DISTRIBUTIONS FROM QUALIFIED RETIREMENT PLANS AND INDIVIDUAL RETIREMENT ACCOUNTS

Developed by
THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL
EMPLOYEE BENEFITS IN ESTATE PLANNING COMMITTEE

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A. Complexity of Subject Matter for the Advisor.

Benefits from qualified retirement plans and individual retirement accounts (IRAs) represent a large part of the net worth of many individuals. Except possibly for life insurance, qualified plan benefits and IRAs likely comprise the largest asset of executives and professionals, as well as elderly people.

1. Types of Distributions.

Planning for the proper handling of distributions from qualified retirement plans and IRAs is complex because of the many forms that such distributions may take. The entire amount of a participant's benefits under a plan may be distributed at one time, in the form of a lump sum. On the other hand, the benefits may be paid out as an annuity over the life of the participant or the lifetimes of the participant and his or her spouse or other beneficiary. The distribution may be made in the form of installment payments over a period certain. For example, installment payments may be made over the life expectancy of the participant, or the joint and last survivor expectancy of the participant and his or her spouse or other beneficiary. The period may be a specified number of years, such as 10 or 20. A distribution may also qualify for rollover treatment, enabling the participant to transfer some or all of the distribution into an IRA, thereby deferring the payment of income tax on the amount distributed until the participant actually withdraws cash from the rollover IRA.

In addition to the determination of the proper form of payment, the designation of the beneficiary or beneficiaries to take any benefits remaining at the death of the participant raises many tax and non-tax questions. The right of the participant to choose a beneficiary may be limited by the necessary consent of a spouse or the right of his or her spouse to a survivor annuity under the Retirement Equity Act of 1984 (REA). If the payments are being made over the joint life and last survivor expectancy of the participant and a beneficiary, the designation of the beneficiary may also affect the maximum period over which the distributions may be made.

2. Timing.

The timing of distributions involves many difficult decisions and varying tax consequences. The participant may begin receiving the distributions while he or she is still employed if he or she has reached the plan's normal retirement age but continues to work for the sponsoring employer. The participant may begin to receive benefits upon retirement or may elect to defer the receipt of benefits as long as possible without incurring the 50 percent tax on required distributions that are not actually distributed. The participant may even receive a distribution while still employed if permitted under the plan and the law, even though the participant has not reached the normal retirement age under the plan.

The issues concerning the planning for distributions arise at least three times. Before the participant retires, the participant will usually have to designate a beneficiary or beneficiaries to take any death benefits payable upon his or her death either before retirement or before all the benefits have been distributed after retirement. The participant may also need to decide on the form of payment, although this decision usually will be subject to change before the participant actually retires. At retirement, the participant must select the form of benefit payment as well as the beneficiary or beneficiaries of any benefits that remain unpaid at the participant's death. Finally, after the death of the participant, the advisor must determine the proper beneficiary or beneficiaries entitled to receive the benefits, as well as advise the beneficiary or beneficiaries as to the form of payment. The advisor will also want to consider whether the designated beneficiary or beneficiaries should disclaim part or all of the benefits. The advisor must plan for the income and transfer tax consequences associated with the payment of the benefits upon the death of the participant.

3. Legislative Changes.

Legislation in recent years has had a tremendous impact on planning for the distributions of qualified plan benefits. Since 1982 what was previously an unlimited exclusion from estate taxes has evaporated to nothing. Indeed, a new 15 percent excise tax on excess retirement distributions and excess retirement accumulations has been added. Other changes in the area, particularly as a result of the Tax Reform Act of 1986 (TRA 86), have had a profound impact on all areas of federal income and transfer tax, including taxes on early distributions, required distributions, the 50 percent excise tax of undistributed amounts, method of recovery of a participant's basis in retirement benefits as well as recovery of voluntary contributions, the taxation of distributions (special averaging and capital gain treatment), permitted in-service distributions from 401(k) plans (also known as cash or deferred arrangements), and treatment of contributions and distributions from non-qualified deferred compensation plans of certain tax-exempt organizations (also known as §457 plans).

B. Factors to Consider.

It is essential that the advisor take into account all the relevant factors when advising the client on the proper handling of distributions from qualified retirement plans and IRAs. Overlooking just one significant factor could lead to the wrong decision on the form of payment, the timing of the payment, or the selection of beneficiaries. These errors could result in the payment of unnecessary taxes because of inappropriate elections or the payment of benefits to the wrong persons because of improper beneficiary designations.
1. Tax Consequences.

