RETIREMENT PLANS

Prepared for 1998 Tax for the General Practitioner
Missoula, Montana
October 15, 1998

by

RICHARD M. BASKETT
Attorney/CPA
Suite 234
210 N. Higgins Ave.
Missoula, Montana 59802

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I. INTRODUCTION

A. Beneficiary Designations

1. This presentation will cover retirement plans with an emphasis on distribution rules and beneficiary designations.
2. To understand the distribution rules and beneficiary designation, it is necessary first to have an understanding of the types of retirement plans that are available, and the requirements that apply to those different types of plans.

B. Qualified Plans

1. Qualified plans entitle the employer to a current income tax deduction while the employee is not required to take any amount into income until actual receipt, which often is several years later.
2. But they are also complex and must meet strict requirements in order to be "qualified."

C. Nonqualified Plans

1. Nonqualified deferred compensation arrangements defer the reporting of income by the employee, as do qualified plans, but do not entitle the employer to a current deduction; that is available only at the same time as the employee is required to report the income.

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[1]This outline derives substantial portions from an outline prepared by the author entitled "Income and Estate Planning with Respect to Qualified Plan Accounts" and presented at the 1995 CLE & Ski sponsored by the State Bar of Montana.

2. Although the tax treatment is not as beneficial for the employer, the deferred compensation arrangement is not required to comply with the many requirements that apply to qualified plans, such as nondiscrimination, vesting and funding requirements found beginning at §401 of the Internal Revenue Code. Consequently it is possible to provide such nonqualified deferred compensation arrangements to select individuals without having to make them generally available to all employees.

D. Caution

1. Because this outline is geared to a review of general principles, necessarily many important details are omitted.
2. Before relying on anything in this outline, the attorney should carefully review the applicable Internal Revenue Code provisions and related regulations.

II. INCOME TAX BENEFITS OF QUALIFIED PLANS

If a plan is qualified, then it has federal income tax benefits which include the following:

1. The employee gets an immediate tax deduction for contributions made to the plan.[2]
2. The fund established to provide benefits is tax-exempt.[3]
3. The employee-participant is not taxed on his share of the fund until it is distributed to him, which is normally after retirement.[4]
4. Qualifying lump-sum distributions receive favorable tax treatment.[5]
5. Tax is deferred on qualifying distributions of appreciated employer stock until the stock is sold.[6]

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[2]IRC §404
[3]IRC §501(a)
[4]IRC §402; Reg. §1.402(a)-1
[5]IRC §402(d)
[6]IRC §402(e)(4)

III. REQUIREMENTS FOR "QUALIFIED" PLANS

A. Requirements

All defined benefit plans and defined contribution plans must comply with certain requirements in order to achieve the favorable tax results afforded under §401 of the Internal Revenue Code:

1. A qualified plan must have a definite written program setting forth all of the essential elements relating to benefits, rights and obligations.[7]
2. The plan must be communicated to all employees who are potential participants.[8]
3. The plan must be a permanent and continuing program.[9]
4. The plan must have a funding arrangement. A plan that has no funding arrangement but provides that the employer will pay monthly pensions directly to retirees does not qualify.[10]
5. All contributions to the plan must be made either by the employer or by the employees.[11]
6. The plan must be established by an employer for the exclusive benefit of the employees and their beneficiaries.
7. The plan may not discriminate in favor of highly compensated employees.[12]
8. The plan must meet special requirements regarding vesting, minimum contributions for rank-and-file employees, and maximum contributions for key employees if the plan is top-heavy.[13]
9. The plan must meet specified minimum standards regarding participation by employees.[14]

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[7]Reg. §1.401-1(a)(2)
[8]Id.
[9]Reg. § 1.401-1(b)(2).
[10]Rev. Rul. 71-91, 1971-1 CB 116.
[11]IRC §401(a)(1).
[12]IRC §401(a)(4).
[13]IRC §§401(a)(10), 416
[14]IRC §§401(a)(3), 410

10. The plan must meet minimum requirements regarding vesting of benefits.[15] and must provide that participants' rights to benefits vest at certain rates in the course of the participants' employment.

11. The plan must meet minimum coverage standards.[16]

12. The plan must provide for the commencement of benefits within a specified period of time, generally not later than the sixtieth day after the participant either:

    a. terminates employment;

    b. reaches the age of sixty-five or, if earlier, the normal retirement age specified in the plan; or

    c. reaches the tenth anniversary of the year in which the participant commenced participation in the plan.[17]

13. The plan must provide that an employee's benefits must begin not later than April 1 of the calendar year following the year in which he reaches age 70½. In the case of a governmental plan or church plan, the required beginning date is the later of the date determined under the preceding sentence or April 1 of the calendar year following the year in which the employee retires.[18]

14. The plan must meet specified requirements as to the period of time over which all the benefits to which the employee is entitled are to be distributed.[19]

15. If an employee terminates employment when he has met the minimum years-of-service but not the minimum age requirement, the plan must provide for benefits to be paid upon the employee's reaching minimum age.[20]

16. If the plan is a pension plan, it must provide definitely determinable benefits. If the plan is a profit-sharing plan, it must contain a definite formula for allocating contributions and distributing funds on the occurrence of certain events.[21]

17. The plan must limit to a specified extent the contribution or benefits that may be

[15]IRC §§401(a)(7), 411
[16]IRC §§401(a)(3), 410(b)
[17]IRC §401(a)(14).
[18]IRC §401(a)(9)(C).
[19]IRC §401(a)(9).
[20]IRC §401(a)(14).
[21]Reg. §1.401-1(b)(2)(ii).

provided to an individual employee.[22]

18. The plan must prohibit the assignment or alienation of benefits.[23]
19. Any plan that pays benefits in the form of annuities must provide for payment of benefits in the form of a joint-and-survivor annuity to cover the employee and his surviving spouse unless the employee, with the consent of the spouse, otherwise elects.[24]
20. The plan must provide that, should the plan terminate as a result of a merger or consolidation with or a transfer of assets or liabilities to any other plan, each participant of the plan must receive a benefit equal to or greater than the benefit he would have been entitled to receive if the plan were terminated before the merger, consolidation, or transfer of assets.[25]
21. Any plan that is integrated with social security may not decrease the benefits of a retired employee because of increases in social security benefit levels.[26]
22. The plan must generally prohibit forfeiture of benefits attributable to contributions of the employer because the employee withdraws amounts attributable to his own contributions.[27]
23. For purposes of determining the limitations on deductible employer contributions to an employees' trust or annuity plan, any part of the annual compensation of an individual employee that exceeds $150,000 must be disregarded.[28] This amount is adjusted annually for inflation.

B. Plans That Become Nonqualified

1. When a trust becomes nonqualified, it loses its tax-exempt status.[29]
2. All trust income for year becomes taxable.
   a. Employer’s contributions become taxable income to participants in year of disqualification.

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[22]IRC §§ 401(a)(16), 415.
[23]IRC §401(a)(13).
[24]IRC §401(a)(11).
[25]IRC §401(a)(12).
[26]Reg. §1.401(a)-15(a).
[27]IRC §401(1)(19)
[28]IRC §401(1), as amended by Omnibus Budget Reconciliation Act of 1993, Pub.L. No. 103-66, 103rd Congress, 1st Sess. §13212(c) (August 10, 1993).
[29]IRC §501.

b. Distributions:

(1) Do not qualify for lump-sum averaging

(2) Taxed as annuities.

(3) Impact: Generally taxed as ordinary income to participant in year of distribution.[30]

3. What if the reason the plan becomes nonqualified is because it fails to meet the minimum participation or minimum coverage requirements?

a. Does not affect *all* employees.

b. Employees who are not highly compensated will be treated as if the trust were tax exempt.

IV. TYPES OF QUALIFIED PLANS

A. In General

1. Categories of Qualified Plans

a. There are two types of qualified plans:

(1) Defined Contribution Plans; and

(2) Defined Benefit Plans.

2. Distinguishing Defined Benefit Plans from Defined Contribution Plans

a. With a defined contribution plan, the amount that may be contributed is known, but the amount of the eventual benefit is not. The amount of the benefit will depend on the performance of the investment of the plan between the time the contributions are made and the time any withdrawals or distributions are taken from the plan.

b. On the other hand, a defined benefit plan is one where the benefit is known and the contribution generally will be made in such a manner as to fund the benefit. This latter type of plan was much more common in the past but the defined contribution plan is undoubtedly the more common plan today, at least among smaller employers. Actual calculations of the amount necessary to fund benefits under a defined benefit plan are required and so these kind of plans

[30]IRC §402(b); Reg. §1.402(a)-1(a)(1)(ii), (v).

tend to be more complex than the defined contribution plan. On the other hand, defined benefit plans frequently provide an opportunity to make larger contributions into the plan than would be permitted under a defined contribution plan and so they do still have their applicability even for smaller employers. Unlike defined contribution plans, defined benefit plans do not have individual accounts for each participant.

B. Defined Contribution Plans

1. Overview

a. One of the identifying features of a defined contribution plan is that each participant has an individual account. The eventual benefit from the plan will be determined solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.[31] The plan must define the amount of contribution to be allocated to each participant's account. There are a variety of ways of doing this. In a money-purchase pension plan, the amount of the employer's contribution on behalf of each employee may be specified in the plan document. On the other hand, a profit-sharing plan may leave the amount of the annual contribution completely to the employer's discretion. Where the plan in discretionary, however, the method for allocating the employers contribution among the participants must be specified.[32]

b. A participant in a defined contribution plan will forfeit any nonvested portion of the plan if the participant terminates employment before becoming fully vested. The forfeited contributions will be used to pay administrative expenses of the plan, to reduce future employer contributions, or to increase the accounts of the remaining participants.[33]

c. Although there are several forms of defined contribution plans, two of the basic types are pension plans and profit-sharing plans.

2. Pension Plans

a. A Pension plan may be either a defined benefit plan or a defined contribution plan.[34]

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[31] IRC §414 (i).
[32] Reg. §1.404-1(b)(1)(2i).
[33] Reg. §1.401-2(a)(2)
[34] IRC §414(i)

b. All pension plans are established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees.[35]

  (1) The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits.

  (2) Benefits are not definitely determinable if funds arising from forfeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants.

  (3) A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will be considered a pension plan if the employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits, or, as in the case of money purchase pension plans, such contributions are fixed without being geared to profits.

