosure requirements -- some simple, many complex. Generally, these requirements consist of four reports that must be provided to plan participants and/or filed with the government.

- A *Summary Plan Description* describes the plan, identifies the plan sponsor, indicates the funding mechanism, explains the plan's eligibility requirements and identifies procedures for making benefit claims. This report is furnished to plan participants and the Department of Labor.
- An *Annual Report* includes detailed financial information about the plan, including actuarial valuations if the plan is subject to minimum funding requirements, and identifies participants with vested benefits who have separated from the plan. This report is filed with the IRS.
- A *Summary of Annual Report* summarizes the annual report, and is provided to plan participants.
- A *Report on Termination, Merger or Other Changes* reports on any plan that is to be terminated, merged, split-up, etc.

g. Top-Heavy Plans. Special qualification rules were added to address plans that are "top-heavy," *i.e.*, plans in which the accrued benefits or account balances of key employees (as defined in the Code) exceed the value of all accrued benefits or all account balances by a specified percentage. Essentially, these special top-heavy rules were imposed to restrict the use of qualified plans as tax shelters for business owners and highly compensated employees, and to provide a way to measure potential discrimination in benefits. A plan must provide that if it ever meets the definition of a top-heavy plan on a given determination date, all of the top-heavy restrictions will automatically become part of the plan.

Many small plans -- those that cover 10 or fewer participants, for example -- are by their nature top-heavy, and these plans are actually designed according to top-heavy requirements and restrictions. Generally, these requirements (which are in addition to, not in lieu of, the qualification requirements all plans must meet) subject top-heavy plans to accelerated vesting, minimum contribution or benefit requirements for non-key employees, and lowered benefit or contribution levels for key-employees.

h. Distributions. To ensure that qualified plans are primarily used for the purpose of providing retirement or deferred compensation benefits, there are a number of restrictions and rules that apply to distributions. These are discussed in more detail below. The rules are complex and to some extent vary according to the type of plan. Pension plans, for example, do not allow withdrawal of funds prior to termination of employment, whereas profit

sharing plans may.

5. Not-for-Profit Corporations, School and Church Sponsored Plans

Section 403(b) plans (also known as tax-sheltered annuities or TSAs) are available to public school systems and tax-exempt organizations described in IRC § 503(c)(3), which include those operating exclusively for religious, charitable, scientific, literary or educational purposes. This definition encompasses a wide range of non-profit institutions such as churches, private and public schools and colleges, hospitals and charitable organizations.

§ 632 amended IRC § 403(b) so that the benefits available under 403(b) plans are similar to those available under qualified profit sharing plans -- more specifically, Section 401(k) plans. The most common type of 403(b) plan is a salary reduction plan. It allows the participant to elect to contribute part of his or her salary to the plan (as opposed to receiving it as taxable income). The typical arrangement involves the use of a deferred annuity, fixed or variable, as the funding instrument. Premiums paid into the contract (within limits) are excluded from the employee's gross income. Mutual funds are another accepted funding vehicle.

a. **<u>Contribution Limits</u>**. Since the beginning of 2002, employees who participate in 403(b) plans are not taxed currently on either salary reductions or employee contributions as long as the total does not exceed the lesser of $40,000 or 100% of the employee's compensation. Salary reductions also are subject to an aggregate annual limit. The employee must add together each year all of his or her salary reductions for TSA plans, Section 401(k) plans, salary reduction SEPs and Simple IRAs. The total must not exceed the elective deferral limit, which is $16,500 in 2010. The elective deferral limit is adjusted for cost-of-living increases annually, in increments of $500.

b. **<u>Unique Salary Reduction Catch-up for 403(b) Plans</u>**. If the employee has completed 15 years of service for the employer, and the employer is an education organization, a hospital, a home health care agency, a health and welfare service agency, or a church, synagogue or related organization, the elective deferral limit (above) is increased by an additional sum equal to the lower of:

- $3,000;
- $15,000, reduced by any amounts excluded from gross income for prior taxable years by reason of the catch-up provision; or
- $5,000 times the employee's years of service with the employer, less all prior salary reductions with that employer.

The elective deferral limit, plus the salary reduction catch-up provision described in the preceding paragraph, is generally the absolute limit on the amount of annual salary reductions for any employee. However, IRC § 403(b) plan participants who are age 50 and over are eligible for additional elective deferrals. The additional elective deferral amount is $5,500 in 2010.

c. **<u>Unique Distribution rule for IRC § 403(b) Plans</u>**. IRC § 403(b) plans generally are subject to the qualified retirement plan distribution rules at retirement or later.

However those plans that allow for in-service withdrawals are faced with a complex and unclear set of regulations based on the investment vehicles agreed upon by the plan.

d. <u>Plan Requirements for § 403(b) Plans</u>. The requirements previously discussed for qualified plans relating to eligibility, coverage, nondiscrimination, funding, vesting and disclosure also apply to Section 403(b) plans.

6. Workplace Individual Retirement Plans

a. <u>SEP IRAs</u>. Introduced in 1978, Simplified Employee Pensions ("SEPs") were created as an alternative to the more burdensome and expensive defined benefit and defined contribution plans, to encourage more employers to adopt retirement plans for themselves and their employees. SEPs are particularly attractive to small business and professional firms. Under a SEP Plan, individual retirement accounts are established for each participating employee. The employer makes tax-deductible contributions to these accounts. These contributions and the earnings they generate are not taxed as income to the employee when made, and accumulate without current income tax until they are distributed to the employee. The employee is always fully vested in the amounts contributed to the employee's SEP account on his or her behalf; with SEPs, there is a 100% vesting requirement. Once contributions are made to an employee's SEP account, the funds belong to the employee and cannot be forfeited.

Although SEP plans are not subject to the same set of rules as conventional defined benefit and defined contribution plans, they must meet certain requirements with regard to coverage. Basically, for every year an employer makes a contribution to a SEP plan, the plan must cover each employee who is age 21 or older, who worked for the employer during at least three of the previous five years, and who earned at least a certain level of compensation ($550 in 2010) for that year.

A SEP plan is an employer plan, but it effectively operates as an expanded IRA. In other words, once an employer makes a contribution to an employee's SEP account, the control of those funds resides with employee. The employee can direct how those funds are invested and when they are distributed. The distribution rules for SEPs are similar to those that apply to traditional IRAs and are discussed below.

A SEP plan is entirely employer funded. In 2010, the maximum amount that an employer can contribute on behalf of any one participant in any one year is limited to $49,000, or 25% of the participant's compensation. Job Creation and Worker Assistance Act of 2002, § 411(1)(3). During 2010, only the first $245,000 of compensation can be taken into account for this purpose. These contributions are not included in the participant's income, and the employer may deduct the amount contributed. SEP Plans must be treated as defined contribution plans for purposes of the overall limits on employer contributions to qualified plans.

The employee can treat his or her SEP account as an individual retirement account – which, in fact, it is – and make deductible or nondeductible contributions to it under the rules applicable to traditional IRAs, discussed below.

b. **Simple IRAs**. The Small Business Job Protection Act of 1996 (HR 3448) created a savings incentive match plan for employees of a small employers (a "Simple IRA"). These plans are available to employers that do not have qualified plans in place and that employ 100 or fewer individuals. A Simple plan can be set up like an IRA or a 401(k) plan. Both provide for elective employee contributions, employer contributions (under a formula that either matches employee contributions or under a non-elective formula) and the immediate 100% vesting of plan funds.

Employees who received at least $5,000 in compensation from the employer during any two preceding years and who are expected to receive at least that amount during the current year must be allowed to participate, if they choose, by making contributions to the plan. All contributions to a Simple plan, whether made by the employee or the employer, vest fully and immediately in the employee, and cannot be forfeited. These contributions are not currently taxable to the employee and they remain tax deferred until distributed.

Under a Simple plan, contributions are made to an IRA established for each employee. Employees who earn at least $5,000 in the current year can contribute (through salary reductions) up to $11,500 (in 2010) annually.

Since the beginning of 2002, participants who have reached the age of 50 during the plan year may be permitted to make "catch-up" contributions, in addition to the limits listed above. The limit for catch-up contributions is $2,500 for 2010.

The employer is required to make a contribution equal to either:

- A dollar for dollar matching contribution of up to 3% of the employee's compensation (the employer can elect a lower percentage, not less than 1%, in no more than two out of the five years ending with the current year), or
- 2% of compensation for all eligible employees earning at least $5,000 (whether or not they elect salary reductions).

Distributions to employees are generally treated the same as distributions from a traditional IRA, discussed below. However, the 10% penalty tax on early distributions is increased to 25% during the first two years of participation. Furthermore, while a rollover may be made at any time from one SIMPLE IRA to another SIMPLE IRA, a rollover from a SIMPLE IRA to a traditional IRA during the first two years of participation is permitted only in the case of distributions to which the 25% early distribution penalty does not apply.

7. **Individual Retirement Accounts**

IRAs were first introduced in 1974 as a way for those who were not covered by an employer plan to save on a tax-deferred basis for their retirement. Since their introduction IRAs have been subject to many changes – some expansive, other restrictive. The introduction of the Roth IRA and the so-called Education IRA sparked a flood of interest in these plans.

a. **Traditional IRAs**. A traditional IRA can be established by anyone who is under age 70½ and has earned income. Earned income includes wages, salaries, fees, tips and commissions; it does not include investment earnings, interest or dividends, rental income, retirement benefits or disability benefits. For 2010, up to $5,000 or 100% of earned income, whichever is less, may be contributed to an IRA on an annual basis. The earnings on IRA funds are not currently taxable to the IRA owner, and thus the account grows on a tax-deferred basis. Working spouses who file joint returns may each establish an IRA and contribute up to $5,000 each, or $10,000 combined.

The maximum allowable annual IRA contribution is $5,000 for 2010. Beginning in 2009, the maximum allowable annual contribution amount is adjusted for inflation. Individuals who are 50 years of age or older can contribute additional "catch-up" contributions to an IRA of $1,000 per year.

(1) **Spousal IRAs**. A spousal IRA allows for additional contributions of up to $3,000 a year for a spouse who does not have any earned income, or whose earned income is less than $3,000. The typical arrangement is to establish two separate IRA accounts – one for the working spouse and the other for the non-working spouse. A maximum of $10,000 can be contributed for both accounts each year, though no more than $5,000 can be directed to either one account. Annual contribution limits for spousal IRAs will increase in the same manner as contribution limits for Traditional IRAs.

(2) **Traditional IRA Funding**. There are two basic approaches to funding an IRA: through an individual retirement account or an individual retirement annuity. An individual retirement account is a plan established by a written trust or custodial agreement through a bank, brokerage house, mutual fund or other approved sponsor. In this way, IRA funds can be invested in certificates of deposit, stocks, bonds, mutual funds or commodities. They cannot be invested in collectibles (works of art, gem stones, antiques), though certain silver, gold and platinum coins are acceptable. A bank or institution that serves as trustee or custodian may prepare its own prototype IRA agreement for IRS approval, or use IRS prototypes. By contrast, an individual retirement annuity is a contract issued by a life insurance company that meets requirements similar to those described above. The premium on the contract is the contributions made. The product used is a flexible premium annuity, variable or fixed.

(3) **Traditional IRA Contributions: Deductible and Nondeductible**. When IRAs were first created, only those who were not actively participating in an employer-sponsored retirement program were eligible to establish an IRA and claim a deduction for any contribution. This law was changed in 1981, opening IRA eligibility to anyone who had earned income, and allowing full deductions for any IRA contribution within the prescribed limits. In 1986, the law changed again and returned to the earlier rule, limiting deductible IRA contributions only to those employees who were not active participants in another qualified retirement plan.

Today, anyone who is earning income (and is under age 70½) can establish and contribute to a traditional IRA. The IRA participant's ability to deduct those contributions depends in part on whether the IRA participant also is an active participant in an employer- sponsored plan. An individual who is not an active participant in another qualified plan can deduct the full amount of

a traditional IRA contribution. An individual who is an active participant in another qualified plan can deduct IRA contributions fully, partially or not at all, depending on the level of his or her adjusted gross income ("AGI"). If your spouse is an active participant in a qualified plan, your spouse's participation will be attributed to you, limiting your ability to deduct IRA contributions, after another, higher level of AGI. All of these AGI limitations on the deductibility of IRA contributions are adjusted for inflation, and change periodically.

Individuals who cannot deduct any part of an IRA contribution can still make nondeductible IRA contributions. Conversely, IRA owners can elect to treat contributions that would otherwise be deductible as nondeductible.

Deductible or nondeductible, contributions to an IRA cannot exceed the allowable annual amount. Under the provisions of IRC § 4973, if a contribution greater than the allowable amount is made, the excess is subject to a six percent penalty tax each year until it is withdrawn.

b. **Roth IRAs**. In 1997, the Taxpayer Relief Act (P.L. 105-34) introduced a different kind of IRA: the Roth IRA. Roth IRAs are unique in that they provide for "back-end" tax benefits. No deduction can be taken for contributions made to a Roth IRA, but the earnings on those contributions are entirely tax-free, both while in the Roth IRA and when they are withdrawn.

Up to $5,000 a year can be contributed to a Roth IRA for any one eligible individual; up to $5,000 can be contributed on behalf of a non-working spouse. Active participant status is not relevant – an individual can contribute to a Roth IRA regardless of whether he or she is covered by another employer plan or maintains and contributes to other IRA accounts. However, it should be noted that the $5,000 annual limit on contributions applies collectively to both traditional and Roth IRAs. No more than this amount can be contributed in any year for any account or combination of accounts. (An employer contribution to a SEP IRA or a SIMPLE IRA does not affect the contribution limit for an individual IRA account, traditional or Roth.) The annual contribution limit for Roth IRAs will increase in the same manner as the contribution limits for traditional IRAs.

Unlike traditional IRAs, which are limited to those under 70½, Roth IRAs impose no age limit. Any individual with earned income can establish a Roth IRA at any age and make contributions. ("Earned income" for this purpose is defined exactly the same as it is for traditional IRAs.) On the other hand, Roth IRAs are subject to income limits that traditional IRAs are not. High-income earners may not be able to contribute to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA ($5,000 in 2010) begins to phase out for individuals whose modified adjusted gross incomes reach certain levels. Once AGI exceeds those levels, Roth contributions are no longer allowed.

The AGI phase-out for Roth IRA contributions is:

- For unmarried individuals: $105,000-$120,000.
- For married individuals filing joint returns: $167,000 - $177,000.

- For married individuals filing separate returns: $0-$10,000.

➔ **Planning Point**: There is a debate over whether it is better to make deductible IRA contributions or nondeductible Roth IRA contributions. But there is no debate between nondeductible IRA contributions and Roth IRA contributions. If you are not eligible to deduct IRA contributions, you are always better off making Roth IRA contributions, if you are eligible to do so.

The Pension Protection Act of 2006, Pub. L. 109-280 (Aug. 17, 2006) (the "PPA") allows a taxpayer directly to rollover funds from an "eligible retirement plan" to a Roth IRA. Thus, taxpayers no longer must first roll funds from a qualified retirement plan to a traditional IRA and then convert this traditional IRA into a Roth IRA. The Roth IRA conversion rules in effect before the PPA was enacted apply to such rollovers. IRC § 408A(c)&(d). These provisions apply to distributions made after December 31, 2007.

➔ **Planning Point:** The advantages of this new provision increased after 2009 because, as discussed below, the $100,000 AGI limitation on Roth IRA conversions disappeared at that time.

c. Education IRAs. Education IRAs are not really IRAs at all, and are more properly called Coverdell Education Savings Accounts. They are governed by IRC §530. Many (but not all) of the rules that apply to Education Savings Accounts are similar to the rules that apply to IRAs, and contributions are limited both by the amount that can be added to such accounts each year and the AGI of the person contributing to the account.

d. Limits on the Deductibility of IRA Contributions. The available IRA options and contribution limits have become increasingly complex. The following chart, derived from IRS Publication 590, summarizes the current AGI limitations for the deductibility of IRA contributions:

If you are covered by a retirement plan at work, use this table to determine if your modified AGI affects the amount of your deduction.

IF your filing status is …	**AND** your modified adjusted gross income (modified AGI) is …	**THEN** you can take…
Single or Head of Household	$56,000 or less	A full deduction
	More than $56,000 but less than $66,000	A partial deduction
	$66,000 or more	No deduction
Married Filing Jointly or Qualifying Widow(er)	$89,000 or less	A full deduction
	More than $89,000 but less than $109,000	A partial deduction
	$109,000 or more	No deduction
Married Filing Separately	Less than $10,000	A partial deduction

	$10,000 or more	No deduction

8. Roth 401(k) and Roth 403(b) Contributions

The IRS has finalized regulations under IRC § 401(k)&(m) regarding Roth 401(k) contributions. T.D. 9237, 2006-6 I.R.B. 394. The IRS also has issued final regulations under IRC § 402A, 403(b) and 402(g) primarily regarding the taxation of and reporting rules pertaining to distributions from designated Roth accounts under IRC §§ 401(k) and 403(b) plans. T.D. 9324, 2007-22 I.R.B. 1302. The following discusses some of most important provisions for attorneys.[1]

a. **<u>In General</u>**. A *designated Roth account* is a separate account under a IRC § 401(a) plan to which designated Roth contributions are made that satisfies the requirements of Treas. Reg. § 1.401(k)-1(f) (listed below) and that are made in lieu of elective contributions or deferrals. A designated Roth account is subject to the same rules that apply to other 401(k) plans, except to the extent IRC § 402A provides otherwise. For purposes of IRC § 72, the applicability of which is discussed below, an employee may only have one separate designated Roth account. Treas. Reg. § 1.402A-1, A-9.

A *designated Roth contribution* is an election to make contributions to an IRC § 401(k) plan in lieu of all or a portion of the elective deferrals the employee is otherwise eligible to make under the plan, that has been irrevocably designated by an employee as designated Roth contributions that are not excludable from the employee's gross income and maintained in a separate account. Treas. Reg. § 1.401(k)-1(f). Thus, amounts deferred as a designated Roth contribution will be subject to income tax to the employee at the same time the employee would have received the contributed amounts in cash if the employee had not made the elective deferral, unlike traditional IRC § 401(k) deferrals. The modified adjusted gross income and conversion limitations applicable to Roth IRA contributions under IRC § 408A(c)(3) are inapplicable to designated Roth accounts.

The employer cannot make matching contributions to a designated Roth account. The employer can, however, limit the amount of deferrals treated as designated Roth contributions. Such contributions, however, may not be accepted by a plan that does not permit pre-tax elective deferrals.

➔ **<u>Planning Point</u>:** Designated Roth accounts are subject to the minimum required distribution provisions of IRC § 401(a)(9), discussed in detail below. Treas. Reg. § 1.401(k)-1(f)(3). In contrast, minimum required distributions from Roth IRAs are not required until after the employee's death. An owner of a designated Roth account can therefore prevent application of the lifetime minimum distribution rules by rolling the designated Roth account to a Roth IRA. However, for years other than 2010, rollover contributions to Roth IRAs are an option only for taxpayers with modified adjusted gross income below certain levels. IRC § 408A(c)(3) (as amended by the Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222, May 17, 2006, 120 Stat. 345).

An employee's Roth contribution is subject to the annual limitation on elective deferrals set forth in IRC § 402(g). Thus, the sum of an employee's traditional IRC § 401(k) deferrals and designated Roth contributions cannot exceed the maximum amount of elective deferrals excludable from gross income that the employee otherwise could make. Generally, the annual limitation on the exclusion for elective deferrals is $16,500 in 2010. <u>See</u> Section B.3.e. above. However, the employee contributing to both types of plans must irrevocably make an election regarding the allocation between the two types of plans at the same time the employee makes the cash-or-deferred election. Retroactive elections are not permitted. Treas. Reg. § 1.401(k)-1(f)(1)(i). Designated Roth contributions may be treated as catch-up contributions and serve as the basis for a participant loan.

A designated Roth account under a IRC § 401(k) plan can be distributed only upon the various events that permit 401(k) distributions in general: retirement, death, disability, severance from employment, attainment of age 59½, plan termination or hardship. With regard to the taxability of distributions, only a *qualified distribution* from a designated Roth account is excludable from gross income. IRC §§ 402A(d)(1) & 408A(d)(1); Treas. Reg. § 1.402A-1, A-2(a). Generally, a qualified distribution is a distribution that is made after the employee has been a participant in the Roth plan for a five-year period and that either (1) is made on or after the date the employee attains age 59½, (2) made to a beneficiary or the estate of the employee on or after the employee's death or (3) is attributable to the employee being disabled under IRC § 72(m)(7). If the distribution is not a qualified distribution, then the distribution is included in the distributee's gross income as determined under IRC § 72. Consequently, the distribution is included in the distributee's gross income to the extent allocable to income on the contract and excluded from gross income to the extent allocable to investment in the contract (<u>i.e.</u>, basis). The amount of a distribution allocated to investment in the contract is generally determined by applying to the distribution the ratio of the investment in the contract to the account balance.

b. **<u>Five-Year Rule for Qualified Distributions</u>**. Generally, the five-year period during which a distribution is not a qualified distribution begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the designated Roth account and ends when five consecutive-taxable years have been completed. IRC §§ 402A(d)(2)(B) & 408A(d)(2)(B). The five-year period is computed separately for each plan. Treas. Reg. § 1.402A-1, A-4(a), (b).

c. **<u>Nonqualified Distributions</u>**. A nonqualified distribution from a designated Roth account is taxable to the distributee. The portion of any distribution that is includible in gross income as an amount allocable to income on the contract and the portion not includible in income as an amount allocable to investment in the contract is generally determined under IRC § 72(e)(8). Treas. Reg. § 1.402A, A-3. Under that provision, non-qualified distributions from designated Roth accounts carry out basis and earnings proportionately.

➔ **<u>Planning Point</u>:** Thus, assuming earnings have accumulated in the designated Roth account, all nonqualified distributions will be partly taxable. This can be avoided if the earnings are rolled over to a Roth IRA, in which nonqualified distributions first consist of non-taxable investments in the contract. Only when the nonqualified distribution from a Roth IRA

exceeds the investment in the contract is the nonqualified distribution taxable.

A distribution is not qualified to the extent it consists of a distribution of excess deferrals and attributable income described in Treas. Reg. § 1.402(g)-1(e). Certain other distributions are categorized as nonqualified distributions. Treas. Reg. § 1.402A-1, A-2(c), A-11.

d. **Separate Contracts Post-Death**. Separate accounts can be established and maintained for different beneficiaries after the death of an employee. The separate account for each beneficiary is treated as a separate contract under IRC § 72 and is also a separate contract with respect to any other account maintained for that beneficiary under the plan that is not a designated Roth account. When the separate account is established for an alternate payee or beneficiary after the employee's death, each separate account must receive a proportionate amount attributable to investment in the contract. Treas. Reg. § 1.402A-1, A-9(b).

Rollovers from designated Roth accounts are discussed in Section 5 below.

C. The Economic Advantages of Tax Deferred Savings

The primary advantage of saving for retirement within any type of tax deferred investment program is the impact of compounding earnings on a tax deferred basis. It is impossible to exactly compare a taxable investment program with a tax deferred investment program because of the numerous variables that come into play, such as the income tax rates that apply to different types of investments (ordinary income versus capital gains rates), state and local taxes, the timing of the payment of taxes (either when earned or on the sale of a security), and varying rates of investment return (*e.g.*, the interest rate on tax-free municipal bonds versus the after-tax rate on taxable bonds). However, a hypothetical example that has clear assumptions may be useful to illustrate the economic advantages of tax deferred savings over time. Consider the following:

Assumptions:

Annual Contribution: $2,000

Annual Return: 10%

Combined state and federal marginal income tax bracket: 30%

Contributions are made at the end of each year.

Taxes are due when the funds are distributed from the IRA.