The advisor must be familiar with income tax and transfer tax consequences associated with payment of benefits from qualified retirement plans and IRAs. Saving taxes, however, should never be the most important consideration in advising a participant: a participant’s desires and actual needs ascertained as a result of discussion are the most important factors. Once the participant’s desires and needs are known, however, the advisor should be prepared to structure the payment of the participant’s plan benefits in such a way that the income and transfer tax consequences are minimized. This, of course, requires attention to the selection of the appropriate method of payment and the appropriate beneficiary designation.


The financial needs of the retired participant or the beneficiaries are of paramount importance. If the participant has sufficient assets, it may be better to forgo receiving benefits immediately upon retirement, and to defer the receipt as long as possible. On the other hand, if the participant has an immediate financial need, the participant may end up paying more taxes if he or she foregoes the favorable averaging treatment available with respect to a lump sum distribution by rolling some or all of the distribution into an IRA, since the withdrawn amounts from the IRA may be taxed at a higher rate. The transition rules that apply to persons who had reached age 50 on January 1, 1986 also need to be considered when available. The transition rules give the participant more options.

3. Health Factors.

In addition to financial needs, the health of the participant, his or her spouse and other beneficiaries should be considered. For example, if the participant has a terminal illness, the payment of his or her benefit in the form of a life annuity would be a serious mistake. Similarly, a participant with a terminally ill spouse should not elect a joint and survivor annuity if he or she can obtain the spouse’s consent to waive the spouse’s rights to a survivor annuity under REA. Thus, the medical history of a participant’s entire family should be considered.


The advisor must consider the rights of the participant’s spouse. Generally, these rights require that the benefits be paid in the form of a qualified joint and survivor annuity unless such spouse consents to a different form. Even in cases of certain defined contribution plans, such as profit-sharing plans and Employee Stock Ownership Plans (ESOPs), the qualified joint and survivor annuity rules apply unless the death benefit is payable to the surviving spouse, or she or he consents to the naming of another beneficiary. Spousal rights may also be created or limited by qualified domestic relations orders (QDROs), which may require some or all of the participant’s benefit to be paid to a former spouse and children, perhaps even before payments from the plan may commence to the participant.

C. Tax Benefits of Qualified Retirement Plans and Individual Retirement Accounts.

An advisor does not need to become an employee benefits expert. The role of the advisor in planning for distributions from qualified retirement plans does not include designing the plan, qualifying the plan for special tax benefits, or handling other issues that arise under the Employee Retirement Income Security Act of 1974 (ERISA)1 and amendments to that legislation. Nevertheless, the advisor must be familiar with some of the basic concepts of qualified retirement plans and IRAs.


First, the advisor should be familiar with the tax benefits associated with qualified retirement plans and IRAs. The employer obtains a current deduction, within certain limits, for contributions made to a qualified retirement plan.2 An individual may be entitled to an annual deduction (not to exceed his or her compensation for such year) up to $2,000 for contributions to an IRA, and up to $2,250 if at least $250 is contributed on behalf of the individual’s spouse (but only if the spouse has no compensation for the taxable year or elects to be treated as having no compensation).3

The ability to deduct contributions to IRAs is affected by the participation of the individual or his or her spouse in a qualified retirement plan and by the individual’s adjusted gross income or the adjusted gross income of the individual and his or her spouse. If the individual or his or her spouse is an active participant in a qualified retirement plan during the year, then the amount of the deduction for contributions to an IRA is reduced proportionately by the amount of the participant’s adjusted gross income in excess of a certain amount.4 If the participant is filing a return as a single taxpayer, the reduction in the amount eligible for deduction begins at $25,000 of adjusted gross income, and the amount deductible is reduced proportionately for income over that amount until the adjusted gross income reaches $55,000, when the individual may no longer receive a tax deduction for a contribution to an IRA.5 The applicable dollar amounts for an individual filing a joint return are $40,000 and $50,000.6

For example, if a married individual filing a joint return participates in her employer’s qualified retirement plan, and her and her husband’s adjusted gross income is $45,000, each of them could deduct up to $1,000 of contributions to each of their IRAs. If only the wife had income, she could deduct up to $1,125, if at least $125 was contributed to the husband’s IRA.

2. Nondeductible Contributions.

If the amount that an individual may deduct

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2. IRC §404(a).
3. IRC §§219(b)(1)(A) and 219(c).
4. IRC §218(g)(1).
5. IRC §219(g)(3)(B)(ii).
with respect to contributions to an IRA is affected by these rules, the individual may take nondeductible contributions up to the $2,000 limit, reduced by any deductible contributions to IRAs the participant has made for that year. The participant benefits by making nondeductible contributions because the earnings on the investments are tax-free until the individual withdraws the amounts. However, other tax-free investment alternatives (i.e., municipal bonds) should be considered and may be preferable to a contribution to an IRA, since a participant making nondeductible contributions to an IRA is confronted with the complicated IRA distribution rules.