  (4) A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise. However, a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in section 401(h) as defined in paragraph (a) of section 1.401-14).

c. Defined contribution pension plans fall into two categories:

  (1) Target-benefit plans

  (2) Money-purchase plans

d. Target Benefit Plans

  (1) Regular defined benefit plans require periodic adjustments to actuarial assumptions

  (2) Target benefit plans are designed to avoid the need for periodic adjustments

  (3) Retirement benefits are equal to contributions plus earnings

[35] Reg. §1.401-1(b)(1)(i)

i) So ERISA classifies these as defined contribution plans.

ii) Based on original actuarial computations, but those are not subsequently adjusted.

iii) So, similar to defined benefit plans in that based on computation of benefit at retirement, but classified as defined contribution plan for ERISA.

iv) Subject to annual contribution limits under IRC §415.

e. Money-Purchase Pension Plans

(1) The participant's benefit depends on individual account balance.

(2) These are classified as defined contribution pension plans.

(3) Note: minimum funding requirements apply to these plans, which typically apply to defined benefit plans.

(4) Contributions to these plans are computed by formula.

(5) Contributions are mandatory.

i) So, distinguish these from profit sharing plans.

ii) Excise tax is imposed for failure to make contribution.[36]

3. Profit-Sharing Plans[37]

a. A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in profits by employees or their beneficiaries. A specific percentage of profits is not required, but the contributions must be substantial and recurring.

(1) The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. A formula for allocating the contributions among the participants is definite if, for example, it provides for an allocation in proportion to the basic compensation of each participant.

(2) The plan will not be qualified if the contributions to the plan are made at

[36]IRC §412.
[37]Reg. §1.401-1(b)(1)(ii)

such times or in such amounts that the plan in operation discriminates in favor of officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

(3) A profit-sharing plan is primarily a plan of deferred compensation, but may be used to provide for incidental life or accident or health insurance.

b. An employer can make contributions to a qualified profit-sharing plan even though the employer does not have current or accumulated profits or is a tax-exempt organization.[38]

c. Age-Weighted Profit Sharing Plans

(1) In an age-weighted plan, each employee is given points based on age, service, or compensation.

(2) Employer contributions and forfeitures are then allocated in proportion to each employee's total points. Under age-weighted plans, older employees have significant advantages.

d. Thrift and Savings Plans

(1) Under a thrift plan, contributions to the plan are based on a specified percentage of their salaries. The percentage is the same for all participants. The employer will then match the employee's contribution, dollar-for-dollar or in some other specified manner.

(2) Under a savings plan, voluntary contributions by employees are not limited to any specific compensation percentage.

(3) Under both plans, voluntary employee contributions, plus earnings, may be withdrawn before retirement or termination.

4. Stock Bonus Plans

a. A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company.[39]

b. For the purpose of allocating and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, such a plan is

[38]IRC §401(a)(27)(A)
[39]Reg. §1.401-1(b)(1)(iii)

subject to the same requirements as a profit-sharing plan.[40]

5. ESOP's

a. An employee stock ownership plans, ("ESOP"), is either a stock bonus plan or a stock bonus and a money purchase plan, designed to invest primarily in qualifying employer securities.[41]

b. Employer corporations may qualify for additional tax breaks if requirements are met.

6. 401(k) Plans

a. Plans commonly known as "401(k) plans" are cash or deferred arrangements (CODAs) which permit an employee elect either to take a specified amount in cash or to have the employer pay that amount on the employee's behalf to a qualified trust.

b. The qualified trust can be under a profit-sharing plan, a stock bonus plan, a pre-ERISA money-purchase plan, or a rural cooperative defined contribution pension plan.[42]

c. The maximum tax-deferred amount is $9,500 for 1997.[43] Anything over that must either be corrected, that is, distributed by April 15 of the following tax year[44], or included in the employee's gross income.[45]

d. A 401(k) plan must meet not only the general requirements of a qualified plan, but also special additional requirements.[46]

e. Amounts may be distributable for employee hardship (for profit-sharing or stock bonus plans) or the employer's disposition of substantially all of its trade or business, or a subsidiary.[47]

f. For years beginning after December 31, 1997, self-employed individuals may make matching contributions to a 401(k) plan with them being treated as elective contributions; consequently, the matching contributions are not subject

[40]Reg. §1.401-1(b)(1)(iii)
[41]IRC §§409 and 4975(e)(7)
[42]IRC §401(k)
[43]IRC §402(g)(1) and 402(g)(5)
[44]Reg. §1.402(g)-1(e)(2)(ii)
[45]Reg. §1.402(g)-1(a)
[46]*See* IRC §401(k)(2), (3), (11) and (12)
[47]IRC §401(k)(2)(B)

to the limit on elective contributions ($9,500 for 1997).[48]

g. Before this change, made by the Taxpayer Relief Act of 1997, matching contributions for the self-employed were treated as additional elective contributions.

C. Defined Benefit Plans

1. Definition

a. A defined benefit plan is any plan *other* than a defined contribution plan.[49]

b. Defined Benefit Pension Plan:

(1) Provides systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement.[50]

(2) Common determinants of amount of benefit:

i) Compensation

ii) Length of service

(3) Contributions

i) Actuarially determined

2. Various Types of Benefit Formulas

a. Unit Benefit Formulas

(1) Depend on length of service

b. Flat Benefit Formulas

(1) Depend on compensation

c. Cannot discriminate in favor of highly compensated employees

d. Formula must be stated in plan

3. Annuity Plans

a. Annuity plans are defined benefit pension plans funded through the direct purchase by the employer of an annuity contract or contracts from an insurance

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[48]IRC §402(g)(9)
[49]IRC §414(j).
[50]Reg. §1.401-1(b)(1)(i).

company.[51]

b. No trust is used.

D. Contribution Limits

1. Defined Contribution Plans

a. Contributions to a defined contribution plan are limited to the lesser of:

(1) $30,000; or

(2) 25% of compensation.[52]

b. The compensation that can be counted for this purpose is indexed for inflation. For 1997 and 1998, the cap is set at $160,000.

c. This limitation applies to the sum for any year of:

(1) employer contributions,

(2) employee contributions, and

(3) forfeitures.[53]

2. Defined Benefit Plans

a. Contribution to a defined benefit plan must be limited so that the participant will not receive an annual benefit greater than whichever of these is less:

(1) $90,000, adjusted for inflation; or

(2) 100% of the participant's average compensation, not to exceed $150,000, for the three highest consecutive years.[54]

b. The $90,000 limit is subject to annual adjustment for inflation, from October 1, 1986. In 1997, the indexed dollar amount is $125,000 and for 1998, $130,000.

c. The $150,000 cap on participant's compensation is inflation adjusted. For 1997 and 1998, the cap is $160,000.

[51] IRC §§403(a)(1) and 404(a)(2)
[52] IRC §415(c)(1)
[53] IRC §415(c)(2)
[54] IRC §415(b)

V. IRA's AND OTHER PLANS

A. In General

1. Several types of retirement plans are not "qualified plans" for purposes of IRC §401(a), but still enjoy the tax advantages of qualified plans.
2. Individual retirement accounts and variations of it are included in this category.

B. Individual Retirement Accounts

1. Deduction Limit

a. The maximum amount allowable as a deduction for a contribution to an individual retirement account (IRA) is $2,000. If the taxpayer's compensation for the year is less than $2,000, the limit is the amount of his compensation.[55]

(1) This limitation does not apply to SEPs.[56]

(2) Nor does the limitation apply to SIMPLE retirement accounts.[57]

2. Spousal IRA's

a. A married taxpayer who files a joint return may contribute to an IRA and deduct whichever is less:

(1) $2,000, or

(2) the sum of

i) that taxpayer's includible compensation for the tax year, plus

ii) the includible compensation of the taxpayer's spouse reduced by the spouse's allowable IRA deduction for that tax year.[58]

b. In other words, each spouse may make deductible contributions of up to $2,000, including a spouse with less than $2,000 compensation for the year, as long as their combined compensation for the year equals or exceeds the amount contributed.

c. The dollar limitation is reduced if either spouse is an active participant in an employer-sponsored plan. The reduction is in an amount that bears the same

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[55] IRC §219(b)(1)
[56] IRC §219(b)(2)
[57] IRC §219(b)(4)
[58] IRC §219(c)

ratio to $2,000 that the AGI shown on the joint return in excess of $40,000 bears to $10,000. As a result, the dollar limit is zero when the couple have AGI of $50,000, with the deduction reduced when AGI is between $40,000 and $50,000.

d. If either the taxpayer or the taxpayer's spouse is an active participant in a qualified plan, the limit on contributions to IRA's may be reduced, depending on the compensation of the taxpayer and the taxpayer's spouse.

e. If the taxpayer is single, the $2,000 deductible limit will be phased out once the taxpayer's adjusted gross income exceeds $30,000. After 1998, this floor is increased year by year until in 2005 it will be $50,000.[59]

f. If married filing joint, the phase-out begins at $50,000 of adjusted gross income. After 1998, this floor is increased year by year until in 2005 it will be $80,000.[60]

g. Married taxpayers filing separately may not deduct any part of their IRA contributions if either of them is an active participant in a qualified plan.[61]

h. Nondeductible IRA contributions are permitted.[62]

(1) These cannot exceed $2,500 or 100% of compensation, whichever is less, and then that amount is reduced by the amount allowable as a deduction for IRA contributions by active plan participants.[63]

(2) There is no deduction for the contribution, but the income on the contributions will accrue tax-deferred.

i. Deductions are not permitted for contributions to an IRA when:

(1) the taxpayer is 70½ years old or older;[64]

(2) the contribution is to an inherited IRA.[65]

3. Prohibited Transactions

a. The owner of an IRA cannot:

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[59] IRC §219(g)
[60] IRC §219(g)
[61] IRC §219(g)(3)(B)(iii)
[62] IRC §408(o)(1).
[63] IRC §408(o)(2)(B)(i)
[64] IRC §219(d)(1).
[65] IRC §219(d)(4).

(1) borrow IRA funds;

(2) sell property to the IRA;

(3) use the IRA as security for a loan;

(4) invest the IRA in collectibles.

b. Any one of these prohibited transactions will be treated as deemed premature distributions, subject to the 10% penalty tax on early distributions.

4. Distributions

a. Permissive Distributions

(1) Distributions may begin after age 59½ without penalty tax.

i) As with qualified plans, distributions prior to age 59½ are generally subject to a 10% penalty tax.

ii) Exemptions from the penalty tax are available for distributions following death, disability, for certain medical expenses or as part of substantially equal payments over the life or life expectancy of the taxpayer or the taxpayer and his beneficiary.[66]

iii) But distributions after separation from service (after age 55), or pursuant to a Qualified Domestic Relations Order are not exempted from the penalty tax.[67]

(2) Lump sum distributions from IRA's do not qualify for five-year and ten-year averaging.

b. Required Distributions

(1) Distributions from an IRA are in general subject to the same rules as distributions from a qualified plan.[68]

(2) Accordingly, distributions must begin no later than April 1 of the year following which the taxpayer attains age 70½.

i) Note that for qualified plans, the required beginning date may be postponed beyond age 70½ if the participant is not retired and is not

[66]IRC §72(t).
[67]IRC §72(t)(3)(A)
[68]IRC §408(a)(6)

a 5% or greater owner of the employer.[69]

ii) But no such postponement is available for IRA's.[70]

c. Rollovers

(1) An amount withdrawn from one IRA and contributed to another within 60 days is considered a tax-free rollover. Any portion of the withdrawal that is not rolled over within the 60-day period will be taxed as ordinary income and may be subject to the 10 percent penalty on premature distributions to those under 59-1/2 years of age.