	Tax Deferred		Currently Taxable	
Years Until Withdrawal of Funds	IRA Balance Assuming a $2,000 Annual Deductible Contribution	After-tax Amount if Withdrawn from the IRA at a 30% Income Tax Rate	$1400 Annual Contribution Invested at an Equivalent After-Tax Rate of 7.0%	Benefit Due to Tax-Deferral
5	$12,210	$8,547	$8,051	$496
10	$31,875	$22,312	$19,343	$2,969
15	$63,545	$44,481	$35,181	$9,301
20	$114,550	$80,185	$57,394	$22,791
25	$196,694	$137,686	$88,549	$49,137
30	$328,988	$230,292	$132,245	$98,047
35	$542,049	$379,434	$193,532	$185,902
40	$885,185	$619,630	$279,489	$340,140

This is fundamentally a time use of money analysis. For the period of tax deferral, you are using the government's money (the deferred income taxes) to earn money for you. The longer the period of tax deferral, the larger the overall economic benefit. This analysis holds true even if the applicable income tax rates on a currently taxable investment program are lower than ordinary rates, or are partially deferred (*i.e*. capital gains). It may take a longer period of deferral to show an economic advantage under those circumstances, but over time compounded tax deferred earnings is almost always economically superior.

D. The Income Tax Treatment of Distributions from Qualified Plans and IRAs

1. Types of Distributions

There are generally four types of distributions that might be made from a qualified plan: a lump sum distribution, a loan, an annuity and discretionary distributions.

a. **Lump-Sum Distributions**. A lump-sum distribution by IRS definition is one that:

- Is taken from a qualified pension, profit-sharing or stock bonus plan;
- Is made in one taxable year of the participant;
- Consists of the entire balance in the participant's plan (for this purpose, all pension plans must be treated as one plan, all profit-sharing plans must be treated as one plan and all employer stock bonus plans must be treated as one plan); and
- Is payable on account of the participant's death, disability, attainment of age 59½ or separation from the employer's service. (The disability requirement applies only to self-employed individuals; the separation from service requirement applies only to common-law employees and not to the self-employed.)

Only qualified *employer* plans can make lump sum distributions. Lump sum distributions are normally associated with account-based plans, such as 401(k) and profit-sharing plans, but may be available under certain defined benefit plans as well. Lump sum distributions are, by definition, eligible for certain types of favorable income tax treatment, including forward averaging, discussed below. Since it is not possible to take a lump sum distribution from an IRA, SEP or 403(b) plan, none of these plans are eligible for forward averaging or other forms of favorable income tax treatment.

Many lump sum distributions are rolled over. A *rollover* allows a participant to take a tax-free distribution from one qualified plan and deposit it into another plan (or plans), continuing tax deferral.

b. **Loans**. It may be a stretch to call a *loan* a distribution, but given that our definition of distribution is "any outflow from a retirement plan," a loan would qualify. The law allows certain plans to include provisions for loans to participants. Such provisions are not required, however, and a participant cannot borrow from his or her plan unless the plan specifically allows it. Loan provisions are common to profit-sharing plans, 401(k) plans and 403(b) plans. However, IRAs and SEPs are not allowed to make loans.

Plan loans taken in accordance with the conditions prescribed by the plan and by law are without tax consequences at the time the loan is made, and when it is repaid. Loans are not treated as taxable distributions or penalized distributions. In this way, loans do have an advantage over regular distributions.

c. **Annuity Distributions**. *Annuity distributions* are specifically defined as life contingent immediate annuities or life contingent annuitizations. Withdrawals from deferred annuity plans are not annuity distributions for these purposes; they would be considered discretionary distributions. Taking distributions in the form of an annuity as defined here is not a

very popular form of plan distribution. Interestingly enough, some plans -- notably defined benefit pension plans -- offer no alternative.

Annuity payouts are taken in a variety of forms: joint and 100% survivor annuities, joint and 50% survivor annuities, single life annuities, or life annuities (single or joint) with a guaranteed minimum term. Most qualified plans offer at least some of these alternatives. Many plans, in fact, require that married participants receive their retirement benefit in the form of a joint and survivor annuity, unless both participant and spouse waive this form of benefit.

The common thread among all the annuity options is the life contingency. The advantage of the life contingency is that the participant and his or her beneficiary cannot outlive the payment stream. The disadvantage is a complete lack of flexibility and inflation protection. The annuitization of pension benefits is commonly fixed, which locks the participant and his or her beneficiary into an irrevocable income stream -- at today's dollars -- for the rest of their lives. This, of course, would become quite unattractive in an inflationary environment. Annuitized pension benefits typically cease upon the death of the participant or the participant's beneficiary. There is usually no benefit paid to any other beneficiary, other than the guaranteed minimum payment, if there is one.

d. **Discretionary Distributions**. The best way to define a *discretionary distribution* is by elimination. Discretionary distributions are any distributions that are not lump sum distributions, loans or annuity payouts. Discretionary distributions are just as the name implies: they are taken at the participant's discretion. They do not have to be structured. They can be taken, at will, and changed up or down, at will. They can be stopped and reinstated later. Alternatively, discretionary distributions *can* be structured, if the participant desires, so that withdrawals are taken on a systematic basis. The flexibility inherent in this method of distribution makes it quite popular.

It should be noted that not all plans allow for discretionary distributions. Typically, pension plans and most profit-sharing plans do not provide for discretionary distributions; their benefit structures are normally designed for annuitized or lump sum payments. However, payments from IRAs and SEPs are almost always discretionary distributions. A qualified plan participant who wants distribution flexibility should consider the advantages of rolling over his or her qualified plan funds to an IRA.

e. **Distributions by Age**. Another way to differentiate the applicability of distribution rules is by the age of the participant: pre-59½; between 59½ and 70½; and post-70½.

(1) **Pre-59 ½**. Generally, the law does not allow distributions from a qualified or individual retirement plan prior to the participant or owner's age 59½. Any distributions taken before this age are considered to be "early" or "premature" distributions. Typically, early distributions are subject to a ten percent penalty (in addition to any applicable income taxes) unless the circumstances under which the distribution is made qualify as an exception to the penalty.

(2) **Between 59½ and 70½**. There are no special rules regarding

distributions between the ages of 59½ and 70½. During this period, according to tax law, distributions may be taken, but they are not required to be taken. Consequently, plan participants need only comply with the rules of their employer's plan. IRA and SEP owners need not comply with any rules.

From the standpoint of the IRS, the time period between ages 59½ and 70½ is considered to be "normal" or "regular" retirement age. Studies have shown, however, that there are more retirees pre-59½ and post-70½ (combined) than there are between 59½ and 70½. That which is normal or typical in real life does not always correspond to that which is deemed "normal" under the tax laws.

(3) **Post-70½**. Just as the law mandates an age before which distributions are not allowed (at least not without penalty), it also stipulates a point at which distributions must begin. The point at which distributions must begin is generally regarded to be age 70½. See the discussion of the required beginning date ("RBD") below. Distributions from employer plans may be delayed until the individual retires if that is later than age 70½ (unless the participant is a 5% owner), but as a general rule the recognized required distribution point is age 70½.

Distributions at and after this point are subject to the *required minimum distribution* rules or *RMD* regulations, and are also discussed below. Failure to take a required minimum distribution results in a severe penalty: a 50% excise tax on the amount that should have been, but was not, withdrawn. This is one of the highest penalties the tax law imposes.

2. General Rule of Taxation as an Annuity Under IRC § 72

The income tax treatment of retirement plan distributions is fairly straightforward and follows a basic rule: that which was not taxed prior to distribution is taxed upon distribution. This means that any contributions and any interest earnings that were not taxed on "the front end" will be subject to tax when distributed from the plan; conversely, any contribution that was taxed to the participant or owner before it was deposited in the plan is recovered income tax-free. Thus, a distribution from a plan that consists entirely of deductible contributions is fully taxable as ordinary income.

Distributions from retirement plans that contain both deductible and nondeductible contributions will be partly taxable and partly tax-free. Nondeductible contributions represent the participant's *cost basis*, or *investment in the contract*, and they are not taxed when they are distributed. Only the portion of a distribution that represents deductible contributions and interest earnings is taxed. While the income taxation of annuities is complex, in general, each distribution received from a qualified plan or IRA to which nondeductible contributions have been made will be treated in part as a tax-free return of investment (*i.e.*, the tax-free return of nondeductible contributions) and in part as taxable income (the distribution of deductible contributions and earnings on contributions), until all nondeductible contributions have been distributed. IRC § 72.

3. Lump Sum Distributions from Qualified Plans

The rules for the taxation of lump sum distributions from qualified plans are slightly more complex.

a. <u>Ten Year Forward Averaging and Capital Gains Treatment</u>. Certain lump-sum distributions may be eligible for 10-year forward averaging tax treatment. Forward averaging operates to tax the distribution as if it were received over 10 years instead of in a single year, thus reducing the tax liability. The tax is still paid all at once, for the year of the distribution. But the amount of tax is less than it would be if forward averaging were not used. (Basically, you compute the tax on one-tenth of the total taxable amount, then multiply that by ten.) Tax rate tables as in effect in 1986 are used to calculate the 10-year forward averaging tax.

To take advantage of 10-year forward-averaging, certain conditions must apply:

- The distribution must qualify for lump-sum treatment, as explained above (and since only qualified employer plans can distribute lump sums, IRA, SEP and 403(b) distributions cannot be forward-averaged);
- the participant must be over the age of 59½ when the distribution is received;
- the participant must elect averaging treatment on all lump sum distributions received during the same year. (For example, if a participant received lump sum distributions from a pension plan and a profit sharing plan and rolled one of them over to an IRA, the other plan would not be eligible for forward averaging.)
- The participant must have reached age 50 by January 1, 1986;
- The participant must have been a participant in the plan for at least five years before the year of the distribution; and
- The participant must not have elected forward averaging on any prior lump sum distribution.

Participants who attained age 50 prior to January 1, 1986, also (or alternatively) can elect capital gains treatment at a 20% long-term capital gains rate for any portion of the distribution attributable to plan participation prior to 1974.

As is the case with other types of distributions, any portion of a lump-sum distribution attributable to after-tax (nondeductible) contributions is returned tax-free to the participant.

b. <u>Net Unrealized Appreciation in Employer Securities</u>. On a distribution of employer securities from a qualified plan, certain appreciation will not be taxed. If the distribution is part of a lump sum distribution, the entire net unrealized appreciation with respect to employer securities will escape taxation at the time of distribution. IRC § 402(e)(4)(A) and (B). The net unrealized appreciation is the excess of the market value of the securities at the time of distribution over the cost or other basis of the securities to or in the qualified plan.

On a subsequent sale of employer securities received in a lump sum distribution from a qualified plan, all of the (previously untaxed) appreciation in the securities will be taxed at the lowest capital gains tax rate. This can be a very attractive distribution option for a qualified plan balance that consists primarily of low basis employer stock that the participant wants to hold for some period of time.

> **<u>EXAMPLE</u>:** An employee has a vested account balance in a qualified retirement plan of $1,000,000, consisting of: (1) $600,000 in stocks, bonds and mutual funds; (2) and $400,000 in employer securities. The employer securities have a cost basis to the plan of $100,000.
>
> The employee has two tax-favored distribution options. The employee can direct that the entire account balance be directly rolled over to an IRA. This has no current tax consequences to the employee. All distributions are taxed as ordinary income when made. Alternatively, the employee can direct that the $600,000 in stocks, bonds and mutual funds be rolled over to an IRA. This has no current tax consequences to the employee. When withdrawn, distributions from the IRA will be subject to ordinary income tax. The $400,000 of employer securities can be distributed (in kind) to the employee and placed in a personal investment management account. This results in ordinary income tax on the $100,000 of cost basis in the employer securities. The $300,000 of net unrealized appreciation is taxed as long term capital gain (at 15% rates) only when and as the securities are sold. The effect of this is to reduce the income tax on the distribution by as much as $60,000 (the difference between maximum ordinary income tax rates and maximum capital gains rates on $300,000 of net unrealized appreciation.).
>
> In determining which alternative is better, the timing of the payment of the capital gains tax becomes important. If the employee wants to diversify his or her holding in the employer securities, the rollover might be preferred, as the deferral of the income tax on the $100,000 cost basis in the securities and the $15,000 capital gains tax may be worth more economically than the $90,000 tax saved. If the employee plans to hold the stock, or if the employee needs cash for other reasons, this is an excellent strategy for minimizing income taxes.

4. Distributions from IRAs

The rules regarding IRAs have been subject to a myriad of changes. However, very little has changed with regard to the taxation of IRA distributions until the introduction of the Roth IRA. The rules regarding the taxation of IRA distributions now vary, depending on whether the instrument is a traditional IRA or a Roth IRA. (SEP IRA and SIMPLE IRA plans are set up using traditional IRAs, so the distribution rules that pertain to traditional IRAs also apply to these plans.)

a. **Traditional IRAs**. The general rules regarding distributions from traditional IRAs are similar to those that pertain to qualified employer plans: they are not allowed prior to age 59½ (at least, not without the imposition of a ten percent penalty unless qualified under an exception to the penalty); they *may* be taken after age 59½; and they *must* be taken, in at least minimum amounts, once the owner reaches age 70½. Upon withdrawal or distribution, traditional IRA earnings are subject to ordinary income tax under IRC § 72, as are any contributions that were deducted when they were initially contributed to the account. If the account consists of contributions that were fully deducted by the owner, the entire amount of each distribution is subject to tax. On the other hand, it is not uncommon to find traditional IRA accounts that contain both deductible and nondeductible contributions. The way in which one would determine the taxable and nontaxable portion of a distribution in this circumstance is determined under IRC § 72, with nondeductible contributions representing the participant's cost basis, or investment in the contract, that are distributed to the participant without income tax.

Distributions from traditional IRAs are, by their nature, "discretionary." The timing and amount of each distribution is at the discretion of the account owner. However, it is important that IRA owners review the provisions of their account documents prior to the required distribution date, since a certain methodology of calculating required distributions may apply under the plan documents, unless changed by the owner.

b. **Roth IRAs**. The general rules regarding the distribution and taxation of funds from a Roth IRA are more straightforward than those imposed on traditional IRAs. The reason is that a traditional IRA is a *tax-deferred* vehicle and a Roth IRA is a *tax-exempt* or *tax-free* vehicle. With a tax-deferred product, taxes are still due and owing; every traditional IRA contribution that is deducted and every dollar that is earned while in a traditional IRA account carries an obligation to pay future taxes. These taxes are typically applied when a distribution is made. With a tax-exempt or tax-free Roth IRA, taxes have been paid "up front" -- as long as the rules are followed, there are no future taxes due. Consequently, with Roth IRAs the IRS really has a minimal ongoing interest because, theoretically, there are no other taxes to collect. That is, as long as the distribution rules are followed.

(1) **Qualified and Nonqualified Distributions from Roth IRAs**. Distributions from a Roth IRA are either *qualified* or *nonqualified*. A *qualified distribution* is one that provides for the full tax advantage the Roth IRA offers: tax-free distribution of earnings. To be a qualified distribution, two requirements must be met:

- the funds must have been held in the account for a minimum of five years, *and*
- the distribution occurs for one of the following reasons:
  - ► the owner has reached age 59½; *or*
  - ► the owner dies; *or*
  - ► the owner becomes disabled; *or*
  - ► the distribution is used to purchase a first home.

If these requirements are met, no portion of the distribution is subject to tax.

To be considered a "qualified" distribution from a Roth IRA and therefore completely tax free, one of the requirements is that the amount attributed to the distribution must have been held in the account for at least five years. The five-year holding period begins the first year for which a contribution was made. Individuals may even delay an initial contribution until April 15 of the next year, designate it as a contribution for the previous year and initiate the five-year holding period as of the previous year.

A *nonqualified distribution* is one that does not meet the above criteria. The result is that distributed Roth *earnings* are subject to tax. This would occur when the distribution is taken without meeting the above requirements *and* the amount of the distribution exceeds the total amount that was contributed to the Roth IRA. Remember, Roth contributions are made with after-tax dollars; they are not subject to taxation again upon distribution. Therefore, the only portion of a nonqualified Roth distribution that is subject to taxation is earnings, and only when those earnings are withdrawn from the account without having met the above requirements. Amounts taken from a Roth IRA are treated on a FIFO (first-in/first-out) basis: they will be considered first as withdrawals of nontaxable contributions until all contributions have been distributed. After that, nonqualified distributions will be treated as distributions of taxable earnings. As with the taxation of other distributions from qualified plans and IRAs, the distribution of basis (after-tax or nondeductible contributions) is not subject to tax or penalty. In the case of distributions from a Roth IRA, all distributions are deemed to be a return of basis until all basis is fully recovered. Only then might earnings be distributed, and subject to tax and a possible penalty.

If the owner of a Roth IRA is younger than 59½ when a distribution is taken, the distribution will be considered "early," or "premature," and, if the distribution does not qualify under an exception to the early distribution rules, the earnings portion will be assessed a ten percent penalty in addition to the applicable ordinary income tax.

(2) **Minimum Required Distributions and Roth IRAs**. Unlike traditional IRAs, Roth IRAs do not require mandatory distributions during the lifetime of the participant. There is no minimum distribution requirement for the account owner; the funds can remain in the account as long as the owner desires. In fact, the account can be left intact and passed on to heirs or beneficiaries. However, upon the owner's death, any funds that do remain in a Roth IRA must be distributed to the beneficiary in accordance with the same minimum distribution requirements that apply to other qualified plans and IRAs, as discussed below.

(3) **Roth IRA Conversions**. Under prior law, only individuals with an AGI of less than $100,000 for the year in which the conversion takes place could convert traditional IRA funds to a Roth IRA. Married couples filing separately were not eligible to make a Roth IRA conversion at all. Under Section 512 of the Tax Increase Prevention and Reconciliation Act, P.L. 109-222 (May 17, 2006), these two limitations were repealed for 2010, making the Roth IRA conversion available to everybody who owns a traditional IRA.

The conversion can be accomplished through: (1) a rollover of a distribution within 60 days of receiving the distribution; (2) a trustee-to-trustee transfer; or (3) redesignating a

traditional IRA as a Roth IRA. Treas. Reg. § 1.408A-4, Q&A-1(b). Any amount converted in excess of the transferor's basis is included in gross income. An individual acquires a basis in a traditional IRA through non-deductible contributions. For purposes of determining the taxable amount, all converted traditional IRAs are aggregated.

After the conversion, the owner may receive qualified distributions from the Roth IRA tax-free (after satisfying a five-year waiting period and reaching age 59½, discussed above). As with other Roth IRAs, the assets in the Roth IRA grow tax-free and the Roth IRA is not subject to minimum required distributions ("MRDs") during the owner's lifetime (but a non-spouse beneficiary of the Roth IRA will be subject to the MRD rules). IRC § 408A(c)-(e); Treas. Reg. § 1.408A-6, Q&A-2.

➔ **Planning Point:** Thus, an individual who is likely to be in the same or a higher income tax bracket at the time he or she receives a distribution, or a person who believes that the assets in the Roth IRA will grow substantially in value, will benefit from a Roth conversion. Furthermore, because marginal ordinary income tax rates are scheduled to return to 39.6% in 2011, and may be even higher in later years, deferring tax under a traditional IRA may not be as beneficial as converting to a Roth IRA and paying the tax now at lower tax rates.

Also, with respect to conversions occurring in 2010 only, a taxpayer may elect to defer the tax attributable to the conversion with the result that one-half of the converted amount will be includible in gross income in 2011 and the other one-half in 2012. IRC § 408A(d)(3)(A). The gross income inclusion of any deferred converted amounts will be accelerated, however, if converted amounts are distributed before 2012. The tax is accelerated to the extent of the lesser of the tax on the distributed amount or the remaining unpaid tax. IRC § 408A(d)(3)(E)(i).

An individual may elect out of the deferral of the tax. Because marginal ordinary tax rates are scheduled to return to 39.6% in 2011, deferring the income tax will likely create a higher tax cost. An individual may be able to elect out of the deferral as late as the due date of the 2010 income tax return, including extensions, which could be as late as October 15, 2011. For years after 2010, any conversion would be fully includible in the taxpayer's income in the year of conversion. IRC § 408A(d)(3)(A).

➔ **Planning Point:** One of the biggest impediments to converting is the up-front tax cost. If funds in the IRA are used to pay the tax, the withdrawn amount will be subject to a 10% penalty. IRC § 408A(d)(3)(F); Treas. Reg. § 1.408A-6, A-5(b). The IRA owner may address this issue by making only a partial conversion so that the resulting tax will be affordable. The portion of the traditional IRA that is not converted can be converted later in the same year or in future years. Another option to deal with this tax cost is to combine the conversion with charitable giving, as discussed below.

➔ **Planning Point:** If a charitable entity is the beneficiary of the IRA, converting to a Roth IRA will likely result in a larger gift to the charitable

beneficiary due to tax-free growth and the lack of MRDs (and, of course, resulting in a larger charitable deduction for estate tax purposes, if estate tax is in effect). In addition, during the owner's lifetime, withdrawals of Roth IRA assets followed by a transfer of funds to a charitable entity will result in a charitable deduction with no offsetting income tax upon the receipt of the funds from the Roth IRA.

As one can surmise from the above discussion, the analysis of whether to convert to a Roth IRA is different for each taxpayer. The taxpayer and his or her advisor need to analyze the overall financial situation of the taxpayer and perform the necessary calculations. The primary factors that should be considered include the following:

- The taxpayer's present and future consumption needs and whether the taxpayer has liquidity outside of the IRA for personal consumption.
- The likelihood of future income tax rate increases.
- Whether the taxpayer anticipates a change in his or her tax bracket.
- What investment rate of return assumptions are made, both inside and outside of the traditional/Roth IRA.
- Whether the taxpayer can forgo distributions after age 70½.
- The taxpayer's overall estate planning objectives.

c. **<u>Comparing Distribution Rules: Traditional and Roth IRAs</u>.**

	Traditional IRA	**Roth IRA**
Allowable Distributions	After owner's age 59 ½	After holding period of 5 years *and:* - age 59 ½ *or* - death *or* - disability *or* - first-time home purchase
Tax Treatment	Subject to ordinary income tax, to extent distribution represents deductible contributions and earnings	No tax
Premature Distributions	Prior to owner's age 59 ½	Prior to owner's age 59 ½
Tax Treatment	Income tax plus a 10% penalty on amount included in income, unless distribution qualifies as an exception to the premature distribution penalty	10% penalty on distributed earnings, unless distribution qualifies as an exception to the premature distribution penalty; earnings subject to income tax unless distribution is taken due to death, disability or for first-time home purchase

Required Distributions	After owner's age 70 ½	None while owner is alive
Tax Treatment	Subject to ordinary income tax, except for the return of non-deductible contributions	None on qualified distributions

5. Rollovers and Transfers of IRAs and Qualified Retirement Plan Assets

Effective for years beginning on or after January 1, 2002, any of these plans now may be rolled over to any other qualified retirement plan or individual retirement arrangement. IRA distributions also may be rolled over to other workplace retirement plans (if the accepting plan allows it) and individual retirement arrangements. IRC § 408(d)(3). Spousal rollovers may now be made to a qualified plan, IRC § 403(b) annuity, or governmental IRC § 457 plan in which the surviving spouse participates, as well as to an individual retirement arrangement. The PPA has added IRC § 402(c)(11), which allows nonspouse beneficiaries to rollover a distribution into an IRA, and amends IRC § 408A(e), allowing qualified plans to be transferred through a direct rollover to a Roth IRA. However, the penalty and withholding requirements, which are covered later, still apply. Notice 2007-7, 2007-5 I.R.B. 395, provides additional guidance concerning nonspouse rollovers, including rules regarding the calculation of minimum required distributions after the rollover.

Any distribution from a qualified retirement plan or IRA that is rolled over to another qualified plan or IRA in a qualifying rollover contribution is income tax free in the year of the rollover. For distributions in 2002 and after, tax-free rollovers of distributions to and from qualified plans, IRC § 403(b) tax deferred annuity plans, traditional IRAs, SEPs and eligible IRC § 457 governmental plans are specifically authorized by the Internal Revenue Code. IRC § 402(c)(8)(B) and IRC § 408(d)(3). Rollovers between different types of plans are permitted. For example, a participant could rollover an eligible rollover distribution from a qualified retirement plan under IRC § 401(a) to an IRC § 403(b) tax deferred annuity, and then back to a qualified retirement plan.