A withdrawal from an IRA by a participant who has made nondeductible contributions will be treated as a pro rata withdrawal of the nondeductible contributions (which will be tax-free), deductible contributions, and earnings on all contributions, both deductible and nondeductible. For this purpose, all IRAs owned by the individual are aggregated.


An alternative to an IRA is available for many corporate executives or professionals, as well as their family members, who serve on the boards of directors of various companies. So long as they have not otherwise had the maximum pension contributions made on their behalf, directors’ fees may be the basis of a contribution to a retirement plan that covers a self-employed person, known as a Keogh Plan. The contribution may consist of up to 25 percent of such self-employment income and can replace the loss of deductible IRA contributions in many cases.


The second tax benefit afforded qualified retirement plans is the deferral of the participant’s recognition of gross income as a result of the employer’s contribution to the plan until the participant receives the benefit at retirement or other distribution date set forth in the plan.

5. Tax Exempt Earnings.

Third, the earnings on the amounts held in a qualified retirement plan or IRA are generally exempt from current taxation. The exemption from current taxation allows the investment in the qualified retirement plan or IRA to increase more rapidly than an equivalent investment that is subject to current tax.

6. Distributions.

Finally, distributions from qualified retirement plans may be entitled to special tax treatment, such as five-year averaging or, in the case of a participant who had reached age 50 before January 1, 1986, ten-year averaging or capital gain treatment. Capital gain treatment also is available to some extent through 1991 for all qualified retirement plan participants. A participant in an IRA is not entitled to this special averaging or capital gain income tax treatment. A participant in a qualified retirement plan also may choose to roll over a distribution from the plan into an IRA, thereby deferring the payment of tax on the income until the participant makes withdrawals from the IRA. See Section III for a discussion of the income taxation of distributions from qualified retirement plans.

D. Types of Qualified Retirement Plans.

1. Defined Benefit Plans.

There are two types of qualified retirement plans: defined benefit plans and defined contribution plans. A defined benefit plan provides definitely determinable benefits pursuant to a benefit formula that is based on a number of factors. These factors may include either the years of service with the employer or the years of participation in the plan, as well as either the participant’s compensation during either his or her participation in the plan or service with the employer or the participant’s average compensation received during a shorter period ending at retirement. In such a plan, the amount of the employer’s contribution is based on an actuarial determination as to the amount required to fund the benefits payable under the plan. The employer has a legal obligation to make the required contribution and is liable for a penalty tax on any so-called funding deficiencies. Benefits under a defined benefit plan are guaranteed up to a certain limit by the Pension Benefit Guaranty Corporation (PBGC), a quasi-government corporation created under ERISA.

In a defined benefit plan, a participant usually is entitled to a periodic benefit and, unless the participant’s spouse has waived his or her rights, the spouse also is entitled to a survivor annuity, which is payable whether or not the participant actually survives to begin receiving benefits. In many defined benefit plans a lump sum distribution is not available. The sponsoring employer may have elected not to permit lump sum distributions because of a paternalistic concern that a participant may elect to receive lump sum distributions and squander the money or may have a concern about the cash flow consequences to the plan if a number of participants retired and elected lump sum treatment in the same year.

While at one time death benefits in the form of life insurance were prevalent in defined benefit plans, in recent years many defined benefit plans have eliminated death benefits, except for the survivor annuities required under REA. Many employers have replaced these benefits with increased amounts of group term insurance.

2. Defined Contribution Plans.

Under a defined contribution plan the participant is entitled to the amount that is in the participant’s account when the participant retires or otherwise is entitled to a distribution under the plan. The account

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7. IRC § 408(c).
8. IRC § 408(e)(1).
9. IRC § 72(e)(9)(B).
11. IRC § 501(a).
12. See generally IRC § 402.
13. ERISA § 4002.
balance will be composed of the employer's contributions, forfeitures allocated to the participant's account from the accounts of participants that separated from service before they were fully vested, contributions made to the plan by the participant, and income and gains (offset by losses) on the amounts in the account. The employer has no obligation with respect to the amount of the accrued benefit of the participants in the plan at any given time, such as retirement, except to make any contributions required under the plan.

3. Profit Sharing Plans.

There are different types of defined contribution plans. A profit-sharing plan allows the employer to decide each year the amount that the employer wishes to contribute to the plan. Generally, an employer's contribution is allocated to the participants' accounts in the same proportion as each participant's compensation for the year bears to the compensation of all participants for the year.