(2) An IRA may also receive a tax-free rollover from a qualified plan.[71]

i) But if any part of a lump sum distribution from a qualified plan is rolled over to an IRA, five-year and ten-year averaging is not available.[72]

ii) And if the distribution rolled over is not a lump-sum distribution from the qualified plan, averaging is not available for a later lump sum distribution.[73]

5. Roth IRA's

a. Qualified distributions of the earnings of a Roth IRA are tax-free, but contributions are not tax deductible.[74]

b. One may make contributions both to a Roth IRA and to a deductible IRA, as well as to a nondeductible IRA, but the maximum annual contribution to all IRAs is limited to $2,000 annually.

c. Income Limits

(1) Eligibility for a Roth IRA is phased out for single taxpayers with adjusted gross income (AGI) between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000.

(2) Contributions made to Roth IRAs may be made even after an individual reaches age 70.

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[69]IRC §401(a)(9)(C)(ii)(I)
[70]IRC §401(a)(9)(C)(ii)(II)
[71]IRC §402(c)
[72]IRC §402(d)(4)(K)
[73]IRC §402(c)(10)
[74]IRC §408A

(3) Traditional IRAs can be converted to a Roth IRA without paying the 10 percent tax on early withdrawals.

i) This is available only for taxpayers with AGI less than $100,000.

ii) If the assets are rolled over before January 1, 1999, the amount included in gross income from the deemed distribution of the regular IRA will be spread ratably over four years.

iii) Married taxpayers who file separately cannot take advantage of this rollover provision.

d. Withdrawals

(1) Beginning 5 years after the first Roth IRA contribution, the taxpayer may make tax-free withdrawals:

i) After reaching age 59;

ii) To a beneficiary (or the individual's estate) after the individual's death;

iii) Upon disability;

iv) For first-time homebuyer expenses of the individual and the individual's spouse and their children, grandchildren, and ancestors (this, however, is subject to a lifetime cap of $10,000).

(2) Any distribution not qualified will be includible in income to the extent attributable to earnings and generally subject to the 10 percent early withdrawal tax. Significantly, distributions are deemed first to come out of amounts contributed, which are not taxable.

(3) A Roth IRA is not subject to mandatory distribution rules, which distinguishes it from other IRA's and retirement plans.

C. SIMPLE Retirement Plans

1. A savings incentive match plan for employees ("SIMPLE") is available for any employer who has no other employer-sponsored retirement plan, and 100 or fewer employees who received at least $5,000 of compensation for the preceding year.[75]

2. A self-employed individual qualifies as an "employee" for these plans.[76]

3. Contributions must be made under a "qualified salary reduction arrangement."

[75] IRC §§401(k)(11) and 408(p)
[76] IRC §408(p)(6)(B)

a. The arrangement must be written.

b. Employer contributions are elective.

c. Employer contributions are expressed as a percentage of compensation.

d. Employer contributions are made to a “SIMPLE retirement account” on behalf of the employee or to the employee directly in cash.

e. The amount an employee may elect for any year cannot exceed $6,000, as indexed for inflation.[77]

f. Allowable employer contributions are set forth in the IRC.[78]

4. A “SIMPLE Retirement Account” into which employer contributions under a SIMPLE retirement plan are made is an individual retirement account (IRA) or annuity.[79]

   a. Only contributions under a "qualified salary reduction arrangement" that meet vesting, participation, and administrative requirements are allowable.[80]

   b. The right of employees to all simple account contributions must be nonforfeitable.[81]

5. Elective contributions of up to $6,000 per year may be made by an employee to his or her IRA.

   a. This is available even though the maximum amount that may be contributed to a traditional IRA is $2,000.

   b. The employee deferral of $6,000 also may be matched by the employer, resulting in a maximum deferral to the SIMPLE retirement plan IRA of $12,000.[82]

6. Distributions from SIMPLE retirement plans are taxed under the rules relating to IRAs in the year of distribution.[83]

D. Simplified Employee Pensions (SEPs)

[77]IRC §§408(p)(2)(A)(i) and 408(p)(2)(A)(ii)
[78]IRC §408(p)(2)
[79]IRC §408(p)(1)
[80]IRC §408(p)(1)(A)
[81]IRC §408(p)(3)
[82]IRC §408(p)(8)
[83]IRC §402(h)(3)

1. Simplified employee pensions, or SEPs, provide that an employer will make contributions to individual retirement accounts of employees.[84]

2. Usually, each participating employee will have a separate account in a group IRA set up under IRC §408(c).

3. Deductible employer contributions are excluded from the employee's gross income.

4. A written allocation formula for employer contributions must be executed within the time for making a deductible contribution.[85]

5. Maximum allowable contributions by an employer to a SEP on behalf of an employee for any year cannot exceed the lesser of:

    a. 15 percent of the compensation from the employer includible in the employee's gross income for the year (determined without regard to the employer's SEP contribution), or

    b. the dollar limitation for defined contribution plans.[86]

6. SEPs are required to comply with participation standards.[87]

7. Employee contributions to the SEP-IRA, when an employer contributes under a SEP for the employee, are permitted, subject to the rules that apply to contributions by an individual to an IRA.

8. The employer cannot deduct more than 15 percent of the compensation paid to employees for the calendar year, cut any excess can be carried over and deducted in later years, subject to the 15 percent limitation for the carryover year.[88]

9. Contributions to a SEP will reduce the amount of allowable contributions to qualified profit-sharing and stock bonus plans and the 25 percent limitation on deductible contributions to a combination of plans.[89]

E. Salary Reduction SEPs (SARSEPs)

1. In plan years beginning before 1997, a salary reduction (cash or deferred)

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[84]IRC §408(k)

[85]IRC §408(k)(5)

[86] If the SEP is integrated with Social Security, this dollar limitation is reduced by the amount above the integration level for a highly compensated employee. IRC §402(h)(2)

[87]IRC §408(k)(2)

[88]IRC §404(h)(1)(C)

[89]IRC §404(h)(2)

arrangement could be established as part of a SEP. This was known as a "SARSEP."

2. A SARSEP may not be set up in plan years beginning after 1996, but those established before 1996 may continue to operate.
3. These are available only if the employer has no more than 25 employees at any time during the preceding year and at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP.

VI. NONQUALIFIED PLANS

A. In General

1. Nonqualified plans have their own particular uses.
2. A "nonqualified" plan does not meet the requirements of IRC §§ 401 to 419, and therefore does not qualify for the favorable income tax treatment outlined above in II.

B. Benefits of Nonqualified Plans

1. No need for written plan
2. No need to cover all employees; can be tailored for the highly compensated
3. No limitation on compensation that can be deferred (except, of course, to the limits of reasonable compensation).

C. Disadvantages of Nonqualified Plans

1. No current income tax deduction to employer
2. Employee's deferred compensation must be at risk.

D. Nonqualified Deferred Compensation Plans

1. Risks

a. The participant is at risk with deferred compensation arrangements. The key to the compensation being deferred is that it not be "constructively received" by the participant. If too much security is given to the participant for the ultimate payment of the deferred compensation (e.g., if the compensation were placed in escrow), the participant may have constructive receipt and would therefor be taxed. Until paid to the participant, any assets used to fund a deferred compensation arrangement must remain subject to the claims of the employer's creditors.[90] Any nonqualified deferred compensation arrangement is inherently risky to the participant.

b. In order to provide some comfort to the participant, a trust arrangement may be used. The IRS first approved an unfunded, nonqualified deferred compensation fund that had been established by a congregation for its rabbi. Consequently, these arrangements are frequently referred to as rabbi trusts. The IRS has issued a model rabbi trust agreement.[91]

c. Funded deferred compensation arrangements may be used, as long as the participant's interest in the fund is nontransferable and is subject to a substantial risk of forfeiture.[92] As the risk of forfeiture lapses, the income becomes taxable to the participant.

2. Estate Tax Treatment

a. The value of post-death payments under a deferred compensation arrangement is includible in the decedent's estate for tax purposes.[93]

b. Deferred compensation is income in respect of a decedent.[94] Consequently, the income will be taxable as an asset of the estate, and will still be subject to income tax as it is received, though there will be a credit against the income tax for the amount of estate tax attributable to the income.

VII. QUALIFIED SURVIVOR ANNUITIES

A. In General

1. In order to be a qualified plan, the trust must provide for payment of benefits of married, vested participants in the form of a qualified annuity.[95]
2. In addition, the plan must provide a written explanation to each participant of the qualified annuities.[96]
3. There are two kinds of qualified annuities:

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[90]Reg. §1.83-3(e); Ltr. Ruls. 8917030, 8917024.
[91]Rev. Proc. 92-64, 1992-33 IRB 11.
[92]IRC §83.
[93]IRC §2031.
[94]IRC §691.
[95]IRC §401(a)(11).
[96]IRC §417(a)(3).

a. Qualified Joint and Survivor Annuities; and

b. Qualified Preretirement Annuities

4. Whether one or the other of these annuities applies depends on whether the participant dies before or after the annuity starting date.

   a. If the participant dies *after* the annuity starting date, the plan must provide a "qualified joint and survivor annuity" for the surviving spouse.[97]

   b. If the participant dies *before* the annuity starting date, the plan must provide a "qualified preretirement survivor annuity" for the surviving spouse.[98]

B. "Qualified Joint and Survivor Annuity"[99]

1. An annuity is a "qualified joint and survivor annuity" if:

   a. It is an annuity for the life of the participant with a survivor annuity for the life of his spouse;

   b. The survivor's annuity not less than 50% and not more than 100% of the amount of the annuity payable during the joint lives of the participant and the spouse; and

   c. It is the actuarial equivalent of an annuity for the life of the spouse.

2. This is the default form of distribution for most qualified plans. *See* VII.E at page 25. Unless a special election is made waiving joint and survivor annuity (*See* VII.D at page 24), this is the form in which distributions will be made from a qualified plan to a married participant or spouse of a participant.

3. If a waiver is signed, then other options may be available, depending on the provisions of the plan. Examples of these would be:

   a. Life annuity for the participant;

   b. Joint and nonspousal survivor annuity;

   c. Annuity for a fixed term of years.