Any distribution from an "eligible retirement plan" is eligible for rollover to another eligible retirement plan, except:

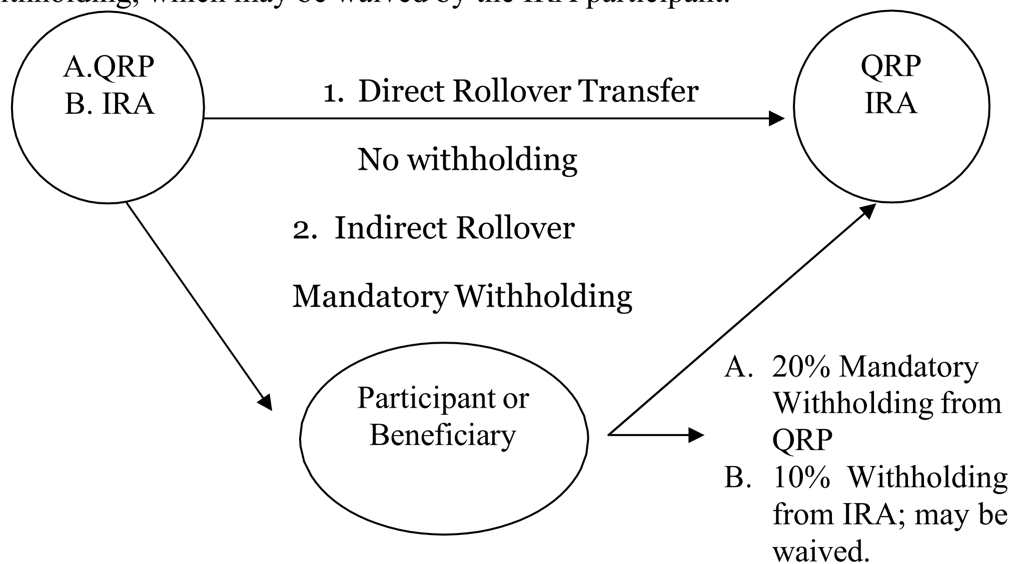
- A required minimum distribution (generally beginning at age 70 ½);
- A distribution that is one of a series of substantially equal periodic payments payable (a) for a period of ten years or more, or (b) for the life or life expectancy of the employee or the employee and a designated beneficiary;
- A "hardship" distribution;
- In most cases, after-tax contributions or other amounts not included in gross income.

An "eligible retirement plan" is a qualified plan under IRC § 401(a), an IRC § 403(b) tax deferred annuity plan or an IRA. There may be some restrictions on particular assets that cannot be rolled over. For example, a life insurance contract held under a qualified plan cannot be rolled over to an IRA, for which life insurance is not a permitted investment. Loans also cannot always

be rolled over.

Eligible rollover distributions received from an eligible retirement plan must either be transferred to another eligible retirement plan by means of a "direct rollover" at the employee's election, or transferred by the employee to the other plan not later than the 60th day after distribution from the plan. However, under the PPA, a distribution to a nonspouse beneficiary will not be considered an eligible rollover distribution unless the rollover is achieved through a direct rollover from a qualified plan to an IRA and not through a distribution to the employee. Furthermore, the PPA provides that qualified plans can be rolled over to a Roth IRA but only through a direct rollover.

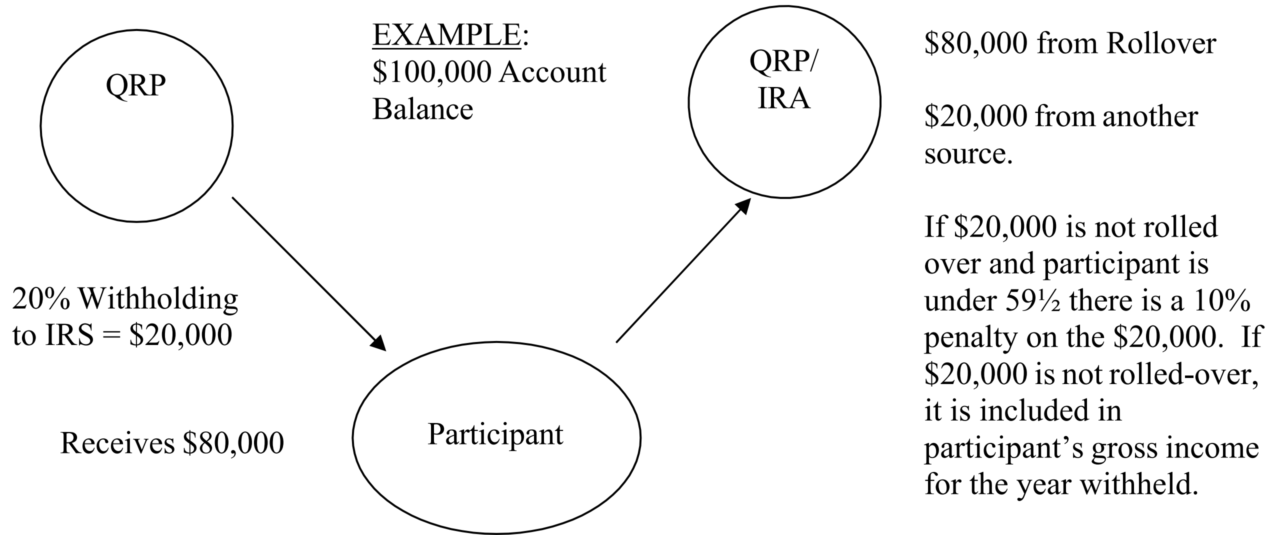
A "direct rollover" is defined as an eligible rollover distribution that is paid directly to another eligible retirement plan for the benefit of the employee. It can be accomplished by any reasonable means of direct payment, including the use of a wire transfer or a check that is negotiable only by the trustee of the new plan or rollover IRA. If the "direct rollover" method is not chosen in the case of a distribution from a qualified retirement plan, an IRC § 403(b) plan, or an eligible IRC § 457 governmental plan, the distribution is subject to mandatory withholding at 20%. Distributions from an IRA (other than direct IRA trustee to IRA trustee transfers) are subject to 10% withholding, which may be waived by the IRA participant.



IRA rollovers may only be made once a year, but a direct trustee to trustee transfer is not considered a rollover for purposes of this rule. Partial rollovers are allowed. However, the amount not rolled over is subject to the 10% early withdrawal penalty (if applicable) and must be reported as ordinary income.

➔ **Planning Point:** If the distribution is first paid to the employee before being rolled over (within 60 days), the qualified retirement plan will withhold 20% of the distribution. In order to rollover the entire distribution and avoid current income taxation (and a possible 10% penalty tax) on the 20% of the

distribution that is withheld, the employee will have to make up the 20% withholding from some other source.



In order to preserve capital gains and special averaging treatment for a lump sum distribution from a qualified retirement plan, a "conduit IRA" must be used to hold qualified plan funds for transfer from one qualified plan to another when an employee changes employers. The initial transfer from the qualified plan to the IRA is income tax-free if the amount is transferred within 60 days. (The distribution will be subject to 20% mandatory withholding unless transferred by means of a "direct rollover.") If the IRA contains no assets other than those attributable to the distribution from the qualified plan, then the amount in the IRA may subsequently be transferred, tax-free, to another qualified plan, if that plan allows such transfers. The special income tax treatment is preserved. Special income tax treatment will not be preserved if the qualified plan distribution is commingled with traditional IRA funds. An existing IRA should not be used for conduit rollovers; a new IRA always should be established for that purpose.

a. Rollover of Distributions From Designated Roth Accounts.

(1) Rollover of Distributions to Other Designated Roth Accounts. Generally, a distribution from a designated Roth account can be rolled over through a *direct* rollover in whole or in part *only* to another designated Roth account or to a Roth IRA. IRC §§ 402(c)(8) & 402A(c)(3). The provisions of IRC § 402(c)(2) involving the distribution of an amount not includable in gross income apply to a distribution from a designated Roth account.

If a portion of a distribution from a designated Roth account is a *qualified* distribution, and such distribution is to be rolled over into a designated Roth account under another plan, this rollover *must* be accomplished through a direct rollover. Treas. Reg. § 1.402A-1, A-5. Thus, the nontaxable portion of a designated Roth account cannot be rolled over to an IRC § 403(b) plan. Also, a distribution from a designated Roth account may be rolled over to an IRC § 401(k) plan or IRC § 403(b) plan only if that plan has a designated Roth program.

If the entire amount of a rollover distribution from a designated Roth account under a IRC § 401(k) plan is rolled over to a designated Roth account under another IRC § 401(k) plan, the amount of the rollover contribution allocated to investment in the contract in the recipient designated Roth account is the amount that would not have been includable in gross income if the distribution had not been rolled over. Treas. Reg. § 1.402A-1, A-6.

Under Treas. Reg. § 1.402A-1, A-5(b) & A-6, if only a portion of a *nonqualified* distribution from a designated Roth account is rolled over to an appropriate recipient, the portion rolled over is deemed to consist, first, of the part of the distribution attributable to earnings under IRC § 72(e)(8). Thus, the earnings are more likely to be considered rolled over and not includible in the employee's income due to a nonqualified distribution.

If the participant makes a direct rollover from a designated Roth account under another plan, the five-year period for the recipient plan begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the distributing plan, if earlier. IRC § 402A(d)(2)(B); Treas. Reg. § 1.402A-1, A-4(b).

If the employee receives a *taxable* portion of a distribution from a designated Roth account and then rolls this amount over to another IRC § 401(k) plan within 60 days (a "60-day rollover"),

the participant's period of participation in the distributing plan is not carried over to the receiving IRC § 401(k) plan for purposes of determining whether the participant has a five- tax year period of participation in the receiving plan. Treas. Reg. § 1.402A-1, A-5.

(2) Rollovers from Designated Roth Accounts to Roth IRAs. Generally, a distribution from a designated Roth account can be rolled over to a Roth IRA through either a direct rollover or through a 60-day rollover. Treas. Reg. § 1.402A-1, A-5(a). This is true regardless of whether the employee's income exceeds the limits imposed on contributions to a Roth IRA or on conversions from a traditional IRA to a Roth IRA under IRC § 408A(b)(3). Treas. Reg. § 1.408A-10, Q&A-2.

If the distribution from the designated Roth account was itself a *qualified* distribution, the distribution is treated as a regular contribution to the Roth IRA, regardless of whether the Roth IRA owner had maintained the Roth IRA for five years. The owner of the Roth IRA can make a tax-free withdrawal of a regular contribution at any time. In other words, the entire amount of the rollover of the qualified distributions is treated as investment in the contract in the Roth IRA. Treas. Reg. § 1.408A-10, A-3, A-4. In this situation, only the earnings accumulated after the rollover will be subject to the new five-year period, and distributions of such earnings will be taxable unless it is a qualified distribution. Treas. Reg. § 1.408A-10, A-3, A-4(b), Ex. 3.

Generally, when a *taxable* portion of a designated Roth contribution is rolled over to a Roth IRA, the period that the rolled-over funds were held in the designated Roth account does not count towards the five-year period for determining qualified distributions from the Roth IRA. In this situation, the employee's five-year period for a recipient designated Roth account or Roth IRA is based on the first year the employee made a contribution to such recipient designated Roth account or Roth IRA. Treas. Reg. §§ 1.402A-1, A-5(c); 1.408A-10, A-4, Ex. 2. However, if an individual had established a Roth IRA and met the five-year period requirement for the Roth IRA, the five-year period determined for this pre-existing Roth IRA will apply to distributions of amounts attributable to a rollover from a designated Roth account. Thus, a subsequent distribution from the Roth IRA in the amount of the rollover would be treated as a tax-free return of basis regardless of whether the individual had maintained a Roth IRA for five years after the rollover. Treas. Reg. § 1.408A-10, A-4(b), Ex. 1. This rule does not apply to the earnings on such amount accumulated in the Roth IRA.

➔ **Planning Point:** The key advantages of rolling a distribution from a designated Roth account to a Roth IRA are: (1) the avoidance of lifetime minimum required distributions; and (2) the use of more favorable recovery of basis rules. In addition, under IRC § 402A, satisfaction of the five-taxable-year requirement with respect to a designated Roth account usually is based on the years since a designated Roth contribution was first made by the employee under that plan. In contrast, the five-year period under IRC § 408A begins with the first taxable year for which a contribution is made to any Roth IRA.

b. Rollover To Designated Roth Accounts From a CODA or Roth IRA. In

contrast to a traditional IRA that may be converted to a Roth IRA, IRC § 402A does not provide for a conversion of a pre-tax elective contribution account under a qualified cash or deferred arrangement ("CODA") to a designated Roth account.

Distributions from a Roth IRA cannot be rolled over into a designated Roth account. The same rule applies even if all the amounts in the Roth IRA are attributable to a rollover distribution from a designated Roth account in a plan. Treas. Reg. § 1.408A-10, A-5.

E. Penalties Applicable to Qualified Plans and Individual Retirement Accounts

1. Penalty for Excess Contribution to IRA

An excess contribution is a contribution in excess of the maximum permissible contribution to Traditional IRAs, Roth IRAs, Education Saving Accounts, Simple IRAs, SEP IRAs and qualified retirement plans. IRC § 4973. The IRA or qualified retirement plan is not disqualified as a result of excess contributions, but various excise taxes and penalties are imposed.

Generally, there is a 6% excise tax on the amount of the excess contribution to any IRA account or qualified retirement plan. This excise tax must be paid each year until the contribution is withdrawn. IRC § 4973(b)(2). This tax is imposed on the IRA owner, rather than the IRA or trustee. Prop. Reg. § 54.4973(b)(1).

If the IRA participant removes the excess contribution (and all earnings on the excess contributions) prior to filing his or her individual income tax return for that year, there is no 6% (or 10%) tax on the excess contribution or on the earnings on the excess contribution. The participant must include the earnings on the excess contribution in gross income. These earnings are taxable in the year the excess contribution is made (not in the year withdrawn). No deduction is allowed for the excess contribution. An excess contribution left in the IRA after the tax return filing date is subject both to the annual 6% excise tax and the 10% premature distribution tax on withdrawal, if the IRA participant is under age 59½ and no exception to the penalty applies. The distribution also will be subject to ordinary income tax in the year withdrawn.

➔ **Planning Point**: One way to eliminate excess contributions is to not make allowable contributions in future years. The excess contribution is treated as (or applied against) the contribution that would have been allowed, but is not made. You still can claim an income tax deduction (if otherwise allowable) for the amount allowable as a contribution but that is not made is order to offset an excess contribution.

2. Penalty for Early (Premature) Distribution from Qualified Plan or IRA

We noted earlier that one element that differentiates types of distributions from qualified plans and IRAs is the age of the participant. Distributions taken between age 59½ and 70½ are "normal" or "regular" (or more precisely, they are what the IRS considers normal or regular). Thus, by extension, a distribution taken before age 59½ is "early" or "premature."

a. **Early Distribution Defined**. According to IRC § 72(t), an early

distribution is one that takes place prior to age 59½. The participant's age 59½ is the designated point: any distribution received before that is early, or "premature"; any distribution received on or after that date is regular, or "normal."

b. <u>The Taxation of Early Distributions</u>. The premature distribution rules under IRC § 72(t) impose a 10% penalty on distributions taken before the age of 59½. More precisely, this penalty is applied to the portion of the distribution that is includable in income -- in other words, it is imposed on the same amount that is subject to income tax. The purpose of the early distribution penalty is to discourage the use of qualified plans and individual retirement accounts as short-term tax shelters.

In the case of SIMPLE IRA plans, the impact can be even more significant. Because these employer plans are so accessible by the participant, Congress added an extra level of impediment to discourage premature distributions. This impediment is an additional 15% penalty for early withdrawals, in addition to the normal 10% penalty, during the first two years of plan participation. After the two-year period has passed, the penalty reverts to 10% (assuming the participant is still under age 59½). Other than this, Simple IRAs operate identically to traditional IRAs with regard to premature distributions.

c. <u>Exceptions to the Ten Percent Penalty on Early Distributions</u>. Not all early distributions are subject to the 10% penalty. For certain reasons and under certain circumstances, distributions can be taken before the age of 59½ without imposition of the 10% penalty. The following list cites these exceptions; however, it is important to know that not all of the exceptions on the list apply to every type of plan:

- Death
- Disability
- separation from service after age 55
- certain (qualifying) medical expenses
- health insurance premiums while unemployed
- higher education expenses
- first-time home purchase
- qualified domestic relations orders
- ESOP dividends
- to reduce excess contributions or deferrals
- as substantially equal periodic payments over life

Despite what many people think, most of these exceptions have very limited applicability.

Ten Percent Early Distribution Penalty Exceptions by Plan Type			
	Qualified Pension, Profit Sharing and 403(b) Plans	**401(k) and SIMPLE 401(k) Plans**	**Traditional IRA, SEP IRA, SIMPLE IRA* and Roth IRA**
Death	X	X	X
Disability	X	X	X
Separation from service after age 55	X	X	
Certain medical expenses	X	X	X
QDROs	X	X	
To reduce excess contributions and/or deferrals	X	X	X
As substantially equal payments over life	X	X	X
First-time home purchase			X
Higher education expenses			X
Health insurance premiums while unemployed			X
ESOP dividends	X**		

**Except 403(b) Plans

* For Simple IRAs, the premature distribution penalty is 25% if the distribution is taken during the first two years of participation.

	Roth IRA Held Less than 5 Years		Roth IRA Held 5 Years or More		Traditional IRA	
Reason for Distribution	**Earnings Taxed**	**10% Penalty**	**Earnings Taxed**	**10% Penalty**	**Distributions Taxed**	**10% Penalty**
Pre-59 ½	Yes	Yes	Yes	Yes	Yes	Yes
Death	Yes	No	No	No	Yes	No
Disability	Yes	No	No	No	Yes	No
First-time home purchase	Yes	No	No	No	Yes	No
Substantially equal payments	Yes	No	Yes	No	Yes	No
Medical payments	Yes	No	Yes	No	Yes	No
Health insurance while unemployed	Yes	No	Yes	No	Yes	No
Higher education expenses	Yes	No	Yes	No	Yes	No
Post-59 ½	Yes	No	No	No	Yes	No

3. Penalty for Failing to Make a Required Distribution from a Qualified Plan or IRA

Minimum distributions from qualified retirement plans, Section 403(b) tax deferred annuity plans, IRAs, SEPs, Simple IRAs and Section 457 governmental deferred compensation plans must begin not later than April 1 of the year following the later of: (a) the year in which the employee attains age 70 1/2; or (b) the year an employee (who is not a 5% owner) retires. IRC § 4974. The second (retirement year) alternative is not available for a participant who owns more than 5% of the business sponsoring the qualified plan, or for an IRA participant.

If the annual distribution is less than the minimum amount required, there is a penalty equal to 50% of the amount that was not distributed, but should have been.

➔ **Planning Point:** If the taxpayer has more than one IRA, the required minimum distribution amount must be calculated separately for each IRA. However the IRA participant can receive the total minimum distribution amount in whole or in part from any one or more of the IRAs, as long as the aggregate amount distributed from all of the IRAs equals the aggregate minimum required distribution from all of the IRAs. Treas. Reg. § 1.408-8, A-9.

This "aggregate dollar approach" may not be used for qualified retirement plans. Each qualified retirement plan must make its own required minimum distribution.

A qualified retirement plan can be disqualified, and no longer entitled to the tax benefits of

qualified status, if the plan consistently fails to make required distributions.

4. Prohibited Transactions

IRAs and qualified retirement plans may not engage in prohibited transactions. There are many different types of prohibited transactions, primarily centered around investments and "self-dealing" transactions. Any type of sale or exchange, lending of money, extension of credit, furnishing of goods or services, or other act of dealing with plan assets for personal benefit that is engaged in by a disqualified person and the plan is prohibited, unless subject to exemption, either under the statute or by special exemption. IRC § 4975. A disqualified person is any person who is a fiduciary under the plan, a sponsoring employer, an employee organization whose members are covered by the plan, a 50% owner of a sponsoring employer, a member of the family of any of the above, any corporation, partnership, trust or estate that is 50% owned by any of the above, and officers, directors, 10% shareholders and highly compensated employees of a sponsoring employer, employee organization, controlling shareholder or related entity. IRC § 4975(e). Estate planners will most frequently encounter the penalties imposed on IRAs when the participant or beneficiary engages in a prohibited transaction.

There are three possible penalties if an IRA is involved in a prohibited transaction:

a. **<u>Disqualification of the IRA</u>**. The most common IRA penalty for a prohibited transaction is disqualification of the IRA. The penalty applies whenever the IRA participant engages in a prohibited transaction. IRC § 408(e)(2)(a). The tax consequences of disqualification are disastrous. The IRA loses its tax-exempt status (IRC § 408(e)(2)(a)) and the IRA participant is deemed to have received a distribution of the entire account balance on the first day of the tax year in which the prohibited transaction occurs. The IRA participant is subject to ordinary income tax on the previously tax deductible contributions and all earnings. If the participant is under 59½, the 10% excise tax is also charged on the taxable portion of the deemed distribution (unless an exception to the penalty applies).

b. **<u>Excise Taxes</u>**. The second type of penalty for prohibited transactions is the 15% excise tax under IRC § 4975. This penalty applies if someone other than the participant engages in a prohibited transaction. The excise tax is imposed on the persons participating in the prohibited transaction and only on the amount involved in the transaction. The IRA does not lose its tax-exempt status, and the fair market value of the amount involved in the prohibited transaction is not taxable to the participant in the year of the transaction.

c. **<u>Taxation of Prohibited Investments</u>**. The third type of penalty for a prohibited transaction is imposed when a prohibited investment is made in an IRA. The fair market value of the improper investment is treated as a taxable distribution to the IRA participant, and is subject to ordinary income tax and (if applicable) the 10% penalty for early distributions. The IRA is not disqualified and there are no excise taxes under IRC § 4975. IRA investments in collectibles, the assignment of the IRA, pledging the IRA as security for a loan, and purchasing life, health or accident insurance in the IRA are prohibited transactions subject to this type of penalty.

F. The Income Taxation of Non-Qualified Plans

Non-qualified employee benefit plans are not eligible for the special income tax treatment afforded qualified plans. The employee must include in income the value of any property transferred to him or her in connection with the performance of services as soon as it is no longer subject to “a substantial risk of forfeiture.” IRC § 83(a). This rule also applies if the property is transferred to a trust for the benefit of the employee. IRC § 402(b). If the property is subject to risk of forfeiture, which includes a condition that the employee remain employed in order to become entitled to receive the property, it is not taxable to the employee, but the employer does not get a current income tax deduction either. IRC § 83(h).

There is a certain tension between employers and employees in the design of non- qualified employee benefit plans. From the employer’s perspective, the employer does not want to lose control of (or give up) property for which it gets no current income tax deduction. This can be addressed by creating an unfunded plan - that is, a plan that is based only on the employer’s contractual obligation to pay the promised benefit, and that is not secured by a trust or other assets. There is no deduction to the employer, but the employer also has not given up anything of current economic value. From the employee’s point of view, the employee does not want to pay income tax currently on property the employee has not yet received. At the same time, the employee is less sure of receiving a benefit based solely on the employer’s unsecured promise to pay the benefit some time in the future.

Most non-qualified employee benefit plans are unfunded. If the employer does transfer assets to a trust to secure the plan, the trust is not tax-exempt. Income earned in the trust either is subject to income tax under the traditional rules governing the income taxation of trusts, or the trust may be characterized as a grantor trust to the employer. The trust assets will be taxed to the employee as ordinary income when they are no longer subject to a substantial risk of forfeiture under IRC § 83. When distributions are made to the employee from the trust after the employee has been subject to income tax on part or all of the trust assets, the distribution is taxed as an annuity under IRC § 72, with the amount previously subject to income tax constituting the employee’s cost, or investment, which is distributed to the employee without further income tax. A trust that is part of a funded non-qualified employee benefit plan does not become a grantor trust to the employee by virtue of the fact that some or all of its assets have been taxed to the employee as income. Special rules apply to these trusts with respect to highly compensated employees. IRC § 402(b).

An employee may elect to accelerate the recognition of income on property transferred as part of a non-qualified employee benefit plan. This has a benefit to the employee if the property transferred under the plan is likely to appreciate. The value of the property at the time of the election is subject to ordinary income tax; post-election increases in value will be taxed as capital gains on disposition of the property. There is a risk as well. If this election is made but the right to receive the property is subsequently forfeited (*e.g.*, because the employee terminates employment), the employee will get no deduction, and will have paid income tax on assets never received.