4. **Caution:** If a form of annuity other than a life annuity is chosen, there is a risk the payout would not satisfy the minimum required distribution rules.

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[97]IRC §401(a)(11)(A)(i).
[98]IRC §401(a)(11)(A)(ii).
[99]IRC §417(b).

C. "Qualified Preretirement Survivor Annuity"[100]

1. A qualified preretirement survivor annuity provides the surviving spouse of the participant an annuity for life when the participant dies before retirement.

2. The payments to the surviving spouse may not be less than the amounts that would be payable under the plan as a survivor annuity under the qualified joint and survivor annuity.

   a. If the participant dies *after* the earliest retirement age, the annuity must be computed as if the participant had retired with an immediate qualified joint and survivor annuity on the day before the participant's date of death; or

   b. If the participant dies on or *before* the participant has attained the earliest retirement age, the annuity must be computed as if the participant had:

      (1) separated from service on the date of death;

      (2) survived until the earliest retirement age;

      (3) retired with an immediate qualified joint and survivor annuity at the earliest retirement age; and

      (4) died on the day of the participant would have attained the earliest retirement age.

   c. The date for the surviving spouse to start receiving annuity payments may not be postponed beyond what would have been the earliest retirement age for the participant.

   d. In the case of a participant who dies on or before the earliest retirement age *and* who actually separates from service prior to death, the amount of the annuity is calculated by reference to the actual date of separation from service rather than the date of death.

D. Waiver[101]

1. A participant may elect to waive the requirement for a qualified joint and survivor annuity or a qualified preretirement survivor annuity.

2. The spouse must consent to the election. The consent is valid only if:

   a. it is in writing;

[100] IRC §417(c).
[101] IRC §417(a).

b. the election designates a beneficiary or a form of benefits which may not be changed without spousal consent (unless the consent by the spouse expressly permits such changes); and

c. the spouse's consent acknowledges the effect of the election and is witnessed either by a plan representative or a notary public.

3. What if the spouse refuses to cooperate (e.g., participant going through divorce)? There is no requirement to obtain the consent of the spouse if the plan representative is satisfied that the consent may not be obtained because there is no spouse, because the spouse cannot be located, or because of such other circumstances as permitted by the Regulations. But if spousal consent is required and not obtained, the plan could be liable to the surviving spouse for the survivor annuity.

4. This election is revocable during the "applicable election period."[102]

   a. For qualified joint and survivor annuities, this is the 90 day period ending on the annuity starting date.

   b. For qualified preretirement survivor annuities, this is the first day of the plan year in which the participant attains age 35 and ends on the date of the participant's death.

5. For any profit-sharing plan not subject to the survivor annuity rules, the spouse can waive the right to the death benefit at any time after the marriage.[103]

6. For all other plans, the consent may be executed at any time. But if the spouse executes the consent prior to age 35, another consent must be executed upon attaining age 35.[104]

7. Premarital agreements do not constitute effective waivers. The spouse's consent must be obtained *after* the marriage.[105]

E. Applicable Plans[106]

1. The survivor annuity requirements apply to:

   a. defined benefit plans and defined contribution plans subject to minimum funding standards of Section 412, such as money purchase pension and target

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[102] IRC §417(a)(1), (6)
[103] Reg. §1.401(a)-20, Q&A 33(a)
[104] IRC §417(a)(6)(B); Reg. §1.401(a)-20, Q&A 33(b)
[105] Reg. §1.401(a)-20, Q&A 28
[106] IRC §401(a)(11)(B).

benefit plans;

b. other defined contribution plans, such as profit-sharing and stock bonus plans, unless excepted as noted below.[107]

2. The survivor annuity requirements do *not* apply to profit sharing plans or stock bonus plans, if the plan contains the provisions specified in the Code,[108] including a provision that the plan is payable in full on the death of the participant to the participant's spouse or other duly designated beneficiary.

3. Certain ESOP (Employee Stock Ownership Plan) benefits also are exempt from the survivor annuity requirements.[109]

4. A written explanation of the QJSA's and QPSA's terms, including discussion of the right to waive the survivor annuities, must be provided to participants in plans subject to the survivor annuity rules.[110]

F. Newlyweds

1. The survivor annuity rules are not violated if the plan requires the participant and spouse to have been married throughout the one-year period ending on the earlier of:

   a. the participant's annuity starting date; or

   b. the date of the participant's death.

2. There is an exception to this exception, however, for participants who die having been married for at least one year.[111]

G. Divorce[112]

1. In general, a qualified plan may not permit a participant to assign or alienate benefits.

2. An assignment of benefits pursuant to a qualified domestic relations order (QDRO), however, is permitted. (See the discussion of QDROs in section XI of this outline, beginning at page 55).

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[107]IRC §401(a)(11)(B)(iii).
[108]IRC §401(a)(11)(B)(iii).
[109]IRC §401(a)(11)(C).
[110]IRC §417(a).
[111]IRC §417(d)(2).
[112]IRC §401(a)(13), 414(p)(5).

3. To the extent provided in any QDRO, the former spouse of a participant shall be treated as a surviving spouse of such participant for all or some purposes under the Code provisions relating to qualified joint and survivor annuities and qualified preretirement survivor annuities.

4. There is only one spouse at a time for purposes of these rules. So, to the extent an ex-spouse is deemed to be the surviving spouse pursuant to a QDRO, any current spouse cannot be.

   a. But the QDRO does not have to be all or nothing. The former spouse can be treated as the surviving spouse for one portion of the plan and the current spouse for the other.

   b. Even when the former spouse is treated as the current spouse, if the former spouse dies before the annuity starting date, the current spouse is treated as the surviving spouse, unless the QDRO provides to the contrary.

H. Gift Tax Considerations

1. An easily-overlooked gift occurs when a participant who has a vested right to an annuity from a retirement plan elects to take a reduced payment during his life so that a survivor annuity will be paid to his designated beneficiary.[113]

2. A spouse who waives the right to receive a joint and survivor annuity, however, is not deemed to have made a gift.[114]

VIII. INCIDENTAL BENEFIT RULE

A. Purpose

1. The primary purpose of a qualified plan must be to provide for retirement. The provision of other benefits, such as life insurance or death benefits, must be incidental to the purpose of accumulating funds for distribution upon retirement.[115]

2. A plan will satisfy this requirement if the present value of payments to be made to the participant is more than 50 percent of the present value of the total payments

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[113] Reg. §25.2511-1(h)(10)
[114] IRC §2503(f).
[115] Reg. §1.401-1(b)(1).

to be made to the participant and his beneficiaries.[116]

B. Required Distribution Rules

1. In 1984, required distribution rules were adopted,[117] which require in general the distributions to begin and proceed in such manner as to be completely distributed during the participant's lifetime. As a result, the use of retirement plans for accumulating assets to be distributed upon one's death is more difficult than it was prior to the required distribution rules.
2. Also, the importance of the incidental benefit rule was weakened, because there was less likelihood that someone other than the participant would receive the benefit of the plan.

C. Death Benefits

1. A plan may provide for death benefits, but is not required to.
2. If death benefits are provided, they must not exceed 100 times the monthly annuity amount, or they will not be considered incidental.

D. Life Insurance

1. Life insurance as a benefit of a *defined benefit plan* may be deemed incidental.[118]
2. In a *profit-sharing plan,* life insurance also is permitted as a benefit under restricted conditions.[119]
3. If the plan is a *money-purchase plan,* life insurance may be offered as a benefit it the requirements applicable to either profit-sharing plans or defined benefit plans are met.[120]

IX. TAXATION OF DISTRIBUTIONS

A. In General

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[116]Rev. Rul. 74-325, 1974-2 CB 127.

[117]IRC §401(a)(9).

[118]*See* Rev. Rul. 74-307, 1974-2 CB 126, *clarifying and modifying* Rev. Rul. 73-501, 1973-2 CB 127; Rev. Rul 68-453, 1968-2 CB 163.

[119]Reg. §§ 1.401-1(b)(ii), 1.403(a)-1(d); Rev. Rul. 60-83, 1960-1 CB 157; *See* Rev. Rul. 73-501, 1973-2 CB 127.

[120]Rev. Rul. 74-307, 1974-2 CB 126.

1. In general, distributions from a qualified plan are taxable income to the recipient. The contribution was deductible by the employer and not taxed to the participant, but when the distribution is made, the participant (or beneficiary) is taxed.
2. The primary exception is when the contribution was not deductible. Because income tax has already been assessed, there is no income tax when the distribution is made.

B. Classification of Income

1. Distributions are taxable as ordinary income, unless an exception applies.
2. Exceptions include the following:
   a. Five-year lump sum averaging;
   b. Ten-year lump sum averaging;
   c. Rollover distributions;
   d. Loans from plans.

C. Lump-Sum Distributions

1. "Lump-Sum"[121]

a. A distribution is "lump-sum" if the participant's entire account is distributed within 1 taxable year.

b. In addition, for self-employed participants, the lump-sum distribution must be made because of the individual's death, or it must be made after age 59½, unless the individual was previously disabled.

c. For other participants, the lump-sum distribution must be made because of the participant's death or separation from the service of the employer, or it must be made after the individual has attained age 59½.

d. In addition, to get lump-sum treatment, the recipient must elect it for all amounts received during the tax year.[122] If any portion of the lump-sum distribution is rolled over, lump-sum treatment is not available.[123]

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[121] IRC §402(d)(4)(A)
[122] IRC §402(d)(4)(B)
[123] IRC §402(d)(4)(K)

2. Plans to Which Lump Sum Treatment Applies[124]

a. The special tax treatment of lump-sum distributions applies only to distributions from:

(1) Qualified pension plans;

(2) Qualified profit-sharing plans; and

(3) Qualified stock bonus plans.

b. It is *not* available for distributions from:

(1) Individual Retirement Accounts (IRA's); and

(2) Simplified Employee Pensions (SEP's).

3. Five Year Averaging

a. Expiring: The Small Business Job Protection Act of 1996 repealed five-year averaging for lump-sum distributions from qualified plans, effective for taxable years beginning after December 31, 1999.[125]

b. For previous years, five year averaging permits the participant to determine the tax on the distribution *as if* the distribution had been in equal amounts over a five year period. Actually, the tax is computed as if only 1/5 of the distribution had been received, but then multiplying that tax times five.

(1) Note, the tax is not payable over a five year period. It is payable in the year of distribution, but is computed as if the distribution had been paid out over five years.

(2) The benefit to the participant is that the distribution does not dump as much income into one year, and therefore may subject to the distribution to lower tax overall. The idea is that more of the income will be taxed at lower rates and less at higher rates. This was perhaps a greater benefit when there was a greater spread in income tax rate brackets.

c. The tax is computed using the rates applicable to single filers.

d. Five-year averaging is available only if the participant is at least age 59-1/2 when the distribution is made and has been an active participant in the plan for at least five years before the year of the distribution.

e. The tax is computed on the excess of the total taxable amount of the lump sum

[124] IRC §402(d)(4)(A)

[125] P.L. 104-188, §1401, amending Code §402(d)

distribution over the minimum distribution allowance.[126]

f. The minimum distribution allowance is the smaller of $10,000 or ½ of the amount of the total taxable amount of the lump sum distribution for the tax year, reduced (but not below zero) by 20 percent of the excess (if any) of the total taxable amount over $20,000.

g. Five-year averaging may be used only once.[113]

Planning Note

For clients who have failed to take advantage of five-year averaging, they can amend their returns at any time within the period for claiming refunds. That period is 3 years from the date the return was filed, or 2 years from the date the tax was paid, whichever is later.

4. Ten-Year Averaging

a. Ten-year averaging is similar in concept to five-year averaging, but is available only to individuals who were 50 years or older before January 1, 1986.

b. Whereas the Small Business Job Protection Act of 1996 repealed five-year averaging after 1999, it left in place the transition rule that permitted ten-year averaging

(1) To qualify, the individual must have attained age 50 before January 1, 1986.

(2) Ten-year averaging is elective and uses pre-1987 rates.[114]

D. Rollovers[115]

1. Rollover distributions are not includible in gross income.

2. A rollover is a distribution from a qualified trust to the participant which the distributee transfers to an eligible retirement plan.

a. If property other than money is distributed, that same property must be rolled over into the new account.

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[126]IRC §402(d)(1)(B).
[113]IRC §402(d)(4)(B)
[114]P.L. 104-188, §1401, amending Code §402(d) as in effect immediately before the amendment.
[115]IRC §402(c).

b. If money is distributed, an equivalent amount of money must be added to the roll over account.

3. The rollover must be completed no later than 60 days after the distributee receives the distribution.

4. Certain distributions are not eligible for rollover treatment:

a. Any distribution which is one of a series of substantially equal periodic payments made for the life or life expectancy of the participant or the joint lives or joint life expectancies of the participant and the participant's designated beneficiary or for a period of 10 years or more; and

b. Any required distribution (pursuant to the minimum distribution rules of IRC §401(a)(9)). For example, distributions made because the participant has attained age 70½ may not be rolled over.

5. Five-year averaging is not available for lump-sum distributions of rollover amounts.

6. A surviving spouse can roll over a distribution paid as a result of the participant's death, but the rollover may only be to an IRA. *See* X.G.5.0.a.(3) beginning at page 47.

E. Distributions Other Than Lump-Sum

1. Annuity Distributions

a. If distributions are in the form of an annuity, they are taxable under the annuity rules.[116]

2. Non-Annuity Distributions

a. If the distribution is not in the form of an annuity, then in general the entire distribution is included in income.

b. In certain circumstances, however, a portion of the payment may still be excluded from income.[117]

F. Distributions of Employer Securities[118]

1. If employer securities are distributed as part of a lump-sum distribution, the

[116] IRC §§402(a) and 403(a); see also Reg. §§1.72-6, 1.72-8, 1.72-13; and IRC §414(k)(2)

[117] *See* IRC §72(d) & (e); Reg. §1.72-11

[118] IRC §402(e)(4).

distribution is eligible for preferential tax treatment. In particular, the distributee is not taxed on the "net unrealized appreciation" of the securities distributed. That gain is taxed only when the distributee subsequently sells the securities.

2. If the distribution is *not* lump-sum, only the net unrealized appreciation in securities of the employer attributable to amounts contributed by the participant qualifies for this special treatment. And then, only nondeductible participant contributions qualify.

3. The gain on sale is taxed as long term capital gain. If the estate of a deceased participant sells the securities, the net unrealized appreciation is treated as income in respect of a decedent and taxed as long-term capital gain property.

G. Penalty Tax for Early Distributions[119]

1. In general, an early distribution from a qualified plan is subject to a 10% penalty tax, which is in addition to any income tax attributable to the distribution.

2. An "early" distribution is one that is made before the participant attains age 59½.

3. Not all early distributions are subject to the penalty tax. The following are exempt:

   a. Distributions on or after the participant's death to a beneficiary or to the participant's estate.

   b. Distributions attributable to the participant's disability.

   c. Distributions over the life or life expectancy of the participant or the joint lives or joint life expectancies of the participant and his designated beneficiary.

      (1) This exemption does *not* apply to amounts paid from qualified plans unless the series of payments begins *after* the participant separates from service with the employer.

      (2) This exemption *does* apply to amounts paid from an IRA *without* regard to separation from service.

[119]IRC §72(t).

Planning Note

IRA's can be a source of funds for taxpayers who have not yet attained age 59½ without being subject to the 10% penalty tax, if the funds are taken out over the life or life expectancy of the participant or the participant and the designated beneficiary.

d. Distributions after the participant has separated from service with the employer, *if* the participant has attained age 55.

(1) This exemption does not apply to a distribution from an IRA or a SEP.

e. Distributions for medical expenses.

(1) This exemption is limited. The distribution is exempt only to the extent it does not exceed the participant's deductible medical expenses for the year. In other words, those medical expenses that exceed 7.5% of the participant's adjusted gross income (though the participant is not actually required to itemize deductions in order to fall within this exemption).

(2) This exemption does not apply to a distribution from an IRA or a SEP.

f. Certain distributions out of an ESOP of dividends generated by stock held by the ESOP.

H. Excise Tax on Excess Distributions

1. The 15% excise tax on excess distributions has been repealed effective with respect to excess distributions received after December 31, 1996.[120]

2. Prior to that, distributions from qualified plans were subject to a 15% excise tax on the excess amount.[121]

a. The term "excess distributions" meant the aggregate amount of the retirement distributions with respect to any individual during any calendar year to the extent such amount exceeds the greater of:

(1) $150,000, or

(2) $112,500 adjusted for inflation after 1987.

b. Certain distributions were excluded from the calculation of excess distributions.

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[120]Taxpayer Relief Act of 1997, P.L. 105-34, §1073(a).
[121]IRC §4980A(a).

c. Lump-sum distributions were treated separately. Only the amount of the lump-sum distribution in excess of five times the $150,000/$112,500 dollar limits would be considered "excess." So, a lump-sum distribution would have had to exceed at least $750,000 before it could be subject to the penalty tax.

d. The 15% penalty tax on excess distributions and the 10% penalty tax on early distributions, if both applied, were offset so that there was no more than 15% total tax.

I. Excise Tax on Excess Accumulations

1. Section 1073(a) of the Taxpayer Relief Act of 1997 repealed the 15% excise tax on excess accumulations effective with respect to decedents dying after December 31, 1996.[122]

2. For decedent's dying prior to December 31, 1996, a 15% excise tax applies to excess retirement accumulations.[123]

   a. This tax is not protected by either the unified credit or any other credit.

   b. The tax is deductible from the gross estate.[124]

   c. The tax is imposed on decedents dying after December 31, 1986.

   d. The tax applies to the excess of:

      (1) the value of the decedent's interest over

      (2) the present value of a single life annuity with annual payments equal to the limit on excess distributions under IRC §4980A(c) (that is, the greater of $150,000 or $112,500 indexed for inflation).

   e. A surviving spouse is provided an optional election.

      (1) Distributions to a surviving spouse will qualify for the marital deduction, but have no effect on the 15% excise tax.

      (2) If the surviving spouse is the beneficiary of *all* the decedent's interests in qualified plans and individual retirement accounts, the spouse may elect not to have excess amounts taxed at the decedent's death and rather have the retirement accounts treated as if they were the surviving spouse's.[125] Then the 15% tax will not apply until the subsequent death of the

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[122]Taxpayer Relief Act of 1997, P.L. 105-34, §1073(a).
[123]IRC §4980A(d)(1).
[124]IRC §2053(a), (c)(1)(B).
[125]IRC §4980A(d)(5)(A).

surviving spouse.

X. REQUIRED DISTRIBUTIONS — §401(a)(9)

A. Summary

1. Section 401(a)(9)

a. The rules for required distributions are found at §401(a)(9) of the Internal Revenue Code.

b. These rules dictate when distributions must begin and how rapidly they must continue in order for the plan to be qualified.

2. The 1987 Proposed Regulations

a. On July 27, 1987, the Internal Revenue Service issued proposed regulations[126] relating to required distributions from qualified plans, individual retirement plans, and section 403(b) annuity contracts, custodial accounts, and retirement income accounts.

b. Generally, the proposed regulations provide that distributions from an individual retirement account (IRA) made before the IRA owner's death must be made for the year in which the IRA owner attains age 70½ ("the 70½ year") and for each year thereafter.

c. In general, the minimum distribution rules applicable to qualified plans are identical to those for IRAs, but the participant's benefit under the plan used in place of the account balance as of December 31 of the preceding calendar year.

(1) This amount is adjusted for contributions and forfeitures allocated and distributions made after that date.

(2) Additional rules are provided for a number of special rules including multiple beneficiaries and changes in beneficiaries, death of an IRA owner before or after distributions are required to commence, distributions in the form of an annuity, a trust being named as a beneficiary, rollovers from one IRA or plan to another, and portions of benefits being payable to an alternate payee under a qualified domestic relations order.

3. The 1997 Amendments

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[126] EE-113-82

a. On December 30, 1997, the Service published amendments[127] to the existing proposed regulations under section 401(a)(9) that change the rules if a trust is named as a beneficiary under a retirement plan.[128]

b. The 1987 proposed regulations provide that if a trust is named as a beneficiary of a participant's benefit under a plan, the underlying beneficiaries of the trust may be treated as designated beneficiaries for purposes of section 401(a)(9). But these proposed regulations also impose certain requirements if a trust is to be used, one of which is that the trust be irrevocable. The new proposed regs modify the trust beneficiary requirements by, among other things, permitting the designated beneficiary of a *revocable* trust to be treated as the designated beneficiary. The details of these new amendments are discussed later. *See* X.F beginning at page 40.

c. As in the case of the existing proposed regulations, taxpayers may rely on the new proposals pending the issuance of final regs. If future guidance is more restrictive, it will be applied without retroactive effect.

B. Permissible Distribution Periods – §401(a)(9)(A)

1. In order to be qualified, the plan must provide that the entire interest of each participant will be distributed over a permissible period of time.[129]

2. The plan can be qualified if it provides that distributions will be complete not later than the required beginning date, the definition of which is discussed subsequently, at X.D.

3. The plan can also be qualified if it provides that distributions need not begin until the required beginning date, but then will continue over:

   (1) the life of the participant;

   (2) the lives of the participant and a designated beneficiary; or

   (3) a period that does not extend beyond the life expectancy of the participant and the designated beneficiary.