One issue that a practitioner must address when dealing with non-qualified plans is the applicability of IRC § 409A, which was enacted as part of the American Jobs Creation Act of 2004 ("AJCA"), P.L. 108-357 (Oct. 22, 2004). Regulations under IRC § 409A were finalized in 2007. T.D. 9321, 2007-19 I.R.B. 1123. IRC § 409A and its regulations impose additional rules that may have a substantial effect on the tax consequences to an employee who holds a non- qualified plan or many other types of deferred compensation (excluding, however, many or all of the vehicles discussed elsewhere in this Chapter). An in-depth discussion of IRC § 409A and its regulations is beyond the scope of this Chapter.

The advantage of non-qualified employee benefit plans is that they are not subject to the funding, vesting, contribution and benefits limitations applicable to qualified plans. They can (and often do) discriminate in favor of executives, officers and highly paid employees.

G. Minimum Required Distributions from Qualified Plans and IRAs

1. Introduction

Income tax deferral on qualified plans and IRAs is an extremely important consideration for most retired clients. Beneficiary designations that accomplish estate-planning goals at the expense of income tax deferral are not always in the client's best interests. Understanding the IRS rules regarding the minimum amounts that must be withdrawn from qualified plans and IRAs after retirement will permit you to advise clients, not only on the proper disposition of the plan benefits as part of the client's overall estate plan, but how to structure distributions to maximize the potential for income tax deferral.

Income tax deferral does not have to end at death. In fact, it is as important a consideration for the survivors as it is for the plan participant, and for the same reasons. This is particularly true when there is a surviving spouse. In that case, the estate tax is deferred, but the income tax is a current obligation, the payment or deferral of which could significantly affect the spouse's standard of living.

Congress and the IRS have promulgated complex "minimum distribution" rules, set forth IRC § 401(a)(9) and in Treas. Reg. § 1.401(a)(9), that are intended to limit the deferral of income attributable to qualified plan and IRA benefits by requiring that certain minimum distributions be made annually after a participant has reached age 70½. The rules governing the calculation of minimum required distributions (or "MRDs") originally were set out in proposed treasury regulations issued in 1987. These 1987 proposed regulations were superseded by a set of proposed regulations issued on January 17, 2001. The 2001 proposed regulations introduced significant simplification into the process of calculating minimum required distributions from most qualified plans and IRAs, particularly for distributions made during the participant's lifetime, but remained problematic in a number of respects. Final regulations were issued on April 17, 2002 that addressed some, but not all, of these concerns.

Special distribution rules are contained in the regulations for annuities. These rules are of primary interest to plan administrators, not attorneys. The most important estate planning issues

and opportunities arise with respect to retired individuals who are receiving discretionary distributions from defined contribution plans and IRAs. The minimum distribution rules for these types of accounts are described in detail below.

2. Distributions During Life

Under the old proposed regulations, during a participant's lifetime the minimum required distribution for any year was calculated by dividing the account balance as of the last day of the previous year by the life expectancy of the participant and his "designated beneficiary." Under the final regulations, the minimum required distribution for any year during the participant's life is the amount obtained by dividing the account balance as of the last valuation date of the previous year by the factor set forth in the "Uniform Lifetime Table" (discussed below) for the participant's age on the participant's birthday during the distribution year. Treas. Reg. § 1.401(a)(9)-5, A-3 and A-4. The concept of designated beneficiary is no longer relevant for purposes of calculating lifetime minimum required distributions from a qualified plan or IRA.

> **EXAMPLE:** Your client's birthday is October 1, 1920. The balance in his IRA on December 31, 2001 was $100,000. The client's minimum required distribution for the distribution year 2002 is calculated by dividing the December 31, 2001 balance by the factor on the Uniform Lifetime Table for age 82, or 17.1. The MRD for 2002 is $5,848 ($100,000/17.1=$5,848).

a. **Required Beginning Date**. Distributions must begin from a qualified plan or IRA no later than the participant's "Required Beginning Date." A participant's Required Beginning Date generally is April 1 of the year following the year in which the participant reaches age 70½. This general rule applies to all IRA participants. A participant of a qualified plan who is not a 5% owner may, however, defer his Required Beginning Date until April 1 of the year following the year in which the participant retires. A 5% owner who participates in a qualified plan is treated for this purpose the same as an IRA participant. The Required Beginning Date for a 5% owner is April 1 of the year following the year in which the owner reaches age 70½, whether or not he or she is retired. Treas. Reg. § 1.401(a)(9)-2, A-2.

IRC § 416 defines a 5% owner as a person who owns 5% of the outstanding stock of a corporation or stock with more than 5% of the total combined voting power. If the employer is not a corporation, a 5% owner is a person who owns more than 5% of the capital or profits interest.

> **EXAMPLE:** Your client's birthday is November 15, 1930. The client will reach age 70 on November 15, 2000. The client will reach age 70½ on May 15, 2001. The client retires on June 30, 2002. If the client is a qualified plan participant who is not a 5% owner, the client's Required Beginning Date is April 1, 2003 (April 1 of the year after the year the participant retires). In all other cases, including all IRA participants, the client's Required Beginning Date is April 1, 2002 (the year after the year the participant reaches age 70½).

b. **First Distribution Year**. The distribution required to be made on a participant's Required Beginning Date is actually the distribution for the participant's "first distribution year." The first distribution year generally is the year in which the participant reaches age 70½. (The first distribution year for a qualified plan participant who is not a 5% owner is the later of the year in which the participant reaches age 70½ and the year in which the participant retires.) The year in which the Required Beginning Date occurs is the second distribution year. The required distribution for the second distribution year must be made before December 31 of that year. Treas. Reg. § 1.401(a)(9)-5.

> **EXAMPLE:** Your client's birthday is November 15, 1930, and her Required Beginning Date wais April 1, 2002. Assume that the client's IRA balance is $100,000 on December 31, 2000, and $110,000 on December 31, 2001. The minimum required distribution to be paid on April 1, 2002 is calculated for the first distribution year, or 2001. This calculation is made by dividing the year end account balance for the preceding year (the December 31, 2000 balance of $100,000) by the Uniform Lifetime Table factor for the participant's age on her birthday during 2001, the first distribution year (the factor for age 71 is 26.5). The MRD required to be paid on April 1, 2002 is $3,774.

c. **Other Distributions**. While a qualified plan or IRA participant must begin to take mandatory distributions on the participant's Required Beginning Date in the defined minimum amounts, there is no IRS prohibition against taking larger amounts. After age 59½, there is no penalty for taking out more than the minimum required distribution. Ideally, a participant will want to qualify for the longest permitted distribution period, which produces the smallest *mandatory*, or minimum, payments, both during lifetime and after death. This allows for the most income tax deferral, and is the most flexible.

➔ **Planning Point:** Although after age 59½ there is no prohibition against withdrawing more than the MRD in any year, excess distributions taken in one year cannot be used to reduce minimum required distributions to be made in another year. Treas. Reg. § 1.401(a)(9)-5, A-2. There is one exception to this general rule. A MRD paid during the first distribution year can be treated as the MRD required to be paid by April 1 of the following year.

> **EXAMPLE:** Your client's birthday is November 15, 1930, and her Required Beginning Date is April 1, 2002. Assume that the client's IRA balance is $100,000 on December 31, 2000, and $110,000 on December 31, 2001. The minimum required distribution to be paid on April 1, 2002 is $3,774. This distribution can be made at any time during 2001, or in 2002 before April 1.

d. **After the First Distribution Year**. After the first distribution year, the MRD for any year is calculated by dividing the year-end account balance for the preceding year

by the factor from the Uniform Lifetime Table for the participant's age on his or her birthday during the distribution year. Generally, no adjustments are made to account for prior distributions in excess of the MRD, or for any distributions required, but not made, in a prior year. (This is a change from earlier proposed regulations.)

> **<u>EXAMPLE</u>:** Your client's birthday is November 15, 1930, and her Required Beginning Date is April 1, 2002. Assume that the client's IRA balance is $100,000 on December 31, 2000, and $110,000 on December 31, 2001. The minimum required distribution for the first distribution year, to be paid on or before April 1, 2002, is $3,774. If the distribution is deferred to 2002, the 2001 year end account balance includes the deferred payment. Nevertheless, to calculate the 2002 MRD, you still divide the December 31, 2001 year-end account balance, of $110,000, by the factor from the Uniform Lifetime Table for your client's age on her birthday during 2002 (72), or 25.6. $110,000 ÷ 25.6 = $4,297. This is the MRD for the second distribution year, which has to be paid on or before December 31, 2002. Note that if the MRD for the first distribution year is paid *during* the first distribution year, the MRD for the second distribution year is reduced to $4,149 ($110,000 - $3,774 = 106,226 ÷ 25.6 = $4,149).

e. <u>The Uniform Lifetime Table</u>. The Uniform Lifetime Table sets forth factors representing the joint, recalculated life expectancy of an individual and another person ten years younger. The Uniform Lifetime Table is used to calculate MRDs for all distributions during the lifetime of a participant, with a single exception. If the participant's spouse is more than 10 years younger than the participant, and the participant's spouse is the sole beneficiary of the account or plan for the entire year, then the participant may use the actual recalculated joint life expectancy of the participant and the spouse instead of the factor set forth in the Uniform Lifetime Table. The Uniform Lifetime Table is used whenever the spouse rolls over an IRA or qualified plan. Life expectancy factors are determined by reference to the tables promulgated by the IRS in the regulations under IRC § 401(a)(9).

➔ **<u>Planning Point</u>:** Another way to calculate minimum required distributions is to *multiply* the year-end account balance by the percentage obtained by dividing 100 by the factor for any stated age. These percentages, for all ages, are shown in the table contained in Appendix A. This method provides a clearer understanding of whether MRDs are exceeding investment returns in the account. For example, at age 80, the MRD represents 5.3476% of the account balance. As long as the investment return exceeds 5.4%, the account balance will continue to grow, notwithstanding the payments of MRDs.

➔ **<u>Planning Point</u>:** Ordinarily, the MRD has to be calculated separately for

each qualified plan and IRA, and paid separately from the account with respect to which it is calculated. There is one exception to this general rule. If your client has multiple IRAs, the aggregate MRDs for any one or more of them may be paid out of any one or more of them in any proportions, as long as total IRA distributions from all IRAs each distribution year at least equal the total MRDs for all IRAs for that distribution year. The MRD for each IRA still has to be calculated separately, for each separate account.

3. The "Designated Beneficiary"

It is important to name a "designated beneficiary" to receive post-death distributions from a qualified plan or IRA in order to maximize income tax deferral after death. If a designated beneficiary is not named, post-death distributions either must be made within 5 years after death (if the participant died before his or her "Required Beginning Date") or over the participant's remaining single life expectancy (if the participant died after his or her "Required Beginning Date"). If a designated beneficiary is named, however, the life expectancy of the designated beneficiary can be used to measure post-death distributions from the account. Unless the beneficiary is very elderly, the account will be eligible to be distributed over a longer period of time if a designated beneficiary is named, and income tax deferral will be maximized. So it is important to understand who is eligible to be a "designed beneficiary."

➔ **Planning Point:** Under the final regulations, only post-death distributions are affected if the named beneficiary is not a designated beneficiary. Consequently, whether or not there is a designated beneficiary is unimportant if post-death income tax deferral is not required. For example, if the participant wants his or her remaining account balance to pass to a qualified charity at death, the post-death deferral of income tax is not a concern, because the charitable beneficiary is income tax exempt. The fact that a qualified charity is not a designated beneficiary is not relevant for calculating distributions during the participant's lifetime, and does not matter after the participant's death.

The same situation can arise if the qualified plan or IRA assets are the only source of liquid assets in the participant's estate, and will be required to pay debts, taxes and administration expenses. While one might prefer to avoid this situation, that is not always possible. If the qualified plan or IRA has to be liquidated shortly after death to meet estate cash requirements, the fact that the estate does not qualify for an extended distribution period because the estate is not a designated beneficiary is not a concern.

➔ **Planning Point:** If a qualified plan or IRA is the only source of liquid assets available in a participant's estate to pay debts, taxes and administration expenses, overall taxes may be reduced if the account is liquidated immediately prior to death. This potential opportunity should be included

on your pre-mortem planning checklist, for consideration in appropriate cases.

a. **<u>Eligible Designated Beneficiaries</u>**. A designated beneficiary is either an individual or a qualified trust. Treas. Reg. § 1.401(a)(9)-4. A charity, a corporation, a partnership, an estate or a nonqualified trust cannot be a designated beneficiary. If the qualified plan or IRA can be used to pay estate obligations, such as debts, taxes or administration expenses, the estate is considered the (non-designated) beneficiary. The beneficiaries of an estate, whether the participant died testate or not, cannot be treated as the designated beneficiaries of a qualified plan or IRA of which the estate is the named beneficiary (whether expressly or by default).

If a participant names a *qualified* trust as the beneficiary of a qualified plan or IRA, then the trust beneficiaries will be treated as the beneficiaries of the account for purposes of determining whether there is a designated beneficiary and who it is. Treas. Reg. § 1.401(a)(9)-4, A-5. A qualified trust is a trust that satisfies the following four requirements on or before October 31 of the year following the year of the participant's death):

- The trust must be valid under local law. In making this determination the existence or requirement of trust corpus is disregarded.
- The trust must have identifiable beneficiaries. A class, such as descendants, may identify the beneficiaries; they do not need to be identified by name.
- The trust must be, or by its terms become, irrevocable on or before the participant's death.
- One of two documentation requirements must be satisfied. Either a copy of the trust instrument (and all subsequent amendments) must be provided to the plan administrator or trustee, or the plan administrator or trustee must be provided with a list of all the trust beneficiaries, including contingent and remainder beneficiaries, and a statement as to the circumstances under which they will take, determined as of September 30 of the year following the year of the participant's death. The participant must certify that this list is correct and complete and that the three above requirements are satisfied. The participant also must agree to provide a copy of the trust instrument to the plan administrator or trustee on demand.

By far the easier of these two documentation requirements is to provide a copy of the trust instrument to the plan administrator or IRA trustee or custodian. Under the regulations, the date for providing trust documentation (under either option) is October 31 of the year following the year of the participant's death. It is no longer necessary to satisfy the trust documentation requirement during the participant's lifetime, unless the participant's spouse is the sole beneficiary of the trust and wants to be treated as the sole designated beneficiary of the account for purposes of the lifetime minimum distribution rules. This relieves some of the privacy concerns about providing a copy of the entire trust instrument. Note that a testamentary trust can be a qualified trust. Treas. Reg. § 1.401(a)(9)-5, A-7(c)(3), Ex. 2.

b. **Multiple Beneficiaries**. Special rules apply in determining who the designated beneficiary is when there is more than one beneficiary of an account. These rules provide that if *any* beneficiary is not a designated beneficiary, then there is *no* designated beneficiary. These rules also provide that if all of the beneficiaries are eligible designated beneficiaries, then *the* designated beneficiary is that beneficiary with the shortest life expectancy (that is, the oldest). Because trusts usually have more than one beneficiary, the rules for determining the designated beneficiary when multiple beneficiaries are named ordinarily apply to trusts. Treas. Reg. § 1.401(a)(9)-5, A-7.

> **EXAMPLE:** An IRA participant names his three children as beneficiaries of the IRA. All of the children are individuals, so there is *a* designated beneficiary. The oldest child, who has the shortest life expectancy, is *the* designated beneficiary.

Under Treas. Reg. § 1.401(a)(9)-4, A-5(c) and -8, A-2(a)(2), there is a "separate share" rule that in certain cases permits benefits payable under a plan to be treated as payable from separate accounts for purposes of applying the MRD rules, including those relating to the determination of the designated beneficiary. Treas. Reg. §§ 1.401(a)(9)-4, A-5(c), -8, A-2. Two requirements must be met. First, the beneficiaries' interests must generally be fractional or percentage interests in the benefit as of the date of the participant's death (rather than fixed- dollar amount shares). Second, the separate accounts must be established by December 31st of the year following the year of the participant's death. If these two requirements are satisfied, the life of the designated beneficiary of the separate account with respect to whom such separate account was established then may be used as the measuring life for post-death distributions from that share. The separate share rule will be effective for MRDs made during the year that the separate shares are established. Treas. Reg. §§ 1.401(a)(9)-6; -8 A-2(a).

> **EXAMPLE:** An IRA participant names her three children as beneficiaries of the IRA. The participant dies on January 27, 2006, and all three children survive her. In November of 2007, before any IRA distributions are made, the IRA Trustee divides the IRA into three equal separate accounts, one for each of the three surviving children. The separate share rule applies, and the minimum distribution rules are applied separately to each share. As a result, each child is considered the sole designated beneficiary of his or her separate share of the account. See, e.g., PLR 200208029, PLR 200444033.

➔ **Planning Point:** To avoid a very technical ambiguity in the regulations related to the calculation of post-death MRDs under the separate share rules, it is advisable to establish separate shares by September 30 of the year following the year of the participant's death (the "Applicable Date" for determining the identity of the designated beneficiary), rather than December 31 of that year.

Note that these separate account rules are not applicable when a qualified trust is designated as the account beneficiary. Treas. Reg. §§ 1.401(a)(9)-4, A-5(c); 1.401(a)(9)-8, A- 2(a)(2). Several

previous PLRs ruled that, if a trust was to be divided into subtrusts for each beneficiary after the settlor's death, every subtrust must receive distributions based on the life expectancy of the oldest beneficiary of the original trust. See, e.g., PLRs 200317041, 200317043-44 (IRA distributable to a trust that divided the IRA into separate shares and made distributions to separate trusts held not to qualify for separate share treatment). However, the IRS has recently issued a ruling that may indicate how trust beneficiaries may receive separate account treatment.

In PLR 200537044, the decedent executed a trust agreement (the "Trust") and designated nine separate Subtrusts established under the Trust as the primary beneficiaries of the decedent's IRA. The designation also provided that the Subtrusts were established as separate shares under the Trust. The decedent died before his RBD. The Trust directed the Trustee to create nine separate shares under the terms of the decedent's designation no later than September 30th of the year after the year of the decedent's death. Each Subtrust was to be held for the benefit of one individual and was to be funded with a designated percentage of the value of the IRA at the time of the decedent's death. All amounts distributed to each Subtrust from the IRA and other retirement assets while the designated beneficiary was alive were to be paid to or for the benefit of such individual as soon as possible after the Trustee's receipt of such distributions. Thus, the Trust was intended to constitute a "conduit" trust for purposes of the MRD rules. Treas. Reg. § 1.401(a)(9)-5, A-7(c)(3). Upon a beneficiary's death, such beneficiary may exercise a limited testamentary power of appointment. The unappointed property held in a Subtrust for the benefit of such beneficiary is to be divided and added to the other remaining Subtrusts. Before the date of the ruling request, the IRA was divided, by means of a series of Trustee-to-Trustee transfers, into a number of separate IRAs set up and maintained in the decedent's name to benefit the designated beneficiaries of the IRA.

The IRS ruled that each beneficiary of a Subtrust need not be considered in determining who, if anyone, is the designated beneficiary under IRC § 401(a)(9) of another Subtrust. The IRS explained that the facts indicated that the decedent intended the Trustee to divide the trust into separate Subtrusts at the decedent's death, and the Trustee had no discretion in the matter. Also, the decedent specifically designated the Subtrusts created under the Trust, and not the Trust itself, as the beneficiaries of the IRA. In addition, the IRS ruled that, for purposes of calculating MRDs for the Subtrusts, the appropriate measuring life will be the life of the primary beneficiary of each Subtrust. Finally, the IRS ruled that, for purposes of calculating MRDs, the life expectancy of each Subtrust beneficiary may be considered without regard to the life expectancy of the beneficiary of the other Subtrusts.

➔ **Planning Point:** As this ruling indicates, the IRS has apparently taken the position that, to establish separate accounts for the trust beneficiaries, the participant must designate the separate trusts on the beneficiary designation form.

c. Contingent and Successor Beneficiaries. Contingent beneficiaries are included in determining whether there is a designated beneficiary, and who it is, unless the contingency relates to surviving either the participant or another beneficiary (which is the most common, but not the only, kind of contingency). Treas. Reg. § 1.401(a)(9)-5, A-7(b) and (c). The regulations clarify that remainder beneficiaries after a life estate are counted in determining who

are the beneficiaries of a trust, if any part of a qualified plan or IRA distribution could be accumulated in trust for later distribution to the remainder beneficiaries. In contrast, a successor beneficiary is entitled to the remaining benefit only on the primary beneficiary's death where no benefit payments can be accumulated and all account distributions must be distributed to the primary beneficiary. The primary beneficiary is the sole designated beneficiary for MRD purposes when there are only successor beneficiaries and no contingent beneficiaries. Treas. Reg. § 1.401(a)(9)-5, A-7.

EXAMPLE: An IRA participant names her daughter as the beneficiary of the IRA. If the daughter dies before the participant, or before the complete distribution of benefits from the account, the participant names a qualified charity as the beneficiary of the IRA. The daughter survives the participant. In determining whether there is a designated beneficiary after the participant's death, the qualified charity does not have to be considered. The charity's interest takes effect only if the daughter predeceases the participant or the complete payment of benefits. This is a death contingency under Treas. Reg. § 1.401(a)(9)-5, A-7(b) and (c). The charity can be disregarded. The only remaining beneficiary (the daughter) is an eligible designated beneficiary.

EXAMPLE: An IRA participant names his revocable living trust as the beneficiary of the IRA. The trust is a qualified trust under Treas. Reg. § 1.401(a)(9)-1. The trust provides that if the spouse survives the participant, the spouse will receive all of the income of the trust for life, plus principal in the discretion of the trustee for the spouse's health and support. At the spouse's death, or if the spouse predeceases the participant, any remaining trust property will be distributed to a qualified charity. The spouse survives the participant. In determining whether there is a designated beneficiary after the participant's death, the charity has to be included as one of the trust beneficiaries if any part of the benefits payable to the trust from the IRA can be accumulated in the trust. The charity's interest in the IRA is not contingent on surviving the spouse. It is contingent on the existence of any IRA assets remaining in the trust property at the spouse's death. This is not a death contingency under Treas. Reg. § 1.401(a)(9)-5, A- 7(b) and (c). If the charity is included as one of the trust beneficiaries, there is no designated beneficiary, because a charity is not eligible to be a designated beneficiary.

Thus, the regulations permit the primary beneficiary of a trust to be considered the sole designated beneficiary of a qualified plan account or IRA if the trust is a conduit trust - that is, a trust that immediately distributes all retirement plan benefits payable to the trust to the beneficiary and under which no part of any distribution can be accumulated. Treas. Reg. § 1.401(a)(9)-5, A-7(c)(3). Because of these immediate, mandatory distributions, the subsequent beneficiaries are disregarded for purposes of determining if there is a designated beneficiary and who it is. Conduit trusts are discussed in more detail below.

d. **The Ability to Change Beneficiaries**. Under the original 1987 proposed regulations, if anyone other than the surviving spouse had the power to change the participant's beneficiaries, then there was no designated beneficiary for purposes of these rules. In general, this concept was carried forward in the 2001 proposed regulations. (Prop. Reg. § 1.401(a)(9)-5, A-7(d).) However, the 2001 proposed regulations also made it clear that a vested beneficiary could designate a successor beneficiary to receive unpaid benefits in the event of the beneficiary's death before all payments had been received. Although this entire section was eliminated from the final regulations, it is widely believed that the same rule continues to apply under the final regulations, by reason of the way in which the identity of the designated beneficiary is established for post-death distributions under the final regulations.

> **EXAMPLE:** An IRA participant names his son as his primary beneficiary, and provides that if his son dies before him, the IRA will be paid to the son's surviving children. The IRA custodial account agreement provides that if a beneficiary dies before the complete payment of benefits, the beneficiary can designate who will receive any remaining benefits. The son survives his father, and names a qualified charity to receive any remaining IRA benefits that are not distributed to the son during his lifetime. The son is the designated beneficiary. The children are not considered under the "death contingency" rules. Nothing in the final regulations limits the son's ability to name a successor beneficiary.

e. **The "Applicable Date" for Determining the Designated Beneficiary**. Under the regulations, the designated beneficiary is determined on September 30 of the year following the year of the participant's death (the "Applicable Date"). Treas. Reg. § 1.401(a)(9)-4, A-4. The actual death of a designated beneficiary after the participant's death and before the Applicable Date is disregarded, and in that case, the deceased designated beneficiary would continue to be considered a designated beneficiary for purpose of applying the post-death distribution rules.