C. Effect of Death on Permissible Distribution Periods – §401(a)(9)(B)

1. When Distributions Have Already Begun

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[127]REG-209463-82

[128]The amendments are to Q&A D-5 and Q&A D-6 of, and add a new Q&A D-7 to, proposed reg. §1.401(a)(9)-1.

[129]IRC §401(a)(9)(A).

a. If distributions have already begun as of the participant's death, distributions must proceed at least as rapidly as under the method of distributions being used by the participant.

b. Exception: Married couples receive special treatment. The life expectancy of a participant and the participant's spouse may be redetermined annually. *See* X.E beginning at page 39.

(1) The redetermination can be made less frequently than annually, but not more frequently.

(2) Life expectancy cannot be recalculated if a life annuity has been elected.

2. When Distributions Have Not Already Begun

a. 5 Year Rule. If distributions have not yet begun as of the participant's death then, in general, the entire interest must be distributed within 5 years of the death of the participant.[130]

b. Exception. Distributions may extend beyond 5 years if:

(1) Any portion of the benefit is payable to or for the benefit of a "designated beneficiary;"

(2) That portion will be distributed over the life of the designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary); and

(3) Distributions begin no later than 1 year after the participant's death (or such later date as regulations may provide).[131]

c. Surviving Spouse. When the designated beneficiary is the participant's surviving spouse, the interest may be distributed over the spouse's life or a period not longer than the life expectancy of the surviving spouse.[132]

i) An important feature of this option is that distributions are not required to begin until the date on which the participant would have attained age 70½.[133]

ii) And if the surviving spouse dies before the distributions begin, then the rules apply as if the surviving spouse were the employee-

[130]IRC §401(a)(9)(B)(ii).
[131]IRC §401(a)(9)(B)(iii).
[132]IRC §401(a)(9)(B)(iv).
[133]IRC §401(a)(9)(B)(iv)(I).

participant.[134]

iii) Also remember, the qualified joint and survivor annuity rules were designed to benefit surviving spouses. Consequently, distributions pursuant to a qualified joint and survivor annuity are permissible.

3. **Death of the Beneficiary**

a. If the *beneficiary* dies before distributions are completed, distributions may continue to a contingent beneficiary.

b. The *primary* beneficiary's life expectancy will be used to compute the distribution period.

D. Required Beginning Date – §401(a)(9)(C)

1. The "required beginning date" or "RBD" is April 1 of the calendar year following the calendar year in which the employee attains age 70½.

2. The plan may provide that an employee who does not have an ownership interest in the business, or who is a less than 5% owner, need not begin receiving distributions until April 1 of the calendar year following the calendar year in which the employee retires, even if that is after age 70½.[135]

Example

> Employee's 70th birthday is May 20, 1998, therefore, Employee turns 70½ on November 20, 1998. Distributions must begin no later than April 1, 1999 if Employee owns 5% or more of the business; otherwise distributions must begin no later than April 1 of the year following the year Employee retires.

3. The minimum distribution for the 70½ year (or the retirement year, if applicable) must be made by April 1 of the following year. A further distribution must be made by December 31 of each year thereafter. Thus, if no distribution is made in the calendar year in which the IRA owner attains age 70½ or retires, if applicable, distributions for two years must be calculated and made in the next year (one by April 1 and one by December 31).

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[134]IRC §401(a)(9)(B)(iv)(II).

[135]Notice 96-67

E. Recalculation of Life Expectancy – §401(a)(9)(D)

1. No more than once a year, the life expectancy of a participant and spouse may be recalculated.[136]

2. This option is not available for a life annuity.

Planning Note

> This is an important planning opportunity for clients who want to take out the minimum amount each year. Actuarially, one does not lose one year of life expectancy for each additional year one lives. Whatever the life expectancy of a 75 year old, the life expectancy of that same person at age 76 will not have decreased by a full year. The longer we live, the longer we are expected to live. By recalculating the life expectancy each year, the minimum amount of the distribution often can be reduced.

F. Designating a Beneficiary – §401(a)(9)(E)

1. Importance to Planning

a. Designating a beneficiary has important planning opportunities. The minimum distribution is based on the life expectancy of the participant *and* the designated beneficiary. In general, the younger the beneficiary, the longer the distribution period, and the smaller the required distribution.

b. The designated beneficiary for purposes of the minimum distribution rules must be the same person as the designated beneficiary who will receive some or all of the participant's benefit upon the occurrence of a specified contingent event. For example, it is not possible to designate one beneficiary to receive distributions from the plan upon the participant's death and another beneficiary for purposes of computing the minimum distribution amount.[137]

2. Who Can be a Designated Beneficiary

a. The term "designated beneficiary" means an individual designated as a beneficiary by the participant.[138]

b. Under proposed regulations, a beneficiary who is not an individual, such as the participant's estate, may not be a designated beneficiary for purposes of

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[136]IRC §401(a)(9)(D).
[137]Prop. Reg. §1.401(a)(9)-1, D-2.
[138]IRC §401(a)(9)(E).

determining the minimum required distribution, but nevertheless may be designated as the participant's beneficiary under the plan.

(1) If a beneficiary who is not an individual is designated to receive a participant's benefit after death, the participant is treated as having no designated beneficiary when determining the required minimum distribution.

(2) In that case, distributions commencing before death must be made over the participant's single life or life expectancy and distributions commencing after death have to be made within 5 years of the participant's death.

3. Trusts as Designated Beneficiaries

a. Previously, the proposed regulations provided that if a trust was named as a beneficiary, the underlying beneficiaries of the trust could be treated as designated beneficiaries only if, among other things, the trust was irrevocable and a copy of the trust instrument was provided to the plan.[139]

b. The proposed regulations were amended December 30, 1997[140] to ease these requirements:

c. Now even a *revocable* trust may be named as a beneficiary.

d. The requirement that the plan be provided with a copy of the trust document is easier to comply with if certain certification requirements are met.

e. The IRS states that taxpayers may rely on these proposed regulations for guidance pending the issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be applied without retroactive effect.[141]

f. As the proposed regulations now stand, if a trust is named as a beneficiary of a participant, the beneficiaries of the trust will be treated as having been designated as beneficiaries of the participant for purposes of determining the distribution period if the following requirements are met:

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

(2) The trust is irrevocable or will, by its terms, become irrevocable upon the death of the participant.

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[139] Prop. Reg. §1.401(a)(9)-1, D-2A.
[140] REG-209463-82.
[141] REG-209463-82, para. [21].

(3) The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the participant's benefit are identifiable from the trust instrument.

(4) Prescribed documentation has been provided to the plan administrator.

g. These requirements must be met as of the later of the date on which the trust is named as a beneficiary of the participant, or the participant's required beginning date, and as of all subsequent periods during which the trust is named as a beneficiary.

(1) Consequently, it is now possible to name a designated beneficiary in this fashion *after* the participant has reached the required beginning date.

(2) Previously, no change in beneficiary designation was possible after that date.

4. Irrevocability of Trust

a. The proposed regulations had provided that a trust had to be irrevocable as of the participant's required beginning date in order for the beneficiaries of the trust to be treated as designated beneficiaries under the plan for purposes of determining the distribution period under section 401(a)(9)(A). Many trusts established for estate planning purposes and designated as the beneficiary of a participant's plan benefits are revocable instruments prior to the death of the participant. The proposed regulations now provide that a trust named as beneficiary of a participant's interest in a retirement plan be permitted to be revocable while the participant is alive, provided that it becomes irrevocable, by its terms, upon the death of the participant.

b. **Planning Pointer:** The provision that the trust become irrevocable *by its terms* upon the death of the participant suggests that cautious drafters will insert such a provision in the trust instrument rather than rely on state law.

c. **Planning Pointer:** The provision that the trust is irrevocable or *will become* irrevocable upon the death of the participant suggests that testamentary trusts may not be acceptable beneficiaries. A safer approach would be to use an inter vivos trust as the named beneficiary.

5. Information to Plan Administrator

a. In order to permit the plan administrator to substantiate that the requirements for treating the beneficiaries of the trust as designated beneficiaries under the plan are satisfied, the proposed regulations require that a copy of the trust instrument be provided to the plan administrator by the earlier of the required beginning date or the date of the participant's death.

b. The proposed regulations have been modified to permit an alternative method of substantiation.

   (1) As under the initial proposed regulations, a copy of the trust instrument may be provided to the plan administrator. However, because the trust need not be irrevocable, under this method, the participant must also agree that if the trust instrument is amended at any time in the future, the participant will, within a reasonable time, provide a copy of each such amendment.

   (2) In the alternative, the participant may provide a list of all of the beneficiaries of the trust (including contingent beneficiaries) with a description of the portion to which they are entitled and any conditions on their entitlement, and certify that, to the best of the participant's knowledge, this list is correct and complete and that the other requirements for the beneficiaries of the trust to be treated as designated beneficiaries are satisfied. Under this second method, the participant must also agree to provide corrected certifications to the extent that the amendment changes the information previously certified.

   (3) Finally, the participant must agree to provide a copy of the trust instrument to the plan administrator upon demand.

c. In addition, the proposed regulations have been modified to provide that, if the minimum required distributions after death are determined by treating the beneficiaries of the trust as designated beneficiaries, a final certification as to the beneficiaries of the trust instrument must be provided to the plan administrator by the end of the ninth month after the death of the participant.

   (1) This rule applies even if a copy of the trust instrument had been provided to the plan administrator before the participant's death.

   (2) In the alternative, an updated trust instrument may be provided.

d. The proposed regulations also provide that a plan will not be disqualified merely because the terms of the actual trust instrument are inconsistent with the information in the certifications or trust instruments previously provided to the plan administrator if the plan administrator reasonably relies on the information provided in the certifications or trust instruments.

   (1) However, the minimum required distributions for years after the year in which the discrepancy is discovered must be determined based on the actual terms of the trust instrument. For those years, the minimum required distribution will be determined by treating the beneficiaries of the participant as having been changed in the year in which the year the

discrepancy was discovered to conform to the corrected information and by applying the change in beneficiary provisions found under the Existing Proposed Regulations.

(2) However, for purposes of determining the amount of the excise tax under section 4974 (including application of a waiver, if any, for reasonable error under section 4974), the minimum required distribution is determined for any year based on the actual terms of the trust in effect during the year.

6. "Identifiable" Beneficiaries

a. A designated beneficiary need not be specified by name in the plan or by the participant to the plan in order to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan as of the participant's required beginning date, or as of the date of the participant's death (in the case of distributions governed by section 401(a)(9)(B)(iii) and (iv)), and at all subsequent times.[142]

(1) The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible at the applicable time to identify the class member with the shortest life expectancy.