The reason the proposed regulations deferred the date for determining the designated beneficiary until at least nine months after the participant's death is to avoid some of the hardships that had occurred under the old rules, which required that the designated beneficiary be determined as of December 31 of the year following the year of the participant's death. For example, when a trust is named as a beneficiary and one or more of the trust beneficiaries is not a designated beneficiary, the existence of *any* non-designated beneficiary requires the distribution of the account within five years after the participant's death. The application of this rule could be harsh, particularly if the interest of the non-designated beneficiary in the trust was relatively small, or could be satisfied in full out of other assets.

> **EXAMPLE:** An IRA participant named her revocable living trust as the beneficiary of the IRA. The trust was a qualified trust under Treas. Reg. § 1.401(a)(9)-4, A-5. The trust provides that after paying a bequest

to charity of $10,000, a gift to the participant's brother of $20,000, and paying all debts, taxes and expenses, the remaining trust property is to be distributed in equal shares to the participant's three adult children. All of the trust beneficiaries have to be included in determining whether there is a designated beneficiary, and who it is.

If the designated beneficiary were determined as of the date of the participant's death, the charity, the participant's brother, the participant's estate (because trust assets could be used to discharge estate obligations) and the participant's children all arguably would be trust beneficiaries. Because some of these beneficiaries are not eligible to be a designated beneficiary, there would be no designated beneficiary, and the entire account would have to be distributed within five years of the participant's death, if the participant died before her Required Beginning Date, or over the participant's remaining life expectancy, if she died thereafter.

However, assume that the designated beneficiary is determined on the Applicable Date, and that the charity, the brother and all estate debts, taxes and administration expenses are paid before the Applicable Date. Then the only beneficiaries of the trust on the Applicable Date are the participant's three children. Because each child is an eligible designated beneficiary, the account could be distributed over the life expectancy of the oldest child.

➔ **<u>Planning Point</u>:** In administering a trust that is named as the beneficiary of a qualified plan or IRA, you may be able to avoid the unnecessarily rapid distribution of the account, or qualify for a long-term distribution of the account, by completing estate administration duties within nine months after death.

Disclaimers also may be used after death to eliminate non-designated beneficiaries, or Designated Beneficiaries with short life expectancies.

4. Distributions After Death

With that background, the specific rules for calculating MRDs after death follow.

a. <u>Death Before Required Beginning Date</u>. In general, all qualified plans and IRA benefits must be distributed within five years after death, if the participant dies before reaching the participant's Required Beginning Date. IRC § 401(a)(9)(B)(ii). The rule that mandates distribution within five years after death can be avoided by naming a designated beneficiary during lifetime.

(1) <u>The "five-year rule"</u>. If the "five-year rule" applies, the decedent's entire interest in the qualified plan or IRA must be distributed on or before December 31 of

the year that contains the fifth anniversary of the date of the decedent's death. Treas. Reg. § 1.401(a)(9)-3, A-2. However, if a designated beneficiary is named, distributions after the participant's death may be made over the beneficiary's life expectancy. In that case, distributions must commence by December 31 of the year following the year of the participant's death. IRC § 401(a)(9)(B)(iii); Treas. Reg. 1.401(a)(9)-3, A-2.

> **<u>EXAMPLE</u>:** A qualified plan participant dies on May 5, 2003. The general rule is that the participant's entire interest in the plan must be completely distributed on or before December 31, 2008. It does not matter how distributions are made during that time. The account may be distributed in a lump sum or in installments. In fact, the entire account can be distributed on December 31, 2008, with no intervening distributions. However, if the participant has named a designated beneficiary, distributions may be made over a period measured by the beneficiary's life expectancy, but only if distributions begin on or before December 31, 2004.

Special rules may apply if the participant's spouse is the designated beneficiary. These are discussed at length below.

(2) <u>Calculating MRDs After Death Under the Exception to the Five-Year Rule</u>. The procedure for calculating minimum required distributions if there is a designated beneficiary for the account and the participant dies before his or her Required Beginning Date is somewhat similar to the calculation of lifetime MRDs. First, determine the designated beneficiary's life expectancy for his or her age on his or her birthday in the year following the year of death, using the life expectancy tables contained in the regulations under Treas. Reg. § 401(a)(9)-9, A-1. That becomes the distribution factor for the first distribution year (the year following the year of death). Second, divide the account balance at the end of the preceding year (which would be the year of death) by the distribution factor. That calculation yields the MRD for the first distribution year. In each subsequent year, repeat the calculation, using the same method, after reducing the life expectancy factor for the prior year by one. Treas.

Reg. § 1.401(a)(9)-5, A-5(c). Life expectancies are not recalculated unless the beneficiary is the surviving spouse. Special rules that apply to surviving spouses are discussed below.

> **<u>EXAMPLE</u>:** An IRA participant dies on May 1, 2005, at age 65, before his Required Beginning Date. The participant named his adult child as the beneficiary of the IRA. The child survived the participant, and was living on December 31, 2006. The child's birth date was September 15, 1970. The child's age on the child's birthday in 2006 is
> 36. The life expectancy factor for a person age 36 is 47.5 years, under Treas. Reg. § 401(a)(9)-(9) Single Life Table (<u>see</u> Appendix B). To calculate the MRD for 2006, divide the December 31, 2005 year-end account balance by 47.5. To calculate the MRD for 2007, divide the December 31, 2006 year-end account balance by 46.5 (47.5 minus 1). To calculate the MRD for 2008, divide the December 31, 2007 year-

end account balance by 45.5 (46.5 minus 1).

b. **Death After Required Beginning Date**. If a participant dies after the participant's Required Beginning Date, qualified retirement plan and IRA benefits must be distributed "at least as rapidly" as they were being distributed to the participant during the participant's lifetime. IRC § 401(a)(9)(B)(i). The regulations interpret this rule differently, depending on whether or not the participant has named a designated beneficiary.

(1) **If There is No Designated Beneficiary**. If the participant dies after the participant's Required Beginning Date and has no designated beneficiary, post-death distributions are to be made over the participant's remaining single life expectancy, without further recalculation.

In this case, a MRD must be made for the year of death. The MRD for the year of death is calculated as if the participant were still alive. (If the year of death MRD was paid to the participant prior to death, the MRD requirement for that year is satisfied, and does not have to be paid again after the participant's death.) To calculate the MRD for the year following the year of death, you determine the participant's life expectancy as of the participant's age on his or her birthday in the year of death, and reduce that number by one. This becomes the distribution factor for calculating the MRD in the year after the year of death. This factor is then reduced by one for each succeeding year. Treas. Reg. § 1.401(a)(9)-5, A-5(c)(3).

> **EXAMPLE:** An IRA participant dies at age 75 in 2006. She names her estate as her beneficiary. The account balance on December 31, 2005 is $250,000. In 2006, the MRD is calculated under the Uniform Lifetime Table. The December 31, 2005 account balance is divided by the factor on the Uniform Lifetime Table for age 75 (22.9). The MRD is $10,917 ($250,000/22.9=$10,917).
>
> The MRD for 2007 is calculated by determining the participant's single life expectancy for age 75 (13.4) and reducing that number by 1 (12.4). Then, the December 31, 2006 account balance is divided by this factor to determine the MRD. If the account balance on December 31, 2006 is $275,000, the MRD for 2007 is $22,177 ($250,000/12.4=$22,177).

(2) **If There is a Designated Beneficiary**. If the participant has a designated beneficiary, post-death payments may be made from a qualified plan or IRA over the *longer of*: (a) the participant's remaining single life expectancy; and (b) the *beneficiary's* remaining single life expectancy, in either case without recalculation (unless the designated beneficiary is the surviving spouse, discussed further below). As is the case when the participant dies after his or her Required Beginning Date without a designated beneficiary, a minimum required distribution must be made for the year of death. This is calculated as if the participant were still alive, and is satisfied to the extent of distributions made to the participant prior to death. The distribution period for the year after the year of death is calculated with reference to the beneficiary's life expectancy as of his or her age on his or her birthday in that year (the year following the year of death). That age is reduced by one for each succeeding year. Treas. Reg.

§ 1.401(a)(9)-5, A-5(c)(1). Life expectancies are not recalculated or re-determined after the participant's death, unless the participant's designated beneficiary is the surviving spouse. If the designated beneficiary is the surviving spouse, special rules may apply, as described more fully below. Treas. Reg. § 1.401(a)(9)-5, A-5.

c. **Special Rules for the Surviving Spouse**. There are a number of special rules that apply if the participant of a qualified plan or IRA names his or her spouse as the beneficiary of the account.

(1) **Distributions During Participant's Life**. If the participant's spouse is more than 10 years younger than the participant, and the participant's spouse is the sole beneficiary of the account or plan for the entire year, then the participant may use the actual recalculated joint life expectancy of the participant and the spouse (instead of the factor set forth in the Uniform Lifetime Table) as the distribution factor for calculating the MRD for that year. Treas. Reg. § 1.401(a)(9)-5, A-4(b). Life expectancy factors are determined by reference to the tables promulgated by the IRS in the regulations under IRC § 401(a)(9)-(9), reproduced as Appendix C. Although, generally, this younger spouse has to be the sole beneficiary of the entire account for the whole year, a change in marital status (by reason of death or divorce) during the year will not affect the calculation of the MRD until the following year.

> **EXAMPLE:** An IRA participant was born on March 15, 1930. Her first distribution year is 2000, and her Required Beginning Date is April 1, 2001. The participant has named her spouse as the sole beneficiary of the account. If the spouse was born before December 31, 1940, the MRD distribution factor for the participant's first distribution year (2000) is 27.4, based on the Uniform Lifetime Table,
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> because the participant was age 70 on her birthday that year. Suppose the participant's spouse was born on October 10, 1955. In that case, the MRD distribution factor for the first distribution year can be the actual joint life expectancy of the participant and her spouse that year, based on Treas. Reg. § 1.401(a)(9)-(9), Joint and Last Survivor Table (Appendix C). The participant's age on her birthday in her first distribution year is still age 70. Her spouse's age on his birthday in the participant's first distribution year is 45. The joint life expectancy of two persons aged 70 and 45 is 39.4. The participant's MRD for her first distribution year is calculated by dividing the 1999 year-end account balance by 39.4.

(2) **Death Before Required Beginning Date**. If the participant names his or her spouse as the designated beneficiary and dies before his or her Required Beginning Date, then the spouse may defer post-death payments until the participant's (hypothetical) age 70½. That is, distributions to the spouse do not have to begin until December 31 of the year in which the participant would have reached age 70½, had the participant survived. When payments are required to begin to the spouse in that year, the spouse's single recalculated life expectancy is used to calculate minimum required distributions. The factor for calculating the MRD for the first

distribution year (the year in which the participant would have reached age 70½, had the participant survived) is the spouse's life expectancy factor based on the spouse's age on the spouse's birthday during that year. The factor for calculating the MRD for the next year is the spouse's recalculated life expectancy factor based on the spouse's age on the spouse's birthday during that next year. Treas. Reg. § 1.401 (a)(9)-5, A-5(c)(2).

If the spouse dies before distributions to the spouse commence, distributions are required to be made from the account under the same rules that would have applied if the spouse were the participant and had died before his or her Required Beginning Date. Treas. Reg. § 1.401(a)(9)-3, A-5. In other words, the general rule is that the entire remaining balance in the account must be distributed on or before December 31 of the year that contains the fifth anniversary of the date of the spouse's death. However, if a designated beneficiary is named, post-death distributions may be made over the beneficiary's life expectancy. In such a case, the first distribution must be made by December 31 of the year following the year of the spouse's death. The distribution factor for that first distribution year is the beneficiary's life expectancy based on his or her age on his or her birthday in that first distribution year. For each succeeding year, this factor is reduced by one.

If the spouse dies after distributions have begun to the spouse, minimum required distributions after the spouse's death are calculated using the spouse's remaining single life expectancy without further recalculation, in the same manner as if the spouse were the participant and had died, without naming a designated beneficiary, after his or her Required Beginning Date. The MRD for the year of the spouse's death is calculated as if the spouse were living. The factor for the first distribution year after the year of death is the factor corresponding

with the spouse's age on the spouse's birthday in the year of the spouse's death, reduced by one. Treas. Reg. § 1.401(a)(9)-5, A-5(c). This factor is reduced by one in each succeeding year.

> **EXAMPLE:** An IRA participant died in 2004 at age 67. He was born on October 10, 1937. His spouse was born on October 10, 1932. The participant named his spouse as the sole beneficiary of his IRA. The spouse is not required to begin distributions from the IRA until December 31, 2008 because the deceased participant would have reached age 70½ that year. If the spouse dies in 2007 with no designated beneficiary, the IRA must be completely distributed by December 31, 2012 (the year in which the fifth anniversary of the spouse's death occurs).
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> The spouse's MRD for 2008 is calculated by dividing the 2007 year-end account balance by the spouse's life expectancy in 2008. In that year, the spouse is age 76, and the life expectancy of a person aged 76 is 12.7. If the spouse dies in 2009 with no designated beneficiary, the IRA may be distributed over the spouse's remaining single life expectancy, without recalculation. In the year of death, the MRD distribution factor is based on the life expectancy of a person aged 77 (12.1) (as if the spouse were still alive). In the year following the year of death, the MRD distribution factor is the spouse's life expectancy

> based on her age on her birthday in the year of the spouse's death, reduced by 1, or 11.1. The *following* year, that factor is again reduced by 1, to 10.1.

(3) **<u>Death After Required Beginning Date</u>**. If a qualified plan or IRA participant dies after the participant's Required Beginning Date and names his or her surviving spouse as beneficiary, distributions after the participant's death must continue to be made at least as rapidly as they were being made during the participant's lifetime. As with other Designated Beneficiaries, post-death distributions may be made over the spouse's remaining single life expectancy. However, unlike other designated beneficiaries, the surviving spouse is entitled to recalculate the spouse's life expectancy each year. As in all cases when the participant dies after the participant's required distribution date, a MRD is required for the year of death, and is calculated as if the participant had not died. The distribution factor for the year following the year of death, and for all subsequent years during the spouse's lifetime, is the spouse's life expectancy, based on the spouse's age on the spouse's birthday in that distribution year.

After the spouse's death, distributions may continue to be made over the spouse's remaining single expectancy, but without recalculation. In the year of death, the MRD is calculated as if the spouse were still alive. In the year following the year of death, the distribution factor is the spouse's life expectancy, based on his or her age on his or her birthday in the year of the spouse's death, reduced by one. The distribution factor continues to be reduced by one in each succeeding year.

> **<u>EXAMPLE</u>:** An IRA participant died in 2006 at age 77. He was born on October 10, 1929. His spouse was born on October 10, 1934. The participant named his spouse as the sole beneficiary of his IRA. The spouse is not required to begin distributions from the IRA until December 31, 2007. The spouse's MRD for 2007 is calculated by dividing the 2006 year-end account balance by the spouse's life expectancy in 2007. In that year, the spouse is age 73, and the life expectancy of a person aged 73 is 14.8. If the spouse dies in 2011, the IRA may be distributed over the spouse's remaining single life expectancy, without recalculation. In the year of death, the MRD distribution factor is based on the life expectancy of a person aged 77 (12.1) (as if the spouse were still alive). In the year following the year of death, the MRD distribution factor is the spouse's life expectancy based on her age on her birthday in the year of the spouse's death, reduced by 1, or 11.1. The *following* year, that factor is again reduced by 1, to 10.1.

(4) **<u>Conduit Trusts</u>**. With one exception, the special rules available to spouses for calculating post-death MRDs are not available if a trust is named as the beneficiary of a qualified plan or IRA, even if the trust is a qualified trust and the spouse is treated as the designated beneficiary. The exception relates to "conduit trusts." A conduit trust is a trust that distributes to the current beneficiary all amounts paid to the trust from a qualified plan or IRA, and

that cannot accumulate distributions from a qualified plan or IRA in the trust for later distribution to anyone else. Treas. Reg. § 1.401(a)(9)-5, A-7(c)(3), Exs. 1 and 2. If a conduit trust for the benefit of the spouse is named as the beneficiary of an IRA or qualified plan, most of the special rules available when the spouse is named as the direct beneficiary can apply to distributions to the conduit trust. PLR 200105058. Thus, a spouse who is a beneficiary of a conduit trust can recompute her or his life expectancy in determining MRDs. Treas. Reg. § 1.401(a)(9)-5, A-5(c)(2), A-6. This last strategy can increase the likelihood that some assets will be in an IRA or qualified plan for the entire lifetime of the surviving spouse. In addition, with a conduit trust, the beneficiary will likely be in a lower income tax bracket than the trust, so less income tax will be paid on the distributions. The conduit trust exception does not apply to spousal rollovers, however, or to a spouse's election to treat an IRA as the spouse's own IRA.

There also has developed a set of rules for determining when a spouse, who is the beneficiary of a trust, can rollover a qualified plan or IRA benefit payable to the trust, and not to the spouse directly. If the qualified plan or IRA benefits are allocated entirely to the spouse, or to a trust for the benefit of the spouse which the spouse is entitled to withdraw without restriction, either by the terms of the governing instrument or by the exercise of fiduciary discretion *that is controlled by the spouse*, the spouse can rollover the benefit. PLR 9533042; PLR 9524020; PLR 9515041; PLR 9515042; PLR 9545010; PLR 9623056. For an example of a situation where a rollover was not permitted because the nonspouse trustee had discretion to determine the allocation and distribution of trust assets, including the IRA, see PLR 9445029.

➔ **Planning Point:** Do not give up entirely on rollover options if a trust has been designated as the beneficiary of a qualified plan or IRA. Review the terms of the governing instruments with care, to see if the spouse might qualify for a rollover under this exception.

Because the designated beneficiary is not determined until the Applicable Date, consider if disclaimers might be used so that the qualified plan or IRA benefits are payable to the spouse, or to a trust for the spouse that qualifies for this exception.

(5) **Spouse's Ability to Treat IRA Interest as Spouse's Own IRA**. A very important special rule available exclusively to participants' spouses that are named as the beneficiary of an IRA is such spouse's ability to elect to treat the spouse's entire interest in the IRA as the spouse's own IRA. Treas. Reg. §§ 1.408-2(b)(7)(ii); -8, Q&A-5(a). The use of this option is very important for income tax deferral planning. A surviving spouse who rolls over an IRA that the surviving spouse has elected to treat as his or her own has all of the income tax deferral opportunities available to the participant during the participant's lifetime, including the right to defer distributions until the spouse's Required Beginning Date, to measure lifetime MRDs to the spouse using the factors from the Uniform Lifetime Table, and to designate new beneficiaries whose life expectancies may be used to measure distributions from the IRA after the spouse's death.

If the spouse is under age 59½, treating an IRA as his or her own or rolling over his or her

interest in a qualified plan may not be an appropriate option if the spouse needs any of the IRA funds for the spouse's support prior to reaching that age. The spouse would be subject to the same penalties as any IRA participant for early distributions. Unless a pre-59½ distribution qualified for one of the exceptions noted in IRC § 72(t), funds paid out of the spouse's IRA prior to the spouse's reaching age 59½ would be subject to the 10% early distribution penalty. Also, if the surviving spouse were to die before reaching age 70½, the surviving spouse will be treated as the IRA owner, rather than as a beneficiary. IRC § 408(d). Thus, if he or she has not designated a succeeding beneficiary of the IRA, the IRA will be distributed after the spouse's death as if there were no beneficiary (i.e., to his or her estate). The MRDs will be higher in this situation and the assets will be subject to the spouse's creditors. These problems regarding the spouse treating an IRA as his or her own IRA apply in the same manner to the situation in which a nonspouse beneficiary rolls over an interest in an IRA or qualified plan, as discussed below at 4.d.

➔ **Planning Point:** One of the exceptions to the 10% penalty for early distributions is payment to a beneficiary by reason of a participant's death. One strategy for taking advantage of rollover opportunities for the younger surviving spouse is to keep in the participant's IRA only that amount of property needed to provide for the surviving spouse's support before he or she reaches age 59½ and to distribute that portion of the participant's IRA to the spouse in a manner that satisfies the applicable post-death MRD rules and meets the spouse's support needs. The spouse can rollover the balance of the account.

Another exception to the 10% tax on early distributions is payment of the account to the participant in equally or substantially equal installments over life, or over the joint life expectancy of the participant and his or her designated beneficiary. IRC § 72(t)(2)(a)(iv). Thus, another way for a surviving spouse to take advantage of rollover options prior to age 59½ without incurring the 10% penalty is to rollover the entire account, and immediately begin distributions over life or joint lives, as provided in this section.

(6) Rollover of Certain Distributions to IRA in the Name of the Deceased Participant. In addition, a spouse who is the beneficiary of a deceased participant's benefit from a qualified plan or IRA may have an additional option that is not available to other beneficiaries: if, under the terms of the plan, the spouse is entitled to a lump sum distribution, the spouse may roll over that distribution into an IRA in the name of the deceased participant. PLRs 9608042, 9418034, 200450057. This option may be more favorable than rolling the lump sum distribution over to the spouse's IRA or qualified plan if the participant was younger than the spouse because distributions may be delayed until the participant would have attained age 70½. This option may also be more favorable than a rollover to the spouse's IRA or qualified plan if, as mentioned above, the spouse will be taking distributions before reaching age 59½ and would be subject to the 10% premature withdrawal penalty. IRC § 72(t)(2)(A)(ii), see also PLR 200650023.

d. Ability of Beneficiaries to Rollover Distributions from Qualified Plans

to IRAs. A beneficiary who is the spouse of the employee may rollover an eligible distribution from a qualified plan or IRA to another IRA. IRC §§ 402(c)(9) and 408(d)(3)(C). For distributions made after December 31, 2006, the PPA added IRC § 402(c)(11) to also allow non- spousal beneficiaries to rollover a distribution from a qualified plan or IRA to another IRA, thereby allowing them to defer distributions. This non-spousal rollover must be through a direct trustee-to-trustee transfer. The minimum distribution rules with regard to inherited IRAs will apply to such rolled over distributions. The recipient IRA is treated as an inherited IRA that must be titled in the name of the participant, and the nonspouse beneficiary must qualify as a designated beneficiary. Transfers may also be made to inherited IRAs that are held by trusts for the benefit of the nonspouse beneficiaries. Notice 2007-7, 2007-5 I.R.B. 395, provides additional guidance concerning nonspouse rollovers, including rules regarding the calculation of minimum required distributions after the rollover. See also PLR 200717023.

If a qualified plan mandates payment when a participant dies before his or her RBD, the nonspousal beneficiary rollover must take place by the end of the first year following the participant's death in order to take MRDs from the IRA over the beneficiary's life expectancy, IRC § 401(a)(9)(B)(iii), rather than over five years from the date of the participant's death. IRC § 401(a)(9)(B)(ii). If the rollover occurs after the end of the first year following the participant's death, the rolled over qualified plan interest must be distributed out of the transferee IRA by the end of the fifth year following the year of the participant's death. No rollover at all is allowed after the fourth year following the year of the participant's death. In addition, all MRDs must be paid to the beneficiary out of the plan each year before the rollover.

The problems discussed above regarding the spouse treating an IRA as his or her own in section G.4.c.(5) apply in the same manner to the situation in which a beneficiary rolls over an interest in an IRA or qualified plan, as discussed in this section.

e. Effective Dates for the 2002 Final Regulations. The minimum distribution rules contained in the 2002 final regulations are effective for all plan years beginning in 2003, and may not be used for plan years prior to 2002. In 2001, MRDs can be calculated under either the 2001 proposed regulations or the 1987 proposed regulations. In 2002, MRDs can be calculated either under the 2001 proposed regulations, the 1987 proposed regulations, or the 2002 final regulations. Note that a minimum required distribution for 2001 that is properly deferred to April 1, 2002 is still a year 2001 distribution, and is not eligible to be calculated under the final regulations. For IRAs, the underlying plan documents do not have to be amended in order for participants to rely on the final regulations. Qualified plans must be amended to incorporate the final regulations before the plan administrator may use them to calculate participant MRDs. IRS Announcement 2001-18, 2001-10 I.R.B. 791. However, if a qualified plan is not amended, and as a result a participant receives a distribution calculated under the old proposed regulations that is larger than the distribution that would have been made under the final regulations, it appears that the participant is entitled to rollover the excess. IRS Announcement 2001-23, 2001-10 I.R.B. 791.