(2) The fact that a participant's interest under the plan passes to a certain individual under applicable state law does not make such individual a designated beneficiary unless such individual is designated as a beneficiary under the plan.

b. Where more than one beneficiary has been designated, the beneficiary with the shortest life expectancy is used in setting the required minimum distribution.[143]

Planning Note

> By designating a trust as beneficiary of a participant's interest, it is possible to pass retirement benefits on to young beneficiaries, and at the same time obtain a relatively small minimum distribution.

G. Coordinating Beneficiary Designations with the Estate Plan

1. Possible Choices

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[142] Prop. Reg. §1.401(a)(9)-1, D-2.
[143] Prop. Reg. §1.401(a)(9)-1, E-5.

a. The proper choice of designated beneficiary, depending on the particular circumstances, may include:

(1) the surviving spouse;

(2) a marital trust for the benefit of the surviving spouse;

(3) a non-marital trust, such as a credit-shelter trust, of which the surviving spouse is a beneficiary;

(4) a non-marital trust for other beneficiaries;

(5) the children or other descendants of the participant or other individuals;

(6) a charity.

b. The identity of the designated beneficiary will determine how rapidly and in what form the retirement plan benefits must be distributed.

2. What to Review

a. The estate planner should review the summary plan description of the retirement plan to determine what distribution options are available.

b. Not all plans permit lump-sum distributions or distributions before retirement.

c. The distribution period may be limited by the plan.

d. The plan may provide for a default pattern of distribution if no beneficiary is designated or if the designated beneficiary does not survive the participant. The plan's default distribution provisions may differ from the client's wishes.

3. The Required Beginning Date

a. In general, once the participant has passed the required beginning date, the beneficiary designation is irrevocable.[144]

b. If, as of that date, there is no designated beneficiary under the plan to receive the employee's benefit upon the employee's death, the distribution period is limited to the employee's life (or a period not extending beyond the employee's life expectancy).

c. The beneficiary designation may become irrevocable *before* the required beginning date if an election is made to receive the benefit in the form of a life

[144]Prop. Reg. §1.401(a)(9)-1, Q&A D-3(a)

annuity or a joint and survivor annuity.[145]

d. But as noted elsewhere (*see* X.F.3 beginning at page 40), by using a revocable trust it is possible to designate the beneficiary *after* the required beginning date.

e. In general, however, withdrawals from an IRA or distributions from a qualified retirement plan *before* the required beginning date will not commit the participant to any particular distribution pattern, and it will be possible as of the required beginning date to elect a different distribution option.

4. The Spouse as Designated Beneficiary

a. Designating the surviving spouse as the beneficiary provides the greatest flexibility, because the spouse is able to rollover a lump-sum distribution into an IRA, and thus defer immediate income tax. This option is not available to any other beneficiary.

b. Estate plans may provide that part or all of the spouse's bequest will be held in trust, either under a credit shelter trust or a marital trust, or both.

c. If distributions from a retirement plan will be used to fund a bequest in trust for the spouse that is intended to qualify for the marital deduction, they must satisfy not only the marital deduction requirements of IRC §2056 but also the required minimum distribution rules of IRC §§401 (for qualified plans) and 408 (for IRA's).

d. One popular form of marital trust, the QTIP trust, requires that all the net income be distributed no less frequently than annually to the surviving spouse.[146]

(1) The minimum distribution rules may or may not meet this requirement.

(2) Consequently, it is important to coordinate the beneficiary designation under the retirement plan with the estate tax requirements to obtain a marital deduction.

e. The spouse of a participant in any qualified retirement plan must consent to any beneficiary designation that does not name him or her as the primary beneficiary or to any distribution other than in the form of a qualified survivor

[145]Prop. Reg. §1.401(a)(9)-1, Q&A B-5(a)
[146]IRC §2056(b)(7)

annuity (except as to some defined contribution plans).[147]

(1) Consequently, this consent would have to be obtained even for a lump-sum distribution to the surviving spouse.

(2) This consent can be waived. *See* VII beginning at page 22.

f. If the spouse consents to naming a trust as beneficiary, the participant may later change the beneficiaries of the trust without obtaining further consent of the spouse.[148]

g. The spouse may wish to obtain independent counsel when deciding on whether to sign a consent.

h. IRC §2036(a)(1) requires that any property interest gratuitously transferred be included in the estate, if an interest in the property has been retained. IRC §2038 requires inclusion in a decedent's estate of any revocable transfer, including any transfer where the decedent had retained the right to control the enjoyment of the property.

(1) Arguably, the waiver by a spouse of a joint and survivor annuity, when a trust in which the spouse will have a beneficial interest is named as beneficiary, is within §2036, §2038 or both.

(2) The spouse's consent to waive rights to distributions under a retirement plan, however, is not a gift.[149] Consequently, the waiver should not cause inclusion in the spouse's estate.

5. Qualifying Distributions for the Marital Deduction

a. Distributions Directly from the Plan to the Surviving Spouse

(1) A lump-sum distribution to the surviving spouse[150] will qualify the benefits for the estate tax marital deduction.

i) But this option may overfund the marital deduction, if the retirement benefits constitute a large portion of the estate.

ii) In that event, a disclaimer may be desirable. Providing for disposition of any disclaimed benefits, therefore, is appropriate in a beneficiary designation.

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[147]IRC §§401(a)(11) and 417.
[148]Reg. §1.401(a)-20, Q&A-31(a)
[149]IRC §2503(f)
[150]Assuming the spouse is a US citizen

(2) A marital deduction would also be available if the spouse has the right at any time to withdraw the entire benefit (or IRA balance).[151]

(3) Rollover. If the plan permits, the surviving spouse may elect to have the benefit rollover into an IRA for the spouse.[152]

i) A surviving spouse is the *only* beneficiary who may rollover a qualified plan distribution into an IRA.

ii) By doing so, the surviving spouse can avoid immediate income tax on the distribution, and the amount rolled over will continue to accumulate with tax deferral; the surviving spouse can wait until April 1 of the year after the spouse attains age 70½ to begin receiving distributions.

iii) **Planning Pointer:** In general, rollover benefits to an IRA for the surviving spouse if the participant is significantly older and leave benefits in the plan if the participant was significantly younger than the surviving spouse. Consider these factors in making your decision:

a) If the spouse is less than 59½ years of age, early withdrawals will be subject to the 10% excise tax, unless an exception applies.[153]

b) On the other hand, if the decedent's benefit is not rolled over into an IRA for the surviving spouse, distributions will not be subject to the 10% excise tax even if the surviving spouse is less than age 59½.

c) But then the surviving spouse must begin to receive distributions by the end of the year the *participant* would have attained age 70½.[154]

d) Once there has been such a rollover, the subsequent distributions from the rollover account receive no other tax benefits, such as five-year lump-sum averaging.

e) The surviving spouse also gets to name the beneficiary who will receive any remaining benefit at the death of the surviving spouse, even if the spouse's required beginning date has passed, that is, the spouse is older than 70½.

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[151]Rev. Rul. 82-184, 1982-2 C.B. 215; Reg. §20.2056(b)-5(f)(6)
[152]IRC §402(c)(9)
[153]IRC §72(t)
[154]IRC §401(a)(9)(B)(iv)(I)

iv) **Planning Pointer:** The IRS has issued a private letter ruling[155] approving an advantageous method for older taxpayers to postpone distributions. Here's how it worked.

Before his death, husband established an IRA, naming his wife beneficiary. As of the husband's death, both he and his wife were older than age 70½. After his death, the wife asked the IRA custodian to make a direct transfer of the husband's IRA balance to her IRA, which then occurred. The wife designated her son beneficiary of the IRA. The Service made several rulings that were helpful for planning:

a) First, the spouse beneficiary could elect to treat her deceased husband's IRA as her own, even though at her husband's death they were both the husband and wife past the required beginning date for determining minimum distributions

b) Second, the direct transfer of funds from the husband's IRA to the spouse's IRA constituted an election to treat the IRA as the spouse's own.

c) Third, the IRA's required beginning date was December 31, 1996, even though the transfer had occurred in 1995.

d) Fourth, because the wife had designated her son as a designated beneficiary before the required beginning date, minimum distributions could be recalculated annually. This significantly reduced the required distributions.

e) So, the apparent planning technique is for spouses to name each other as beneficiaries of their IRAs, entitling the survivor to make a spousal rollover into a new IRA and at that time designate a new beneficiary and elect to recalculate annually the life expectancy for purposes of taking out minimum distributions.

b. Distributions to a Marital Trust

(1) Either a QTIP trust or a general power of appointment trust can be used to obtain a marital deduction for plan distributions.

i) If ultimate disposition of the property upon the death of the surviving spouse is an issue, only the QTIP trust provides for that.

[155] PLR 9711032

a) With a general power of appointment trust, the surviving spouse has the right to withdraw all the corpus at any time or to designate the beneficiary of any remaining amounts at his or her death.

b) A QTIP trust can prevent the surviving spouse from invading principal.

ii) An estate trust could also be used, but those provide that the spouse can appoint to his or her estate. Thus, control is lost there as well.

(2) QTIP Trust as Beneficiary

i) Among the requirements for qualifying a QTIP trust for the marital deduction is that all of the income must be payable at least annually to the surviving spouse.[156]

ii) This may result in distributions from the plan being taken more rapidly than would otherwise be required.

iii) In some situations, it is permissible for the surviving spouse not to immediately begin taking distributions from the plan. Although the plan is generating income, it is not distributing it to the surviving spouse.

iv) Even if distributions are being made, they may be less than the income earned by the plan.

v) Also keep in mind that under trust accounting principles, retirement plan distributions often are allocated to trust principal. The QTIP trust should be drafted so as to override this presumption, and allocate retirement plan distributions to income so that they may then be distributed from the QTIP trust to the spouse.

vi) Under the final QTIP regulations, as long as the surviving spouse has a right to require the trustee to make the assets in the plan or IRA productive and the trustee has the right under the beneficiary designation to accelerate withdrawals in excess of the required minimum distribution to satisfy the spouse's request, the marital deduction appears to be available.[157]

vii) The IRS has ruled in certain circumstances that a marital deduction

[156]IRC §2056(b)(7)(B)(ii)(I)
[157]IRC §§2056(b)(5)(f)(4), (5) and 2056(b)(7)(d)(2)

is available for plan benefits and IRAs distributed to a QTIP trust.[158] Based on those rulings, Louis Mezzullo, in 814 T.M. Estate and Gift Tax Issues for Employee Benefit Plans, suggests that a prudent approach would be as follows:

a) Designate that the retirement plan or IRA will pay to the QTIP trust each year the greater of the income generated by the assets representing the accrued benefit in the qualified retirement plan or in the IRA, or the required minimum distribution determined under §401(a)(9).

b) Provide the Trustee of the QTIP trust the right to require the plan trustee or IRA sponsor to convert non-income producing or low-income producing assets into income-producing assets or assets producing adequate income. This right should be specified under both the beneficiary designation and in the QTIP trust instrument.

c) If it is a defined benefit plan, the trustee of the QTIP trust should have the right to treat a certain amount of the value of the accrued benefit as income each year. This is necessary because defined benefit plans do not set aside a specific account for participant.

d) Provide the trustee of the QTIP trust with the right to withdraw the accrued benefit or IRA balance at any time so that the trustee could withdraw an amount equal to the income that would have been produced if the assets were producing adequate income.

e) Provide in the QTIP trust instrument that the portion of any retirement distribution that represents income will be paid to the spouse in the same manner as any income generated by other assets held by the trust and no expenses that would be chargeable against principal would be charged against the income portion of the distribution.

f) Provide the spouse the right under the QTIP trust instrument to require the trustee of the QTIP trust to make non-income-producing assets into income-producing assets. Also provide the trustee of the QTIP trust the right to distribute other assets of the trust to satisfy this request.

[158] Rev. Rul. 89-89, 1989-2 C.B. 231; PLRs 9416016, 9321059, and 9245033

g) Elect QTIP treatment for both the trust and the retirement plan by listing the plan benefit or IRA on Schedule M of Form 706.

viii) According to Mr. Mezzullo, this approach is conservative, but will defer the payment of principal from the qualified retirement plan or IRA as long as permitted under the minimum distribution rules, and will also ensure that the principal paid to the trust is not paid out to the spouse unless required under and by the trust instrument.

(3) When a trust is the beneficiary, rollover treatment is not available, unless the spouse has the right to revoke the trust or has a lifetime power to withdraw assets from the trust.[159]

(4) Spousal consent is required to name a trust as beneficiary. *See* VII.D beginning at page 24.

6. Distributions to a Non-marital Trust

a. Part or all of the retirement plan or IRA benefits may be needed to fund a credit-shelter or other non-marital trust.

b. Where there are multiple beneficiaries of a trust, there was some question as to whether the beneficiaries are "identifiable," which they must be in order to have designated beneficiaries. That issue, however seems to have been resolved by the regulations. *See* X.F.6 at page 43.

c. Plan benefits payable to a credit-shelter or other non-marital trust will qualify neither for the marital deduction nor for rollover treatment.[160]

7. Choosing between a Marital and Non-marital Trust

a. Income in Respect of a Decedent

(1) In deciding whether to designate as beneficiary the marital or the non-marital trust, remember that IRA and plan benefits are income in respect of a decedent ("IRD").

(2) IRD is subject to income tax by the recipient.[161]

(3) If the surviving spouse receives the IRD and is subject to income tax on it, the income tax paid reduces the spouse's estate, and so could ultimately

[159]PLRs 9401039, 9302022, 9235058, 9047060, 9016067, and 8920045
[160]Rollover treatment is available only for a spouse. IRC §402(c)(9)
[161]IRC §691

reduce the overall estate tax. This indicates the marital trust should be designated as the beneficiary.

(4) On the other hand, the surviving spouse may be in a higher income tax bracket than the children. This indicates the credit-shelter trust should be designated as the beneficiary.

b. Appreciation

(1) Also, it is generally desirable to fund the credit shelter trust with appreciating assets, because this trust will not be includible in the surviving spouse's estate, and so will escape death tax in both spouse's estates.

i) Retirement plan assets generally diminish over time, rather than appreciate.

ii) This indicates the marital trust should be used as the designated beneficiary.

(2) In general, funding the credit shelter trust from assets other than retirement plan benefits is indicated.

c. Size of Estate

(1) If the estate is less than the credit-shelter amount ($625,000 in 1998; $650,000 in 1999, increasing gradually to $1,000,000 in 2007), designating the credit-shelter trust as beneficiary is sufficient.

(2) But if the plan benefits may exceed the credit-shelter amount, then designating the trust as beneficiary could result in an overfunding of the credit-shelter trust, causing death tax upon the death of the participant-spouse.

(3) Consider designating the spouse as primary beneficiary, allowing disclaimer to the credit-shelter trust.

(4) In the alternative, consider using the same sort of formula in the plan or IRA beneficiary designation as is used in the Will or Living Trust.

8. Distributions Beginning While the Participant is Alive

a. In general, allowing deferral tax-free inside the plan will be the option of choice. Taking out the minimum amount will be indicated, unless the participant needs the distributions for support.

b. The repeal of the excise tax on excess distributions and excess accumulations has increased the flexibility of choosing the appropriate forms of distribution.

c. The minimum amount will usually be achieved by electing to have the benefit paid over a period certain equal to the joint and survivor life expectancy of the participant and a designated beneficiary. If the designated beneficiary is the spouse, consider having the participant elect to have his life expectancy recalculated, but not the spouse's.

(1) When one spouse's life expectancy is being recalculated, when that spouse dies, his or her life expectancy will be zero in the following year.[162] If both spouse's life expectancies are being recalculated, then once the survivor dies, the plan must be completely distributed by December 31 of the following year.

(2) If the participant's life expectancy is being recalculated, the participant will then get payments at least as long as he is alive, even if he outlives his life expectancy.

(3) <u>Spouse dies first</u>. If the spouse's life expectancy is *not* being recalculated and the participant dies after the spouse and before the spouse's life expectancy has expired, the plan benefits can continue to be paid out over the life expectancy of the spouse.

(4) <u>Participant dies first</u>. If the participant dies first, the participant's plan benefits and IRA balances can be rolled over into an IRA for the spouse. If the spouse has not reached his or her required beginning date, withdrawals from the spouse's IRA can be postponed until the required beginning date. The spouse can also name a new designated beneficiary (including a new husband or wife) to receive any remaining balance, which avoids the 5-year distribution rule, if the spouse dies before reaching the required beginning date and allows a longer distribution period if death comes after the required beginning date.

9. Disclaimers

a. In GCM 39858, the IRS ruled that a disclaimer of qualified retirement plan benefits was neither a prohibited assignment or alienation under IRC §401(a)(13) or ERISA §206(d) nor an assignment of income.

10. Pecuniary Bequests

a. Receipt of retirement plan benefits and IRA accounts is taxable as income in respect of a decedent.

b. Consequently, those benefits should not be used to satisfy a pecuniary bequest.

[162]Prop. Reg. §1.401(a)(9)-1, Q&A E-8(a)

(1) The estate would recognize income equal to the present value of the receipt of those benefits when the right to receive the benefits is transferred to the beneficiary in satisfaction of the bequest.[163]

(2) Many Wills are drafted to leave the credit shelter amount as a pecuniary bequest, and the marital amount as the residuary, or the marital amount as a pecuniary bequest and the residuary to the credit shelter share.

(3) Use of a fractional share formula will avoid the acceleration of income.

(4) A specific bequest of the right to the qualified retirement plan benefits or IRA also will avoid the acceleration of income.

(5) A beneficiary designation under the plan itself should not result in the acceleration of income, on the theory that the payment of the plan benefit or IRA is not satisfying an obligation of the estate.

H. Payments to Children – §401(a)(9)(F)

1. Any amount paid to a child is treated as if it had been paid to the surviving spouse if that amount will become payable to the surviving spouse upon the child attaining the age of majority.

I. Distributions of Incidental Death Benefits – §401(a)(9)(G)

1. Any distribution required under the incidental death benefits requirements of §401(a) is treated as a distribution required under paragraph (9) of §401(a).

XI. QUALIFIED DOMESTIC RELATIONS ORDERS

A. Definition and Requirements

1. A “qualified domestic relations order” (QDRO) is a domestic relations order which creates or recognizes the existence of an alternate payee’s right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan.[164]

2. In addition, the QDRO must clearly specify:

   a. the name and last known mailing address (if any) of the participant and the alternate payee;

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[163] IRC §691(a)(2); Reg. §1.661(a)-s(f)(1)

[164] IRC §414(p).

b. the amount or percentage of the participant's benefits to be paid by the plan to each such alternate payee, or the manner in which such amount or percentage is to be determined;

c. the number of payments or period to which the order applies; and

d. each plan to which the QDRO applies.

3. Finally, the QDRO must

a. require a plan to provide any type or form of benefit, or any option, not otherwise provided under the plan;

b. require the plan to provide increased benefits;

c. require the payment of benefits to an alternate payee which are required to be paid to another alternate payee under another QDRO.

4. A "domestic relations order":

a. relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant; and

b. is made pursuant to a state domestic relations law.

B. Alternate Payees

1. Who can be an "alternate payee?" The term "alternate payee" means any:

a. Spouse

b. Former spouse

c. Child

d. Other dependent of a participant
who is recognized by a domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to such participant.[165]

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[165]IRC §414(p)(8).

Planning Note

> In any divorce, the attorney should be cognizant of the impact of retirement benefits, and that a QDRO is available to provide for or exclude the participant's soon-to-be ex-spouse. Retirement benefits are taxable as ordinary income when received, but also accumulate without any current tax until distribution. This should be an item of negotiation during the divorce.

2. What happens if the domestic relations order does not meet the requirements of a QDRO?

   a. The distribution will be taxable to the participant, not the alternate payee. Hawkins v. Comm, 102 T.C. No. 3 (1994).

   b. Presumably, by giving effect to such an order the trustee would endanger the qualified status of the plan, since a qualified plan may not permit assignments of plan benefits.

   c. The plan is required to establish reasonable procedures to determine the qualified status of domestic relations orders.[166]

   d. In Karem v. Comm., 100 T.C. No. 34 (1993), the Tax Court stated that §414(p)(6) and (7) contemplates that a domestic relations order will be presented to a plan administrator and adjudged "qualified" prior to any distribution from the plan to the spouse or former spouse.

   Planning Note

   > The proposed QDRO should always be presented to the plan trustee for approval prior to entry of the order. The attorney should review the plan document to determine what procedure has been established for review and approval of QDROs.

3. During the 18-month period beginning with the date on which the first payment would be required to be made under the domestic relations order, and until a determination by the plan administrator has been made whether the order constitutes a QDRO, the plan administrator is required to segregate amounts in accordance with the order.

   a. If the administrator determines the order is a QDRO, the plan administrator

[166] IRC §414(p)(6).

pays such amounts, including interest, to the persons designated in the order.[167]

b. If the administrator determines the order is *not* a QDRO, distribution is made to the persons who would have been entitled to them absent the order.[168]

c. If the determination is made *after* the 18-month period has expired, the determination is prospective only.[169]

[167]IRC §414(p)(7)(B).
[168]IRC §414(p)(7)(C).
[169]IRC §414(p)(7)(D).