➔ **Planning Point.** Distributions made before 2003 that fail to comply either with the 1987 or the 2001 proposed regulations under IRC § 401(a)(9) should not be automatically subject to penalty. Many non-complying distributions might be

defended as based on a "reasonable interpretation" of the statutory requirements, particularly now that the IRS has developed three such "reasonable interpretations" itself.

There are two other effective date rules to keep in mind. If an employee filed an election under "TEFRA 242(b)" (The Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248) on or before January 1, 1984, and has not since revoked the election, the employee is entitled to receive distributions under the plan provisions as in effect in 1983. Some long-standing distribution schemes that do not comply with any of the proposed regulations under IRC § 401(a)(9) may be grandfathered by this election, and, if so, are entitled to continue to use their elected method of distribution without penalty. See, IRS Notice 83-23, 1983 - 2 C.B. 418.

The 1987 proposed regulations under IRC § 401(a)(9) were issued in 1987, but related to tax law changes effective in 1985. These old proposed regulations contain a number of transitional rules for distributions made in 1985, 1986 and 1987. Do not assume that distributions for those years that do not appear to comply with the proposed regulations are incorrect, without first reviewing the transitional rules contained in the 1987 proposed regulations.

H. Estate and Gift Taxation of Qualified Plans and IRAs

1. General Rule - Estate Taxation

As a general rule, the value of qualified plans and individual retirement accounts are included in the gross estate under IRC § 2039, dealing with the estate taxation of annuities. IRC § 2039 annuities are not limited to annuity contracts. For purposes of IRC § 2039, an annuity includes *any* payment receivable by *any* beneficiary under *any* form of contract or agreement under which a payment was to be made to the decedent during his or her lifetime. If the decedent contributed the entire purchase price for the annuity, then the entire value of the annuity is included in the decedent's gross estate. Contributions made by a decedent's employer (or former employer) to the purchase price of an annuity (within the meaning of IRC § 2039) are considered to be contributions by the decedent. The value of the annuity or other payment itself is determined under IRC § 2031 and Treas. Reg. §§ 20.2031-7; 20.2031-8; 20.2031-9.

Although there are certain cases in which it has been successfully argued that payments made to a beneficiary after the decedent's death in connection with the decedent's employment were not taxable as part of the decedent's gross estate, for the most part IRC § 2039 will capture in the gross estate the value of all employment related compensation, including pension and profit sharing plans, whether qualified or non-qualified, and individual retirement accounts.

➔ **Planning Point.** The regulations under IRC § 2031 relating to the valuation of annuities emphasize the valuation of traditional annuity contracts. Because many qualified plan accounts and IRAs are invested by, and can be withdrawn by, the participant at any time, most planners have valued such accounts with reference to the value of the underlying securities or investments in the account. An argument could be made, however, that qualified plans and IRAs should be valued only after taking into account

plan restrictions (such as non-alienability) or other features of the qualified plan or IRA that define it, such as the tax burden inherent in the account if it is distributed, and the income tax deferral benefit that can be obtained if distributions from the account are restricted. However, the IRS has consistently resisted such an approach.

2. Grandfather Provisions For Estate Tax Exclusion under IRC § 2039

Before 1983, the proceeds of many qualified plans and IRAs were exempt from federal estate tax if certain requirements were met. The exclusion applied to employer contributions to a qualified plan, tax deductible contributions to an IRA and rollover IRAs. The proceeds had to be payable to a beneficiary other than the participant's estate. There developed from this requirement a rule that if qualified plan or IRA proceeds could be used to discharge an estate obligation, they would be included in the gross estate under § 2039. (For this reason, it was important to exclude the proceeds of a qualified plan or IRA from the funds out of which tax payments and other obligations could be satisfied.) For qualified plans, the estate tax exclusion did not apply if the recipient of the proceeds elected favorable income tax treatment (that is, ten- year forward averaging or capital gains treatment for pre-1974 participation) for a lump sum distribution of the plan proceeds. An IRA, which was not eligible for favorable income tax treatment, had to be paid in equal installments over a minimum of thirty-six months to be eligible for estate tax exclusion under IRC § 2039, as in effect before 1983.

The estate tax exclusion for qualified plans and IRAs was cut back to a maximum of $100,000 for estates of decedents dying after December 31, 1982. The exclusion was eliminated entirely in 1984 for estates of decedents dying after December 31, 1984.

The Tax Reform Act of 1984 (P.L. 98-369) included special "grandfather" provisions that applied retroactively to retain part or all of the estate tax exclusion under IRC § 2039 for certain qualified plans and IRAs. In its original form, the grandfather provision was largely irrelevant. However, in the Tax Reform Act of 1986 (P.L. 99-514) the 100% federal estate tax exclusion for a qualified plan or IRA was reinstated if the following conditions were met:

- the participant separated from service before 1983.
- the participant elected the form of benefit to be paid under the plan before 1983.
- the participant did not change the form of benefit paid under the plan prior to the participant's death.
- the participant was in "pay status" (that is, received at least one payment pursuant to the benefit option elected) before 1983.
- the distribution otherwise qualified for estate tax exclusion under IRC § 2039, as it existed prior to repeal.

The 1986 Tax Act also reinstated the $100,000 federal estate tax exclusion for qualified plans or IRAs under similar circumstances, with reference to an effective date of July 18, 1984 (P.L. 99-514).

EXAMPLE: Your client retired in 1980, and elected to receive distributions from her qualified plan in installments payable over 30 years. This was a permissible form of distribution in 1980. Payments began to your client in 1981. The client provided that at her death any unpaid installments would be paid, in installments as originally elected, to her revocable trust. The revocable trust precluded the use of qualified plan assets to pay estate obligations and taxes. It further provided that any property that was not eligible for the federal estate tax marital deduction would be allocated to the Family Trust. The client died in 2000, and her spouse survived her.

The undistributed plan benefits should be eligible for estate tax exclusion under the IRC § 2039 provisions. First, the payments would have been exempt from estate tax under IRC § 2039 prior to repeal, because they were not payable to or for the benefit of the estate, and they were not payable in a lump sum distribution for which favorable income tax treatment was elected. Second, the participant had retired prior to 1983, and had elected a form of benefit (30-year installments) prior to 1983 that began before 1983 and had not been changed.

Property that is not included in the gross estate is not eligible for the federal estate tax marital deduction. As a result, under the terms of the trust, the remaining qualified plan installments should be allocated to the Family Trust.

➔ **Planning Point:** If qualified plan assets are excluded from the gross estate under IRC § 2039, they also are exempt from Generation Skipping Transfer Tax under IRC § 2612 (dealing with the taxation of direct skips). The preservation of this estate tax exclusion when it is otherwise available can be enormously valuable. You may think that it is not possible to preserve the exclusion if the form of payment elected prior to 1983 does not conform to current minimum distribution requirements. This is not necessarily the case. Many forms of benefit elections not permitted under current law remain valid if they were elected prior to 1983, under the so- called "TEFRA 242(b)" election (see, P.L. 97-248).

The IRS has acknowledged that these grandfather provisions apply to eligible qualified plan benefits. PLR 9211041. However, the IRS also has taken the position that these grandfather provisions do *not* apply to IRAs under any circumstances. Rev. Rul. 92-22, I.R.B. 1992-13 (March 20, 1992). There are no known decided cases challenging the IRS position on this point, even though it appears to be inconsistent with the original intent of the grandfather provisions and is not supported by the statute.

With the passage of time, the potential benefit of estate tax exclusion under the IRC § 2039 grandfather provisions becomes more and more remote. Eligible individuals would

have had to separate from service before 1985, which for the most part would make them well into their 80's today, if they retired at normal retirement age. What is more, in order for the exclusion to apply, the form of benefit elected prior to the grandfather date cannot be changed prior to the participant's death. Given all of the changes made in the rules governing the calculation of minimum required distributions from qualified plans and IRAs since 1983, an unchanged form of benefit is uncommon. Most forms of benefit have, in fact, been changed, either to comply with revised minimum distribution requirements or in order to avoid a more rapid lifetime distribution than would otherwise be required. Nevertheless, these situations continue to surface from time to time.

➔ **Planning Point:** If your client retired before 1985, be sure to evaluate the status of the client's qualified plans or IRAs under the IRC § 2039 estate tax exclusion grandfather provisions before making any changes in the client's beneficiary designation or distribution election. Consider if you can maximize the benefit of the exclusion, such as by allocating a grandfathered plan to a generation-skipping transfer ("GST") tax exempt trust or share, without disqualifying the plan for the exclusion. Can you qualify the plan for the estate tax marital deduction on a contingent basis, if the exclusion is disallowed? Can you use a formula gift if you are unsure about qualifying for the exclusion (*i.e.*, "allocate to the Family Trust that part of the plan excluded from my gross estate …").

3. Income Tax Deduction for Estate Taxes Paid Under IRC § 691(c)

The basis for the former estate tax exclusion for qualified plans and IRAs was the two- fold concern of (i) imposing income tax and estate tax on the same asset, and (ii) imposing estate tax at a time when the plan benefits themselves might not be available to the beneficiary. With the introduction of the unlimited federal estate tax marital deduction and an easing of the constructive receipt rules (which gave to plan participants and their beneficiaries more flexibility in deciding how to withdraw plan benefits), both of these concerns are alleviated, at least if there is a surviving spouse. However, if there is no spouse, or if the spouse is not the beneficiary of the plan, or if the spouse's benefits under the plan fail to qualify for the marital deduction, the double taxation issue remains severe.

Under IRC § 691, any item that would have been income if payable to a decedent during the decedent's lifetime is taxed as income to the recipient ("IRD") of that item after the decedent's death. This applies to many items, including most employee benefits payable after death, whether qualified or non-qualified. Rev. Rul. 92-47, 1992-1 C.B. 198; Rev. Rul. 69-297, 1969-1 C.B. 131; Rev. Rul. 75-125, 1975-1 C.B. 254. Items of IRD do not receive any basis step up at death. IRC § 1014(c).

EXAMPLE: An unmarried employee dies in 2007 with a deferred compensation account valued at $350,000, plus $2,000,000 in other assets. The employee did not make any lifetime gifts. The deferred compensation account is included in the employee's gross estate under

IRC § 2039. This generates federal estate tax of approximately $157,500. When the deferred compensation account is distributed to the employee's beneficiaries, all amounts distributed are included in the gross income of the beneficiaries. Without reference to the special deduction allowed under IRC § 691(c), and assuming the employee's beneficiaries have an average rate of income tax of 25%, the total income tax on the date of death plan balance will be approximately $87,500. The total effective rate of tax (both income and estate) on the deferred compensation plan is 70%.

To relieve the burden of this estate taxation and income taxation of the same asset, there is an income tax deduction, allowed under IRC § 691(c), for the federal estate tax attributable to IRD. This deduction is calculated with respect to the net value of all IRD items included in the decedent's estate, and then prorated among them. The tax attributable to IRD is calculated at marginal rates. It is measured as the difference between the federal estate tax, calculated on the estate *including* all items of IRD, and the federal estate tax, calculated on the estate *excluding* all items of IRD.

EXAMPLE: An unmarried employee dies in 2007 with a deferred compensation account valued at $350,000, plus $2,000,000 in other assets. The employee's total federal and state estate tax is approximately $169,640. The employee's state of residence imposes a "decoupled" state estate tax which represents $12,140 of the total estate tax. The federal estate tax represents the remaining $157,500. The entire estate tax is attributable to the deferred compensation account because, if that account were not included in the employee's gross estate, there would be no estate tax. (The entire estate tax would have been absorbed by the available applicable credit amount.) When the deferred compensation account is distributed to the employee's beneficiaries, all amounts distributed are included in the gross income of the beneficiaries. Taking into account the special deduction allowed under IRC § 691(c), and assuming the employee's beneficiaries have an average rate of income tax of 25%, the total income tax on the date of death plan balance will be 48,125. This is calculated as follows:

691 income:	$350,000
691(c) deduction:	(157,500)
Taxable amount:	$192,500
25% tax:	$48,125

> Note that the IRC § 691(c) deduction is only available for the federal estate tax, not the state estate tax. The total effective rate of tax (both income and estate) on the deferred compensation plan (after the IRC § 691(c) deduction) is about 62%.

There are a number of important things to remember about the IRC § 691(c) deduction. First, it is complicated to calculate. The actual facts in an estate administration are rarely as simple as those assumed above. IRD includes many items, such as accrued interest and dividends after the record date, and a number of offsets and deductions as well. Further, IRD can be, and often is, received over a period of several years. Second, the deduction is often forgotten, or overlooked. Third, the deduction does not fully compensate for the double taxation of IRD (including qualified plans and IRAs) at death. Finally, the IRC § 691(c) deduction is not available if the IRD is not subject to estate tax. Consequently, the distribution of qualified plan or IRA assets at death to the surviving spouse or a qualified charity will not enjoy the benefit of the IRC § 691(c) deduction.

➔ **Planning Point:** In any administration of a taxable estate, be sure to calculate the § 691(c) deduction. If the right to receive items of IRD are allocated to beneficiaries as part of their distributive share of the estate, be sure to advise them, *and their accountants*, of the amount of the IRC § 691(c) deduction they are entitled to claim against their share of IRD received.

➔ **Planning Point:** Because the IRC § 691(c) deduction is not the same as (or as good as) eliminating the unpaid income tax from the decedent's taxable estate, there are two strategies that might be considered in planning prior to death, if your client will have a taxable estate at death. One is a Roth IRA conversion. This preserves tax-free growth for the future, but does not preserve deferral of the income tax on the current plan balance. Not all clients (particularly those that have taxable estates) will be eligible for a Roth IRA conversion, because of the applicable income limitations.

Another strategy is to withdraw the qualified plan or IRA balance prior to death. While this sacrifices *all* income tax deferral, it can still be a useful strategy in some cases, particularly if a large portion or all of the qualified plan or IRA will have to be liquidated shortly after death to meet estate cash requirements, or if a distribution of the qualified plan or IRA balance over a number years is unavailable for other reasons.

Neither strategy is right in every case. But each is worth considering and merits an analysis of the relative advantages and disadvantages.

4. General Rule for Gift Taxation of Qualified Plans and IRAs

As a general rule, qualified plans and individual retirement accounts do not attract gift tax, because beneficiary designations and other elections are generally revocable by the participant during life. Further, in order to be treated as a qualified plan or IRA under the applicable sections

of the Internal Revenue Code, the participant's interest in the plan or IRA must be non-alienable and non-forfeitable. IRC § 401(a)(13)(A). The inability of a participant to transfer his or her interest in the plan during life in general precludes the gift taxation of plan benefits.

Prior to 1986, Internal Revenue IRC § 2517 expressly provided that the exercise of elections under qualified plans did not constitute a gift, even if the election were irrevocable. The one common situation in which gift treatment might arise with respect to a qualified plan under current law relates to an irrevocable election by a qualified plan participant to receive a joint and survivor annuity at retirement, either with the participant's spouse or another beneficiary.

The characteristics of qualified plans and IRAs that limit the occasions when a gift tax issue might arise do not apply to most non-qualified plans. Irrevocable beneficiary designations or other elections under non-qualified plans may attract gift tax, under the traditional rules governing when a gift is made and completed for federal gift tax purposes. IRC § 2511.

5. Automatic QTIP Treatment for Annuities

In order to prevent the election of a joint and survivor spousal annuity from constituting a taxable gift for federal gift tax purposes, IRC § 2523(f)(6) was added to the Internal Revenue IRC in 1988 as part of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA," P.L. 100-647). This provision specifies that when only a husband and wife have the right to receive payments under an annuity (as defined for purposes of IRC § 2039) during the lifetimes of husband and wife, an irrevocable election to receive a joint and survivor annuity will be treated as a qualifying income interest for life in the donee spouse, eligible for the federal gift tax marital deduction under IRC § 2523. What is more, the election normally required to qualify such an income interest for the gift tax marital deduction under IRC § 2523(f)(2)(C) and IRC § 2523(f)(4) is considered to have been made automatically, unless the donor or spouse affirmatively elects otherwise on a timely filed gift tax return. The interest of a donee spouse who predeceases the participant is not included in the gross estate of the donee spouse under IRC § 2044.

These rules apply retroactively to all irrevocable elections made after December 31, 1981. However, these provisions will not apply if they are inconsistent with the treatment given to such a transfer on a prior estate or gift tax return. Every participant had two years after date of enactment (November 10, 1988) either to elect qualified terminable interest property ("QTIP") treatment for an irrevocable joint and survivor annuity that was inconsistently reported on a prior return, or to elect out of automatic marital deduction treatment for a joint survivor annuity. (See, TAMRA § 6152(c)(2) and (3), P.L. 100-647.)

6. Waiver of Rights Under Retirement Equity Act of 1984 ("REA")

The Retirement Equity Act of 1984 ("REA") requires that defined benefit plans, money purchase plans, profit sharing plans (including HR-10 or KEOGH plans but *not* IRAs) and stock bonus plans all provide survivor benefits (both pre- and post-retirement) for the surviving spouse of any vested plan participant. Generally, participants may waive the survivor annuity

requirements, but, for such a waiver to be effective, the participant's spouse must consent to the waiver in writing before either the plan administrator or a notary public. In certain profit sharing plans, the spouse also must consent to the designation of a beneficiary other than the spouse. If a spouse consents to the waiver of the spouse's survivor benefits during the participant's lifetime, this is not considered a gift by the spouse. IRC § 2503(f). There are no provisions describing the gift tax treatment that may apply to waivers after the participant's death of rights or consents under REA, however.

I. Planning for Distributions of Qualified Plans and IRAs at Death

1. Maximizing Deferral

The economic principles that make deferring distributions from a qualified plan or IRA advantageous during the participant's lifetime, apply equally well after the participant's death. In planning for the distribution of proceeds from qualified plans and IRAs after death, structuring the beneficiary designation and distribution options to maximize income tax deferral should be a primary objective. The difficulty is how to achieve estate tax minimization and deferral at the same time.

a. **Spouse as Beneficiary**. Maximum income tax deferral ordinarily is obtained by designating the spouse as the primary beneficiary of a qualified plan or IRA. If the participant dies before age 70½, the spouse can defer distributions from a qualified plan or IRA until the participant would have reached that age. Alternatively, if the spouse has the right to rollover the qualified plan or IRA to another qualified plan or IRA under IRC § 402(c)(9) or to treat an IRA as the spouse's own IRA under Treas. Reg. § 1.408-2(b)(7)(II); -8, Q&A-5(a), distributions can be deferred until the spouse's age 70½. IRC § 401(a)(9)(B)(iv)(I); Treas. Reg. § 1.401(a)(9)-3, Q&A-3(b). Furthermore, if the spouse rolls over a qualified plan or IRA or treats an IRA as his or her own IRA, the spouse may also name a beneficiary for any remaining benefit at his or her death, regardless of whether the spouse dies before or after his or her RBD. If the participant's spouse is the sole beneficiary of an IRA or qualified plan for the entire year, the MRD for that year will be based upon the actual joint life expectancy of the participant and the participant's spouse instead of the Uniform Lifetime Table. If the participant's spouse is more than 10 years younger than the participant, using the actual joint life expectancy of the participant and the participant's spouse can produce a longer distribution period than under the Uniform Lifetime Table, both during the participant's lifetime and after the participant's death.

Also, if the participant's spouse is the designated beneficiary, the spouse can recalculate the spouse's life expectancy in calculating MRDs after the participant's death. IRC § 401(a)(9)(B)(iv)(I); Treas. Reg. § 1.401(a)(9)-3, Q&A-3(b). Further, if the participant's surviving spouse rolls over a qualified plan or IRA to another qualified plan or IRA, the spouse can name new beneficiaries and recommence the uniform lifetime distribution period, further extending account distributions.

There are a number of other advantages, both tax and non-tax, in naming the spouse as the primary beneficiary of a qualified plan or IRA. Perhaps most important of these is the fact that the unrestricted payment of qualified plan and IRA benefits to the surviving spouse should qualify for

the unlimited federal estate tax marital deduction in the participant's estate, thus deferring any federal estate tax that might otherwise be imposed with respect to the plan benefits. On the non-tax side, designating the spouse as the sole primary beneficiary of a qualified plan or IRA avoids any community property issues that might arise with respect to an IRA and assures compliance with the Retirement Equity Act of 1984 for a qualified plan. Both of these issues are discussed at greater length below.

b. Ability of Beneficiaries to Rollover Distributions from Qualified Plans to IRAs. The PPA added IRC § 402(c)(11) to allow non-spousal beneficiaries to rollover a distribution from a qualified plan or IRA to another IRA, thereby allowing them to defer distributions. The rollover must be through a direct trustee-to-trustee transfer. The minimum distribution rules with regard to inherited IRAs will apply to such rolled over distributions. The recipient IRA is treated as an inherited IRA that must be titled in the name of the participant, and the beneficiary must qualify as a designated beneficiary. Transfers may also be made to inherited IRAs that are held by trusts for the benefit of the nonspouse beneficiaries. Notice 2007-7, 2007-5 I.R.B. 395, provides additional guidance concerning nonspouse rollovers, including rules regarding the calculation of minimum required distributions after the rollover. See also PLR 200717023.

If a qualified plan mandates payment when a participant dies before his or her RBD, the nonspousal beneficiary rollover must take place by the end of the first year following the participant's death in order to take MRDs from the IRA over the beneficiary's life expectancy, IRC § 401(a)(9)(B)(iii), rather than over five years from the date of the participant's death. IRC § 401(a)(9)(B)(ii). If the rollover occurs after the end of the first year following the participant's death, the rolled over qualified plan interest must be distributed out of the transferee IRA by the end of the fifth year following the year of the participant's death. No rollover at all is allowed after the fourth year following the year of the participant's death. In addition, all MRDs must be paid to the beneficiary out of the plan each year before the rollover.

c. "Stretch" Distributions and IRAs. A "Stretch" Distribution and a Stretch IRA are simply references to a qualified plan or IRA that is eligible to be distributed over a long period of time after death, usually when payable to a beneficiary other than the spouse. For income tax deferral purposes, it is preferable for post-death distributions from a qualified plan or IRA to qualify for a Stretch Distribution or as a Stretch IRA. This is accomplished by making sure that the plan or account is payable at the participant's death to a designated beneficiary.

Two strategies exists that will assist in implementing a Stretch IRA. One is to make sure that there are sufficient other liquid assets available for the payment of debts, claims and other obligations in the participant's estate. Qualifying for a stretch distribution is of little use if the account has to be liquidated to pay taxes. The other is for the client to implement a rollover from a qualified plan into an IRA before death. IRAs generally are more flexible in their distribution options, and can qualify for stretch distribution more easily. Most employers opt to liquidate quickly the accounts of deceased participants. Furthermore, designating beneficiaries can also be easier with IRAs because there are few legal restrictions. In contrast, a married individual cannot name someone other than a spouse - such as a credit shelter trust or a child - as a beneficiary of a

qualified plan unless the spouse gives written consent. IRC § 401(a)(11)(B)(iii) and 417(a)(2).

It is important to consider, however, the advantages of qualified plan participation that will be given up in an IRA rollover. These may include investment management costs, when they are absorbed or subsidized in the qualified plan. A qualified plan also has enhanced creditor protection, which is very important if the participant has an ex-spouse that may attempt to attach

the surviving spouse's interest after the participant's death. Such action would be detrimental to the tax advantages available from designating a surviving spouse as the beneficiary. Furthermore, a qualified plan is eligible for certain favorable income tax treatment and may be eligible for the application of certain grandfather provisions, such as estate tax exclusion under the IRC § 2039 grandfather provisions, or exemption from the current minimum distribution rules, under the "TEFRA 242(b)" (See, P.L. 97-248) grandfather provisions. The existence of loans against the plan, or life insurance in the plan, also may be issues, as such assets usually cannot be rolled over to an IRA. IRC §§ 72(p); 408(a)(3); Treas. Reg. §§ 1.402(c)-2, A-9; 1.408-2(b)(3).

One or more individual beneficiaries can qualify as the "designated beneficiary" for purposes of implementing a Stretch Distribution or creating a Stretch IRA. But when designating individual beneficiaries of a qualified plan or IRA for stretch distribution purposes, there are a number of issues that should be considered:

- Is the possibility of minor beneficiaries adequately provided for, either under the beneficiary designation or the underlying plan documentation?
- Will the beneficiary designation be appropriate if there is an unusual order of deaths (*i.e.*, child predeceases parent)?
- Is adequate provision made for the distribution of the account in the event of the death of the individual beneficiary before the complete distribution of his or her share of the account?
- Is the tax posture of the account on the death of an individual beneficiary before the complete distribution of his or her share clear? The account will be subject to estate tax in the beneficiary's estate if the beneficiary has the right to withdraw the account at will, or to designate a successor beneficiary without restriction (either of which constitute a general power of appointment under IRC § 2041), or if the beneficiary's estate will receive any undistributed assets at the beneficiary's death.
- Does the client want to use the qualified plan or IRA as a form of generation-skipping transfer? If so, is it certain that the beneficiary does not have any rights or powers (either under the participant's beneficiary designation or distribution election or under the plan documentation itself) that will cause the value of the account to be included in the beneficiary's estate?
- Is the distribution of the qualified plan or IRA to individual beneficiaries consistent with other provisions of the participant's estate plan, including the allocation or apportionment of estate taxes? To the extent possible, any tax due should be paid from nonretirement assets because the withdrawal of retirement assets to pay taxes will cause additional income tax. If retirement assets must be used, the trust should provide that any such payment must be made by September 30th of the year after the year of the settlor's death to ensure that the estate will not be considered a

designated beneficiary for MRD purposes. Treas. Reg. § 1.401(a)(9)-4, A-4(a); PLR 200432027-29.

- Are there adequate provisions governing investment management in the account after the participant's death?

➔ **Planning Point:** The plan and trust documents for a qualified plan, and the trust or custodial account agreement for an IRA, contain all of the provisions governing the participant's interest under the plan. Although these documents have to comply with IRS requirements, they do not have to include all available options allowed by the IRS, and may specify their own rules regarding investments, distributions and defaults, to the extent not inconsistent with the Internal Revenue Code and ERISA. It is important to keep this in mind when planning for distributions from qualified plans and IRAs, as your planning options may be restricted by the terms of these documents. You may not have the ability to address the issues outlined above in a manner other than as provided in the plan documents.

d. Dynasty Trusts or Other Trusts for Children. To avoid many of the issues noted above regarding stretch distributions, attorneys commonly recommend that payments from a qualified plan or IRA be made after death to a trust for the benefit of individual family members. One main advantage of naming a trust as a beneficiary of a qualified plan or IRA is that part of the distributions from the retirement account are retained inside the trust, and all of the retirement account withdrawals not distributed out of the trust will pass estate tax free to the next generation. This is especially desirable if the surviving spouse is not expected to consume all the MRDs made to the surviving spouse during his or her life.

This technique must be approached with care if income tax deferral is a primary objective. As discussed above, in addition to complying with the documentation requirements described in the regulations, the practitioner must make sure that: (1) all of the trust beneficiaries (including any contingent beneficiaries) are eligible designated beneficiaries, Treas. Reg. § 1.401(a)(9)-4, A-3, A-5(c); and (2) the trust at issue qualifies as a valid see-through trust such that the trust beneficiaries, and not the trust itself, will be considered in determining MRDs. Treas. Reg. § 1.401(a)(9)-4, A-5(b). Furthermore, the retained distributions are taxed at the trust's high income tax rates.

The regulations permit a trust beneficiary to be considered the sole designated beneficiary of the account only if the trust is a "conduit trust" - that is, a trust that immediately distributes all qualified plan benefits payable to the trust to the beneficiary. This is not a traditional way to draft a trust, and in many cases such an approach would defeat the purposes for using a trust in the first instance. However, if the trust is *not* a conduit trust, then all beneficiaries for whom plan benefits could be accumulated for future distribution have to be taken into account in determining who the designated beneficiary is. Conduits trusts are discussed in more detail at G.4.c.4) above and I.2.e. below.

➔ **<u>Planning Point</u>:** The attorney should keep in mind the complicated issues that arise whenever a trust is designated as the beneficiary of any type of property, such as the costs of establishing the trust, preparing tax returns and accountings and the fiduciary liability exposure of the Trustee.

This is a particularly difficult issue when designating a dynasty trust (or multi-generation-skipping transfer tax exempt trust) as the beneficiary of a qualified plan or IRA, and trying to qualify for a stretch distribution. These trusts typically will not be conduit trusts. Treas. Reg. § 1.401(a)(9)-4, A-1, provides that the designated beneficiary need not be specified by name in the plan or by the participant to qualify as a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan. The regulations do not indicate how many levels of contingent beneficiaries need to be considered in this context. How far out do you have to go? If your trust is not subject to the rule against perpetuities, perhaps forever. Nor do the regulations indicate how to treat potential appointees under a power of appointment. Do broad powers of appointment create a class of beneficiaries who are not "identifiable"? Can a trust be designed that never under any circumstances distributes to anyone other than identifiable individual beneficiaries? Maybe, but it would require unusual provisions to do so.

The regulations provide that, if a trust pays all of its income to the participant's spouse and principal may be distributed to the spouse in the Trustee's discretion, both the spouse and the remainder beneficiaries are considered beneficiaries for purposes of determining: (1) whether a person other than an individual is designated as a beneficiary; and (2) who is the oldest beneficiary. Treas. Reg. § 1.401(a)(9)-5, Q&A-7.

If trust assets were intended to be distributed when the beneficiary attained a stated age or ages within the beneficiary's actuarial life expectancy, it could be argued that only the first level of default beneficiaries need to be taken into account; that is, the members of the default beneficiary class presently living. If this class were descendants, the trust distribution could arguably be made over the life expectancy of the oldest living child (as all other descendants would be younger). While this seems like a logical result, the regulations do not give any specific guidance, and the IRS has been less than clear in its private letter rulings on the subject.

(1) **<u>PLR 200228025</u>**. In this PLR, a trust for the benefit of children was designated as the beneficiary of an IRA. Under the trust terms, separate trusts were established for each child. Each trust continued until the child reached a stated age. If the child died before attaining that age, the trust distributed such child's share to the child's descendants, or if none, to the child's siblings (or the descendants of a deceased brother or sister), or if none, to the child's uncle. At the time of the participant's death, the children had not reached the stated distribution age. The IRS ruled that the uncle was a beneficiary of the trust who had to be taken into account in determining the designated beneficiary of the IRA. Taken to its logical conclusion, this analysis is extremely problematic. Whether expressed in the trust instrument or not, every trust has some default taker, which may not be an eligible designated beneficiary or who may be an older family member.

(2) **<u>PLRs 200235038-41</u>**. In these rulings, the participant designated his revocable trust as the beneficiary of his IRA and died after his RBD. The trust provided that a

non-relative was to receive outright 25% of the trust property upon the participant's death. This distribution was satisfied by distributing 25% of the IRA to a separate IRA for the benefit of that non-relative. The remaining 75% of the trust was divided into equal trusts for the benefit of the participant's surviving children. Daughter A was the oldest.

Each child's trust provided that the child had a mandatory income interest and could receive discretionary principal distributions. Each child also had a broad special testamentary power of appointment. In addition, the child was prohibited from exercising that power in favor of a "Disqualified Appointee," which was defined as any person older than Daughter A, any person other than a trust or an individual or any trust that has or may have a beneficiary who is older than Daughter A. The IRS does not state what happens to the property subject to the power of appointment if a child fails to exercise the power. The IRS ruled that the MRDs to each child's trust could be taken from the IRA based on the life expectancy of Daughter A, the oldest child of the participant. Thus, the IRS in these rulings gave its implicit approval of the above- described savings clause. Also, the disqualified appointee provisions were added after the participant's death by way of a court reformation. Practitioners therefore can not only use these provisions in drafting the trust agreement but may also be able to use them effectively in post- mortem planning.

When drafting a savings clause such as the one in the above ruling, there are (at least) three rules to address: (a) that all of the beneficiaries of the trust with respect to the IRA (including contingent and successor beneficiaries) be eligible designated beneficiaries; (b) that all of the beneficiaries of the trust with respect to the IRA or qualified plan (including contingent and successor beneficiaries) be identifiable; and (c) that all of the non-primary beneficiaries of the trust with respect to the IRA or qualified plan be younger than the primary trust beneficiary.

Some attorneys are concerned that such a comprehensive savings clause might introduce significant dispositive distortions or ambiguities into the estate plan, or create an administrative nightmare. Thus, in some cases, a preferable approach when a trust is required may be to use a conduit trust, discussed below.

(3) **PLR 200438044**. An IRA participant died before his RBD and designated the participant's trust as the IRA beneficiary. The surviving spouse was the beneficiary for life and held a testamentary power of appointment in favor of the participant's descendants and their spouses. In default of the power, the property was distributable to the participant's descendants, *per stirpes*, except that a beneficiary under age 30 will have his or her interest held in trust until such beneficiary reached age 30. All the children were over age 30 at the time of the participant's death. These children also had limited powers of appointment. The surviving spouse properly disclaimed his power of appointment. The IRS reasoned that: (1) because each of the decedent's children was over age 30 at the decedent's death; and (2) the surviving spouse disclaimed her testamentary power of appointment over the trusts before September 30th of the year following the year of the decedent's death, "the right of each child to

his/her remainder interest in the [trusts], including [the decedent's] interest in [the plan], was unrestricted at the death of [the decedent]." As a result, the IRS concluded that the surviving spouse and the children were the only beneficiaries of the trusts who must be considered in determining the designated beneficiaries of the decedent's interest in the decedent's qualified plan.

Thus, the IRS took a date-of-death look at the then living trust beneficiaries to determine which remainder beneficiaries could be ignored for purposes of determining the MRDs.

The IRS came to the same conclusion under similar facts in PLR 200708084. From these two rulings, the IRS's position seems to be that, when beneficiaries of a see-through trust receive their trust interests outright, the IRS will not look beyond those beneficiaries when determining the oldest beneficiary for MRD purposes.

There also is a practical problem in naming a trust as the beneficiary of a qualified plan or IRA. In the normal course of trust administration, trust assets are allocated among or distributed to the trust beneficiaries, who may be individuals or continuing trusts for the benefit of those individuals. There is no tax or trust law reason why the right to receive benefits under a qualified plan or IRA could not be allocated or distributed in the same way. PLR 200008044; PLR 199947036; PLR 9751037; Rev. Rul. 78-406, 1978-2 C.B. 157. However, in some cases the plan administrator or IRA sponsor will interpret a beneficiary designation literally, and insist on paying the plan benefits to the named trust, even though there is no other reason for the named trust's continued existence. This interferes with Marital and Family Trust splits, allocation among separate trusts for different beneficiaries, and the distribution of trust assets at stated ages, among other things. Even in the best case, it precludes the efficient administration of the trust. Some plan administrators have argued that this approach is required, as no one is permitted to transfer an interest in a qualified plan or IRA. It is not always possible to persuade them that this form of devolution is not a transfer, but simply the passage of entitlement by operation of the terms of the beneficiary trust.

2. Marital Deduction Qualification Issues

One common situation in which a spouse should not be designated as a direct, unrestricted beneficiary of a qualified plan or IRA is when the participant wants to insure that some portion of the account will pass at the spouse's death to the participant's selected beneficiaries. In other words, the participant does not want the spouse to have unrestricted access to or control over the disposition of the qualified plan or IRA. There are two ways this concern might be addressed. One would be by naming the spouse as the direct beneficiary of the account, but restricting in some way the spouse's rights over the account. Another way would be by naming a trust for the benefit of the spouse as the beneficiary of the account. Either approach raises marital deduction issues.

a. **<u>Restrictions on the Spouse</u>**. In naming the spouse as the primary beneficiary of the qualified plan or IRA assets, it is important that the distribution to the spouse qualify for the federal estate tax marital deduction, or be eligible to elect to qualify for the federal estate tax marital deduction. Problems can arise with the marital deduction whenever restrictions are imposed on the distribution of the account. For example, if instead of allowing the spouse the unrestricted right to rollover the account balance or to make withdrawals at the spouse's election, a participant might decide to direct that a qualified plan or IRA be paid to the spouse in annual installments equal to the minimum required distribution, and that any unpaid installments at the spouse's death will be paid to a beneficiary other than the spouse's estate. On what basis would such an interest qualify for the federal estate tax marital deduction?

Under IRC § 2056(b), there are three exceptions to the general rule that a terminable interest will not qualify for the federal estate tax marital deduction. Two of them, a general testamentary power of appointment marital trust under IRC § 2056(b)(5) and a qualified terminable interest property trust ("QTIP") under IRC § 2056(b)(7), each require that the spouse receive all of the income at least annually for life. The payment of MRDs by no means guarantees that the spouse will receive all of the income of the underlying account each year.

EXAMPLE: A participant owned an IRA that was invested in a certificate of deposit earning 4.5%. The participant provided that, in the event of death, MRDs were to be paid to the participant's spouse for life. Any undistributed balance in the account at the spouse's death would be paid to the participant's surviving children in equal shares. The participant died at age 67 in 2002. The spouse's RBD was April 1, 2006. The value of the IRA upon the participant's death was $100,000. The spouse was age 62 in 2002.

The accounting income in the IRA and the MRDs for the first five years after death are as follows:

Year	*Account Income*	*MRD*
2003	$4,500	-0-
2004	$4,703	-0-
2005	$4,914	-0-
2006	$5,135	$5,649
2007	$5,112	$5,856
Total	***$24,364***	***$11,505***

In this example, no MRDs are required until the participant would have reached age 70½. As a result, during the first three years after the participant's death, no income at all was required to be distributed to the surviving spouse, and the MRDs paid to the surviving spouse during the first five years after death are less than one-half of the accounting income earned in the IRA.

Results of the type postulated in the above example do not occur only when the participant dies before the participant's RBD. This type of result could occur as well if the participant died after reaching his or her RBD, depending on the earnings in the account and the age of the

spouse. Because for marital deduction purposes the spouse must receive all of the income in all events, this form of distribution would not qualify for the marital deduction under IRC § 2056(b)(7).

In Treas. Reg. § 20.2056(b)-7(h), Ex. 10, it is provided that, if the amount to be paid to the spouse is the *greater of* the trust accounting income and the MRD, the installment form of payout will qualify for the federal estate tax marital deduction as QTIP. In Rev. Rul. 2006-26, 2006-22 I.R.B. 939 (modifying and superseding Rev. Rul. 2000-2, 2000-1 C.B. 305), the IRS further held that the spouse's continuing right to compel the distribution of the income of the underlying account is sufficient for marital deduction qualification. This is consistent with Treas. Reg. §§ 20.2056(b)-7(d)(2) and 20.2056(b)-5(f)(8). In either case, however, it is clear that the spouse must have either the right to receive, or the unfettered right to demand the distribution of, all of the accounting income of the underlying qualified plan account or IRA and that MRDs alone will not satisfy the estate tax marital deduction requirements. See Rev. Rul. 2006-26, *supra*.

b. Annuities. IRC § 2056(b)(7)(C) provides that in the case of an annuity that is included in the gross estate of the decedent under IRC § 2039 where only the surviving spouse has the right to receive payments during the spouse's lifetime, the interest of the spouse will automatically be treated as a qualifying income interest for life, eligible for the federal estate tax marital deduction, unless the executor elects otherwise on the decedent's federal estate tax return. It is possible to argue that MRDs that are paid directly to the surviving spouse should qualify as an "annuity" under IRC § 2039, and as QTIP under IRC § 2056(b)(7)(C). It is unlikely, however, that IRC § 2056(b)(7)(C) could be used to claim a federal estate tax marital deduction for MRDs to a trust that otherwise did not provide for the distribution to the spouse, at least annually, of all of the accounting income earned in the underlying qualified plan or IRA.

c. QTIP and General Power of Appointment Marital Trusts. Participants often name a trust for the benefit of the spouse as the beneficiary of a qualified plan or IRA so as to gain more control over the ultimate disposition of the principal while still obtaining the marital deduction for the IRA or qualified plan benefits. The disadvantage of this approach is a loss of maximum income tax deferral. As explained above, when a spouse is the beneficiary of a qualified plan or IRA, he or she can substantially delay the beginning of MRDs and reduce the amount of such MRDs. A disposition to a trust, on the other hand, does not have these advantages. The spousal rollover rules do not apply. The trustee would be required to distribute to the surviving spouse at least annually all of the current income of the trust, including any and all internally generated income inside the qualified plan or IRA.

Qualifying an IRA or an interest in a qualified plan for the marital deduction when proceeds are payable to a trust is complex. The IRS views the retirement benefit plan itself as a vehicle that must separately qualify for the marital deduction. Thus, it is not enough simply to give the trustee of the trust the ability to withdraw distributions from the qualified plan or IRA in excess of the MRD. Either the trustee must be required to exercise that power so that all of the trust accounting income of the underlying plan is distributed to the trust at least annually, or the spouse has to be given the right to do so, or to compel the trustee to do so. Rev. Rul. 2000-2, 2000-1 C.B. 305. In addition, there must be a mechanism, either under the trust instrument itself, under state law rules, or both, to guarantee that all of the trust accounting income that is distributed to the trust from the

underlying qualified plan or IRA (or that the spouse can compel to be distributed) will be allocated to the income account and distributed to the spouse as income. If distributions to the trust from the qualified plan or IRA of income earned in the qualified plan or IRA are allocated to principal, marital deduction qualification is jeopardized. See Rev. Rul. 2006-26, *supra*. Finally, the surviving spouse must be able to compel the trustee to make the qualified plan or IRA assets income producing.

EXAMPLE: A participant owned an IRA that was invested in a certificate of deposit earning 4.5% annually. The participant provided that, in the event of death, MRDs are to be paid to the trustee of the participant's revocable trust at the end of each year. The revocable trust instrument provides that during the spouse's lifetime, the spouse will receive all the income of the trust. Any undistributed balance in the trust at the spouse's death will be paid to the participant's surviving children in equal shares. The participant died at age 67 in 2002. The value of the IRA at that time was $100,000. The spouse was age 62 in 2002.

Assume that the trustee does not have the ability to withdraw funds from the IRA in excess of the MRD. Assume further that the trust instrument requires that receipts be allocated between income and principal in accordance with state law, and that state law allocates all retirement plan payments to principal.

The following chart shows the accounting income in the IRA, the MRDs and the income distributions to the spouse for the first five years after death.

Year	*Account Income*	*MRD*	*Income to Spouse*
2003	$4,500	-0-	-0-
2004	$4,703	-0-	-0-
2005	$4,914	-0-	-0-
2006	$5,135	$5,649	-0-
2007	$5,112	$5,856	$254
Total	***$24,364***	***$11,505***	***$254***

In this example, the MRDs paid to the trust during the first five years after death are allocated to principal. The spouse's right to income under the trust does not include either the income earned in the IRA or the MRDs, but just the earnings on MRDs paid to the trust and allocated to

principal, *after income tax*.

➔ **Planning Point:** State law rules vary significantly in how they allocate qualified plan and IRA payments payable to a trust between income and principal. When naming a trust as the beneficiary of a qualified plan or IRA, if the qualified plan or IRA is to qualify for the federal estate tax marital deduction, it is vital that the trustee or the spouse can withdraw accounting income earned in the plan or IRA in excess of the MRD, and that accounting income distributed from the qualified plan or IRA is allocated to income in the trust for income and principal accounting purposes. See Rev. Rul. 2006-26, *supra*.

Instead of giving the trustee or the surviving spouse the discretion to compel distributions from the underlying plan or account, the beneficiary designation and distribution election could require that annual distributions be made in an amount equal to the *greater of* the trust accounting income and the MRD. This less flexible approach may be required if the underlying plan documents do not permit the beneficiary to make withdrawals in excess of MRDs or otherwise will not accommodate the type of distribution provisions required for marital deduction qualification purposes.

d. "Estate" Marital Deduction Trust. A time-honored (although not often used) form of distribution to a spouse that qualifies for the federal estate tax marital deduction is a form of trust that pays income (and, perhaps, principal) to the spouse in the discretion of the trustee, coupled with a provision that transfers any trust property remaining at the spouse's death to the spouse's estate. This "estate" marital deduction trust qualifies for the federal estate tax marital deduction because it is not a terminable interest. Any form of distribution of a qualified plan or IRA to a qualifying "Estate" marital deduction trust should qualify for the federal estate tax marital deduction.

e. "Conduit Trusts". A conduit trust is not really a type of Marital Deduction Trust. In a conduit trust, all qualified plan or IRA distributions paid to the trust (whether MRDs or discretionary distributions made at the direction of the trustee) are immediately distributed to the beneficiary, and not accumulated for future distribution to the successor beneficiaries. Because none of the MRDs made during the spouse's lifetime can ever be accumulated for the ultimate benefit of anyone but the spouse, the spouse is treated as the sole beneficiary of the IRA or qualified plan. Treas. Reg. § 1.401(a)(9)-5 A-7, Ex. 2. If a client wants both maximum income tax deferral and to use a trust instead of an outright distribution to the spouse, the attorney should consider structuring the Marital Deduction Trust as a conduit trust. This means that, *in addition* to satisfying the requirements for the type of marital trust being employed, the trust instrument *also* must provide for the complete distribution to the spouse of all qualified plan benefits and IRA payments made to the trust.

Conduit trusts used as a marital deduction qualification vehicle are a mixed blessing. They avoid trapping income associated with qualified plan and IRA payments in the trust, where they will be taxed at the higher trust income tax rates, and they enable the spouse to maximize income tax deferral. However, if the spouse's overlife is lengthy, most or all of the IRA or qualified plan

proceeds will be distributed to the spouse, free of the trust. This may defeat, at least in part, the client's objectives in using the trust in the first instance. This is especially true if the conduit trust is also a credit shelter trust, as this outcome is usually something that the credit shelter trust is supposed to prevent. Thus, there is little point in funding a conduit credit shelter trust with retirement assets if it is believed that the spouse will live a long life. A rollover usually will be preferable.

Thus, before using a conduit trust, the attorney must ensure that it is compatible with the client's goals. An example of when to use a conduit trust is when the attorney represents a moderately wealthy grandparent who wants to use his or her GST exemption by leaving a $1 million IRA to his grandchildren, to be paid out to them over their life expectancy. The grandchildren's support comes from their wealthy parents, so the stretch-out is a realistic option for this trust. The primary purpose of the trust is to provide professional investment management and to force the beneficiaries to take advantage of the life-expectancy payout method whether they want to or not. The conduit trust is appropriate in this situation.

f. <u>Funding Credit Shelter Trusts With Retirement Benefits</u>. The problem with funding credit shelter trusts with retirement plan assets is that the mandatory distribution rules usually will cause the retirement assets to be distributed, and therefore taxed, at a faster rate than would be possible by designating alternative beneficiaries, such as the spouse or the children. This is because when an IRA or qualified plan is payable to two or more beneficiaries, it must be liquidated over the life expectancy of the oldest beneficiary. Treas. Reg. § 1.409(a)(9)-5, Q&A 7(c)(3), Ex. 1. Usually that is the spouse.

Furthermore, for estate tax purposes, the practitioner would like the assets in the credit shelter trust, which will escape the estate tax upon the death of the spouse, to grow in value. Conversely, the assets in the marital trust, which will be subject to estate tax upon the death of the spouse, should ideally be frozen or shrink in value. Funding a credit shelter trust with retirement assets, however, often produces results that are the exact opposite of these normal estate tax planning objectives. The credit shelter trust will likely be small because the retirement assets will have been fully distributed and taxed over the spouse's remaining life expectancy. At the same time, the retirement accounts that were rolled over to the spouse's IRA or qualified plan, and that will be included in the spouse's estate, could be very large because rolled over IRAs or qualified plans tend to have relatively small MRDs.

Thus, if assets other than qualified plan or IRA interests exist that can be allocated to the credit shelter trust or directly to children or other beneficiaries, and if the qualified plan or IRA is allocated to the spouse or a trust qualifying for the marital deduction, more wealth will escape estate taxation in the spouse's estate. In this situation, the spouse or the trust, rather than the credit shelter trust or the children, will be paying income tax on the distributions. Consequently, the income tax reduces the amount subject to estate tax at the spouse's death rather than the amount that passes free of estate tax at the spouse's death.

In some cases, however, a participant will not have sufficient assets outside of qualified plans and IRAs fully to fund a credit shelter trust designed to take advantage of the participant's

unified credit. In this situation, some retirement assets will be necessary to fund the full credit shelter amount. Assuming there is sufficient wealth so that all retirement assets will probably not have to be consumed over the surviving spouse's lifetime, some of the following strategies may be useful:

- Instead of transferring the entire available credit shelter amount to a single credit shelter trust that benefits both the spouse and children, consider using a portion of IRA assets to establish stretch IRAs solely for the benefit of the youngest beneficiaries. This is particularly advantageous if the other beneficiaries are considerably younger than the spouse. For example, if $800,000 of IRA assets are needed to fund the credit shelter amount for an individual who has a 78-year- old spouse and two children, consider establishing a $200,000 stretch IRA for each child and only using $400,000 for the credit shelter trust.
- Consider establishing a conduit credit shelter trust to reduce both the size of the required distributions and the income tax rate imposed on their receipt. A rollover, however, will probably be more beneficial if the surviving spouse lives a long life.

If the spouse is young, consider rolling over the entire retirement account and forgoing a credit shelter trust for any retirement assets. The significant income tax benefits from a rollover, which could last for the life of the spouse, could outweigh a speculative amount of estate tax benefits. Decisions concerning the amount that should fund a credit shelter trust or whether it should be funded at all can be implemented after the participant's death by using disclaimers.

g. <u>**When Rollovers are Not Recommended**</u>. One situation in which allowing a spousal rollover might not be desirable is if the participant is in a second marriage and would like assurance that the retirement assets will benefit children from a prior marriage after the death of the second spouse. A QTIP trust is usually the recommended beneficiary of the qualified plan or IRA benefits in this circumstance. Although a QTIP trust will ensure that property is left to the children from a prior marriage, the income tax benefits from designating a QTIP trust as beneficiary will usually be less than what can be achieved from a rollover to a spouse. Consequently, although Rev. Rul. 2006-26, *supra*, sets forth rules for enabling interests in qualified plans and IRAs passing in trust to qualify for the estate tax marital deduction, there are no income tax advantages in using a trust disposition as compared to an outright distribution to a surviving spouse.

Another situation in which a rollover might not be desirable is where the combined estates of a married couple might be subject to estate tax at the death of the surviving spouse. If all of the retirement plan assets of the first spouse to die pass to the other spouse, then the estate of the other spouse may be increased and subject to greater estate tax. Normally, this is a situation that calls for utilizing a credit shelter trust as beneficiary of the retirement plan assets, especially if there are insufficient non-retirement plan assets available to fund the credit shelter trust.

3. Marital Deduction and GST Formulas

Another situation in which a client may not want to name the spouse as the direct, unrestricted beneficiary of a qualified plan or IRA is when these assets are anticipated to be needed

to minimize estate taxes over two estates, usually by means of Marital Trust and Family Trust "zero-tax" estate planning. However, this type of estate planning is generally accomplished by means of a formula gift or bequest, which raises a special problem in the context of IRD.

A formula gift or bequest is one in which the amount of the gift is determined with reference to some external measurement. The most common formula gift is one that measures the value of the gift either with reference to the "applicable exclusion" (or "unified credit equivalent"), or with reference to the unlimited marital deduction. It would be typical, in Marital Trust and Family Trust "zero-tax" estate planning, for example, to allocate to the Marital Trust the smallest amount necessary to eliminate the estate tax, or to allocate to the Family Trust the largest amount possible without generating any estate tax. These are typically called "Marital Deduction Formulas." "GST Formulas" operate in the same way, except that they are calculated with reference to the GST exemption. A typical GST formula would allocate an amount equal to the remaining unused GST exemption to a GST exempt trust.

There are many ways to draft formula gift or bequest clauses, and the choice of language can have an effect both on the amount of property allocated to the disposition under the formula, and on the income tax consequences of allocating assets in kind in satisfaction of the formula gift. While there are many different kinds of formulas, two of the most common are "pecuniary" formulas and "fractional share" formulas. A fractional share formula allocates to the trust (or other beneficiary) that *percentage* of the trust assets required to fund the gift. A pecuniary formula allocates to the trust (or other beneficiary) that *amount or value* of trust assets required to fund the gift. (For example, the formulas described in the preceding paragraph are pecuniary formulas.) One of the primary characteristics of any gift of a pecuniary amount, including a pecuniary formula gift, is that, when assets (rather than money) are used to satisfy the gift, the transaction is treated as a sale of the assets. *Kenan v. Comm.,* 40 B.T.A. 824 (1939), *aff'd*, 114 F. 2d 217 (2d Cir., 1940); *Suisman v. Comm.*, 15 Fed. Supp. 113 (1935), *aff'd*, 83 F.2d 1019 (1936), *cert. den.* 299 U.S. 573; Rev. Rul. 56-270, 1956-1 C.B. 325; Rev. Rul. 66-207, 1966-2 C.B. 243; PLR 9507008; PLR 9315016. In the context of estate administration, the "sale" is often between related parties under IRC § 267, so that gain (but not loss) is recognized.

> **EXAMPLE:** A decedent makes a gift under his revocable trust to his daughter of $250,000. Included in the trust assets is 100 shares of XYZ Company stock, with a cost basis for measuring gain or loss of $100,000, and a fair market value of $250,000. The trustee distributes the stock to the decedent's daughter in satisfaction of her gift.
>
> The gift to the daughter of $250,000 is a pecuniary gift. The transfer of XYZ Company stock to the daughter is the transfer of assets (instead of cash) in satisfaction of a pecuniary gift. The transfer of stock to the daughter under these circumstances is considered a sale, and the trust will recognize $150,000 of capital gains income in the year of the transfer. The daughter's cost basis in the stock for measuring gain or loss on a subsequent sale is $250,000. See, *Ewing v. Comm.*, 40 B.T.A. 912 (1939); GCM 36783 (July 8, 1976).

IRC § 691(a)(2) provides that, if an item of IRD is transferred, either by the estate or anyone else, the fair market value of the right to receive that item of income (at the time of transfer) will be included in the recipient's gross income. For this purpose, the term "transfer" includes any sale or exchange. It does not include a transfer after the decedent's death to the person entitled to receive it by reason of the decedent's death. IRC § 691(a)(2).

If the satisfaction of a pecuniary gift with assets (or "in kind") is treated as a sale for federal income tax purposes, then logically the transfer of an item of IRD in satisfaction of a pecuniary formula gift is a transfer, which results in the immediate income taxation of the IRD. Most planners believe this is, in fact, what happens.

> **EXAMPLE:** Your client's revocable trust instrument provides that, at her death, an amount equal to the largest amount that can be transferred free of federal estate tax will be allocated to the Family Trust, and the balance of the trust property will be allocated to the Marital Trust. Your client's estate consists of a $3,000,000 IRA, payable to the revocable trust. The client's applicable exclusion amount is $1,000,000. After the client's death, the trustee allocates $1,000,000 of the IRA to the Family Trust and $2,000,000 of the IRA to the Marital Trust. The revocable trust will have $1,000,000 of ordinary income in the applicable taxable year as a result of using part of the IRA to fund the pecuniary amount to which the Family Trust is entitled. The transfer of the IRA in satisfaction of a pecuniary formula gift is a "sale," and a sale is a "transfer" under IRC § 691(a)(2), resulting in the immediate recognition of income.

> **EXAMPLE:** Your client's revocable trust instrument provides that at her death, a fractional share of the trust property will be allocated to a Family Trust, and the balance of the trust property will be allocated to the Marital Trust. The numerator of the faction to be allocated to the Family Trust is equal to the largest amount that can be transferred free of federal estate tax. The denominator of the fraction is the value of the trust property. Your client's estate consists of a $2,500,000 IRA, payable to the revocable trust. The client's available applicable exclusion amount is $1,000,000. This produces a fraction (in this case) of 40% ($1,000,000/$2,500,000). After the client's death, the trustee allocates 40% of the IRA to the Family Trust and 60% of the IRA to the Marital Trust. The revocable trust will not recognize any income in the applicable taxable year as a result of using part of the IRA to fund the fractional amount to which the Family Trust is entitled. The transfer of the IRA is *not* in satisfaction of a pecuniary formula gift, so it is *not* a "sale." Because it is not a sale, it is not a "transfer" under IRC § 691(a)(2). Instead, it is a non-taxable transfer to the person entitled to receive the IRA by reason of the decedent's death.

As indicated in the preceding example, this problem is easily avoided. It often is possible to fund the pecuniary formula gift with other assets and not IRD. Further, planners may wish to avoid the use of a pecuniary formula when the estate consists in large part of IRD and instead use a fractional share formula. Another method of dealing with this problem is specifically to allocate items of IRD to a particular beneficiary or trust, perhaps employing cut-back or limiting language (in the case of a trust) or consider the use of disclaimers (in the case of individuals) to deal with the possibility that the trust or other beneficiary will receive more than was intended. See, e.g., Rev. Rul. 55-117, 1955-1 C.B. 233; PLR 9537011. But in all events, be aware of the issue, whenever a client's estate includes large items of IRD. For example, a beneficiary designation that specifies that a portion of a plan benefit or IRA, up to a certain dollar amount (which could be determined under a pecuniary marital deduction formula), should not cause the acceleration of income, because the payment of the qualified plan or IRA benefits is not satisfying an obligation of the estate.

This problem is not limited to qualified plans and IRAs. It could arise with any items of IRD, including installment sales contracts, non-qualified employee benefits, annuities and so on. Nor is this issue limited to pecuniary formula gifts. Any kind of pecuniary gift (*i.e.*, "I give my friend Jack $1,000,000) could attract this problem.

➔ **Planning Point:** If you are required by circumstances to fund a pecuniary gift with qualified plan or IRA assets, consider withdrawing assets from the plan, reserving the income tax on the withdrawn funds, and funding the gift with the net proceeds. The allocation of the right to receive an IRA or qualified plan in satisfaction of a pecuniary gift will have the same income tax result. But if the assets remain in the plan when the right to receive the plan benefits is allocated to the beneficiary, will subsequent distributions from the plan be taxed to the beneficiary for federal income tax purposes *again*?

➔ **Planning Point:** An often recommended beneficiary designation for qualified plans and IRAs is to name the spouse as the primary beneficiary (if the spouse survives the participant), and the Family Trust (or other nonmarital disposition) as the contingent beneficiary (if the spouse predeceases the participant). The thought behind this approach is that, by naming the spouse first, the spouse has every opportunity to maximize wealth by deferring income taxes. If there are not enough assets fully to fund the Family Trust from other sources, the spouse has the option to disclaim part of the qualified plan interest or IRA. In most jurisdictions, disclaimed property passes as if the disclaiming beneficiary (in this case, the spouse) had predeceased the decedent. As a result, the disclaimed portion will pass to the Family Trust and supplement its funding. Such a disclaimer would not result in the surviving spouse's making a taxable gift of the IRA to the Family Trust. By specifically naming the Family Trust as the contingent beneficiary, the IRC § 691(a)(2) issue discussed above is

> avoided. The qualified plan or IRA proceeds also end up in the right place if the spouse actually predeceases the participant.
>
> A variation on this theme is to name the participant's revocable trust as the contingent beneficiary, and to include in the revocable trust language that specifically allocates IRD to the appropriate beneficiary.

It is important to keep in mind that in most cases the use of a trust as the beneficiary of a qualified plan or IRA will not provide for the greatest amount of income tax deferral. Consequently, there often is a trade off to be made at the death of the first spouse to die. Either the client minimizes estate taxes by fully funding the credit shelter amount with plan benefits (which, as IRD, may not fully fund the credit shelter amount in any case), or the client minimizes income taxes by paying the retirement plan benefits to the spouse. It is important that the client understand this trade off.

The approach discussed in the planning point permits the spouse to make a decision regarding this trade off based on the circumstances that exist at the time of the participant's death, and to use disclaimers to achieve the desired result at that time. This approach is not perfect, of course, as the spouse also must disclaim any powers of appointment over the disclaimed benefits, limiting the flexibility of the credit shelter trust. Also, the time period within which a disclaimer may be made (nine months from the participant's death) could elapse. Still further, the spouse may inadvertently accept the benefits before disclaiming, thus destroying his or her ability to disclaim them. Furthermore, the spouse may choose not to disclaim, even if good tax planning would clearly indicate the desirability of disclaiming, particularly if the trust to which the disclaimed benefits will pass restricts the spouse's access to funds. However, when a nonmarital trust is needed primarily for estate tax minimization at the second death, this approach has merit, especially in the current estate tax environment of constant change. Other solutions might include making the credit shelter trust a conduit trust, or using a Charitable Remainder Unitrust as the credit shelter vehicle (discussed below).

4. Tax Apportionment Issues

There are no Internal Revenue Code provisions providing for tax reimbursements for qualified plans or individual retirement accounts taxable under IRC § 2039, other than general transferee liability. If a qualified plan or IRA passes to beneficiaries outside the provisions of a decedent's will and revocable trust, the issue of how estate taxes on those qualified plans and IRA benefits are to be paid must be addressed.

A non-apportionment tax clause in your estate planning documents, which allocates the burden of tax payments to the residue of the estate (whether passing by will or revocable living trust) might bankrupt an estate, or create a significant disproportion in the distribution of assets. Conversely, the apportionment of the tax burden to the qualified plan or IRA beneficiaries might force the beneficiaries to withdraw funds from the plan or account prematurely in order to meet their estate tax obligations, minimizing the potential for income tax deferral. The distribution of funds from a qualified plan or IRA to pay estate taxes will accelerate the income taxation of the distribution. It also will further increase the tax burden imposed on the beneficiary, by creating

an income tax liability to the beneficiary with respect to income the beneficiary does not have, or cannot keep.

There also is the concern that if a qualified plan or IRA is required to contribute to the payment of estate taxes, the estate is functionally a beneficiary of the qualified plan or IRA. The estate is not a designated beneficiary for purposes of the minimum distribution rules, so that if the estate is functionally a beneficiary of the account or plan, distribution of the plan benefits after the participant's death over the lifetime of the beneficiary may not be available. Finally, there always is the question of how to calculate a tax that is to be apportioned, and whether that calculation should be made at marginal estate tax rates or at average estate tax rates. Without statutory guidance, the method of making the calculation, including who is to get the benefit of deductions or credits associated with the distribution, needs to be addressed.

A number of states, either by statute or case law, have developed a scheme for the apportionment of estate taxes to non-probate property that may provide for tax apportionment to employee benefit plans. The Uniform Estate Tax Apportionment Act and the Uniform Probate Code each contain such provisions. Some planners also have argued that tax apportionment under IRC § 2036 may apply to employee benefit plans, though there is no published IRS authority or case law to support the argument.

The issue of who is responsible for the payment of estate taxes on qualified plan benefits and IRAs should be carefully provided for in the estate planning documents whenever the surviving spouse, a qualifying marital deduction trust, a qualified charity or the participant's estate (or other vehicle that provides for the payment of taxes) are not named as the only beneficiaries of the plan proceeds at the participant's death.

5. Charitable Gifts with Qualified Plans and IRAs

The use of employee benefits such as qualified plans and IRAs for charitable giving after-death is extremely tax efficient. A qualified charity is both income and estate tax exempt, and the payment of such benefits to charity is income tax free. PLR 9253038; PLR 9237020.

> **EXAMPLE**: Assume a client with a taxable estate wants to make a gift at his death of $100,000 to charity, and $100,000 to his niece. The client has a $100,000 IRA. Here is how the net after-tax gifts look if the IRA is given to charity, or the niece. Assume the client's estate tax bracket is 45%, and that the niece is in a 25% income tax bracket. Paying the IRA to the niece produces a 45% estate tax on the client's gift to the niece, and a 15% income tax on the IRA payable to the niece, after the applicable income tax deduction under IRC § 691(c).

IRA to Charity			***IRA to Niece***		
Charity	***Niece***	***IRS***	***Charity***	***Niece***	***IRS***

$100,000	$55,000	$45,000	$100,000	$40,000	$60,000

While this approach fails to take into account any benefit the niece might derive from the income tax deferral she could enjoy if she were named as the beneficiary of the IRA, in many cases the benefits of using IRD to fund charitable gifts outweigh even these additional benefits. The advantage applies equally to all items of IRD, including non-qualified employee benefit plans, stock options and other assets burdened by income tax.

This planning strategy was difficult to implement for qualified plans and IRAs when lifetime MRDs were tied to the identity of the participant's designated beneficiary. This is no longer the case. Lifetime income tax deferral is not affected by naming a charitable beneficiary to receive a qualified plan or IRA at the participant's death.

a. **<u>Charitable Remainder Trusts</u>**. This planning strategy also can be implemented by naming a Charitable Remainder Trust ("CRT") as the beneficiary of a qualified plan or IRA. A CRT is a trust that pays to a non-charitable beneficiary a fixed annuity or a percentage of the trust assets valued annually (a "unitrust" interest), for life or for a period of years. At the end of the non-charitable interest, the remaining trust assets pass to charity. The CRT is not a qualified trust, for purposes of identifying the designated beneficiary of a qualified plan or IRA, but this is unimportant, as the plan proceeds can be paid to the CRT, an income tax exempt entity, in a lump sum distribution, without income tax. PLR 9634019; PLR 9237020. The value of the annuity or unitrust interest payable to the non-charitable beneficiary of the CRT will not be exempt from estate tax. But there will be an estate tax charitable deduction for the present value of the charitable interest. If the spouse is the only non-charitable beneficiary of the CRT, the spouse's interest will qualify for the federal estate tax marital deduction. IRC § 2056(b)(8). If there are other family beneficiaries of the CRT, the CRT still might be used for the estate tax free portion of the estate.

The proceeds of the qualified plan or IRA in the CRT will remain and grow on an income tax exempt basis, the same as if they had remained in the qualified plan or IRA. Distributions to the non-charitable beneficiary will be subject to ordinary income tax, for the most part, again, the same as if they were paid from a qualified plan or IRA. But the minimum distribution rules will not apply, and the non-charitable beneficiary's interest will be as it is defined in the CRT - no more, and no less.

6. Non-Tax Issues In Estate Planning For Qualified Plans and IRAs

a. **<u>Retirement Equity Act of 1984</u>**. The Retirement Equity Act of 1984 ("REA") requires that defined benefit plans, money purchase plans, profit sharing plans (including HR-10 or KEOGH plans but *not* IRAs) and stock bonus plans all provide survivor benefits (both pre- and post-retirement) in the form of a survivor annuity or qualified (50%) survivor annuity for the surviving spouse of any vested plan participant. There is an exception to this requirement for profit sharing and stock bonus plans that applies if the participant does not elect distribution in the form of a life annuity and the plan provides that 100% of the account balance will be paid to the participant's surviving spouse at death (the "profit sharing plan exception"). Defined contribution plans otherwise satisfy the pre-retirement survivor annuity requirement if 50% of the participant's vested account balance is applied to the purchase of an annuity for the spouse.

Generally, participants may waive the survivor annuity requirements, but the participant's spouse must consent to the waiver in writing before either the plan administrator or a notary public. The spouse's consent must acknowledge the effect of the waiver. The spouse also must consent to the designation of a beneficiary other than the spouse (if the profit sharing exception applies), and to any cash out of annuity benefits payable at death or on retirement. If a spouse consents to the waiver of the spouse's survivor benefits during the participant's lifetime, this is not a gift by the spouse IRC § 2503(f). There are no provisions, however, describing the gift tax treatment that may apply to post-death waivers or consents. Nor is it entirely clear that REA rights can be disclaimed after death in a qualified disclaimer under IRC § 2518.

b. ERISA Preemption. The Supreme Court has held that ERISA preempts state law rules that are not consistent with qualified plan requirements. In *Boggs v. Boggs*, 118 S. Ct. 9 (U.S. 1997), the Supreme Court specifically held that ERISA preempts the community property law rights of the non-participant spouse with respect to qualified plan assets. In another case, the Supreme Court ruled that state laws revoking beneficiary designations after divorce do not apply to ERISA plans. *Egelhoff v. Egelhoff ex rel. Breiner*, 121 S. Ct. 1322 (S. Ct., 2001).

Although, like *Boggs*, the *Egelhoff* case only applies to ERISA plans, and not IRAs or other nonprobate assets, its implications may be dramatic. The dissent, written by Justice Breyer, describes the usefulness of relying on state property and inheritance laws to resolve ambiguities in the administration of ERISA plans. "Why would Congress want the courts to create an ERISA-related federal property law to deal with such problems?" asks Justice Breyer (*at p. 1332*). Nonetheless, after *Egelhoff*, it will be difficult to predict whether state laws will be preempted by ERISA in such matters as disclaimers, missing persons, presumption of fact or order of deaths, competency at the time of execution, so-called "slayer" statutes, the construction of ambiguous or contradictory language and many other issues.

c. Community Property Issues. As a result of the Supreme Court decision in *Boggs v. Boggs*, supra, it is clear that ERISA and REA preempt the application of community property laws in community property jurisdictions, at least with respect to qualified plans. However, ERISA preemption and REA do not apply to individual retirement accounts or to nonqualified plans. As a result, community property law issues must be considered both with respect to the participant and the non-participant spouse in a nonqualified plan or IRA, to the extent that the participant was married and resided in a community property state during his or her employment.

Community property laws vary considerably from state to state, and do not always address clearly how they apply to IRAs and other employee benefit plans not governed by ERISA. The community property rules of a jurisdiction may apply differently in the event of a divorce, than they do on death (as is the case under ERISA, which recognizes the ability of the state court to divide a qualified plan on divorce by means of a qualified domestic relations order,

or QDRO, but does not permit a similar division on death). The community property rights of the parties may or may not be addressed in the IRA trust or other governing instruments for the plan, and even if they are addressed still may be superseded by state law. Few, if any, courts have attempted to reconcile state community property laws with IRC § 408(g), which expressly provides that IRC § 408 (which governs the qualification requirements and taxation of IRAs and

distributions from IRAs) "shall be applied without regard to any community property laws."

Given this state of the law, be forewarned, and seek the advice of a knowledgeable state law community property expert whenever this issue arises outside of your own jurisdiction.

d. **Beneficiary Designation Issues Involving Retirement Benefit Administrators**. Although plan documents governing qualified plans have to comply with IRS requirements, they do not have to include all available options allowed by the IRS and may specify their own rules regarding investments, distributions and defaults, to the extent not inconsistent with the Code and ERISA. As mentioned above, administrators of qualified plans generally prefer to distribute a deceased participant's interest in the qualified plan as quickly as possible and with the most administrative ease. Therefore, certain beneficiary designations, as well as certain dispositive schemes, for qualified plan interests may not be permitted by the plan documents. Estate planners should ensure that the plan document governing their client's interest in the qualified plan allow for the client's desired dispositive scheme. Further, the plan document may require that a participant obtain the plan administrator's affirmative consent to certain beneficiary designations made on the beneficiary form.

Additional problems may arise from the beneficiary designation form itself. The form may not have enough space for the designation of multiple primary beneficiaries or multiple contingent beneficiaries. Thus, the participant may accidentally eliminate beneficiaries of the participant's retirement plan.

➔ **Planning Point:** Even if the plan document does not require the participant to obtain the affirmative consent of the plan administrator, the attorney should nevertheless take steps to ensure that a written confirmation of approval is obtained from the plan administrator when the beneficiary form is submitted. This approach may help to avoid any serious dispositive problems that could otherwise arise after the participant's death.

Yet another problem arises when designating a trust as the beneficiary of a qualified plan or IRA. In the normal course of trust administration, trust assets are allocated among or distributed to the trust beneficiaries, who may be individuals or continuing trusts for the benefit of those individuals. There is no tax or trust law reason why the right to receive benefits under a qualified plan or IRA could not be allocated or distributed in the same way. Rev. Rul. 78-406, 1978-2 C.B. 157; PLR 200008044; PLR 199947036; PLR 9751037. However, in some cases the plan administrator or IRA sponsor will interpret a beneficiary designation literally, and insist on paying the plan benefits to the named trust, even though there is no other reason for the named trust's continued existence. This interferes with Marital and Family Trust splits, allocation among separate trusts for different beneficiaries, the distribution of trust assets at stated ages, among other issues. Even in the best case, it precludes the efficient administration of the trust. Some plan administrators have argued that this approach is required, as no one is permitted to transfer an interest in a qualified plan or IRA. It is not always possible to persuade them that this form of devolution is not a transfer, but simply the passage of entitlement by operation of the terms of the beneficiary trust.