On the other hand, a money purchase pension plan requires the employer to make a fixed contribution to the plan, determined by a percentage of the participant's compensation. For example, the employer may be required to contribute to the plan each year an amount equal to ten percent of each participant's compensation during the year. The employer is subject to a funding deficiency tax to the extent that the required amount is not contributed, as is the case under the rules applicable to defined benefit plans. A variation of a money purchase pension plan is a target benefit plan, which also requires the employer to make a fixed contribution each year. The amount of contribution allocated to each participant's account is related to the participant's age and is based on compensation and assumed investment results. However, the participant is entitled to whatever his or her account is actually worth on the date of retirement, whether able to produce a higher or lower benefit than the "target." This type of plan clearly favors older employees more than any other type of defined contribution plan as other types generally do not take into account years of service or years until retirement in their allocation formulas.

5. Other Defined Contribution Plans.

In a thrift or savings plan the amount of the employer's contribution allocated to the account of each participant is dependent upon the amount each participant contributes to the plan. For example, the plan may provide that the employer will contribute 50 percent of the amount of the participant's contribution, up to a certain percentage of the participant's compensation. Stock bonus plans and ESOPs are designed to own stock in the sponsoring employer. Finally, a 401(k) plan, also known as a cash or deferred arrangement, permits the participant to forgo the receipt of bonus or reduce the participant's salary and have the employer contribute the amount to the plan. An employer also may sponsor a simplified employee pension plan, which consists of an IRA for each participant. This type of plan requires the least amount of reporting and other administrative details by the employer.


Lump sum distributions usually are available to participants in a defined contribution plan, although the payment in the form of a lump sum may be subject to spousal rights under REA. Certain profit-sharing plans, ESOPs, stock bonus plans and 401(k) plans may pay the participant's benefit in the form of a lump sum without the spouse's consent.


Only experienced practitioners should engage in the designing and drafting of qualified plans. In order to receive the tax benefits discussed in Part C of this Section, a qualified retirement plan must satisfy the requirements of Section 401(a) of the Internal Revenue Code (the Code). This subsection currently contains 28 paragraphs, and many of these paragraphs refer to other lengthy sections of the Code for further amplification.\(^\text{14}\)

Since most qualified plan documents will have been submitted to the Internal Revenue Service for a ruling as to whether they satisfy these requirements, the advisor usually will know that the plan document has satisfied these requirements. Since these requirements impact on the timing of benefit payments, the method of benefit payments, and the determination of a participant's vested accrued benefit in the plan, the advisor should be familiar with the requirements that affect the participant's benefits. The advisor also should be able to determine the value of the participant's vested accrued benefit under the plan.

In addition to satisfying the requirements of the Code, all qualified retirement plans also must satisfy the requirements of the labor laws for pension plans enacted as part of ERISA.\(^\text{15}\) These requirements generally serve to protect the participant's rights to his or her vested accrued benefits and impose on the employer and other fiduciaries the responsibility for protecting the benefits of the participants of the plan. The advisor should be familiar with the various reports ERISA requires the plan administrator to furnish to participants annually. The advisor should review the summary plan description and annual benefit statements.

Finally, the participant has certain rights under ERISA. These rights must be exercised first through the administrative process provided by the plan, pursuant to a claim procedure that must be written and made available to the participant.\(^\text{16}\) If not satisfied after exhausting the plan's administrative remedies, the participants can enforce such rights at his or her option in either state or federal court.\(^\text{17}\)

\(^{14}\) IRC §401(a). Note that paragraphs 18 and 21 have been repealed.

\(^{15}\) ERISA Title I.

\(^{16}\) ERISA §503.

\(^{17}\) ERISA §502.
F. Plan Benefits.

The following three sections deal with the requirements of the Code pertaining to the timing of benefit payments, the method of benefit payments, and the determination of the participant’s vested accrued benefit.

1. Timing of Benefit Payments.

a. Mandatory Distributions.

The Code and ERISA require that, unless the participant otherwise elects, distributions of a participant’s benefit under a qualified retirement plan commence no later than 60 days after the close of the plan year in which occurs the latest of:

1. The date the participant reaches the earlier of age 65 or the normal retirement age under the plan;
2. The tenth anniversary of plan participation; or
3. The participant’s termination of employment.

This requirement can be explained as follows. If a participant begins to participate in the plan before he or she reaches age 55 and the normal retirement age is 65 or later, then he or she must be entitled to his or her benefit at age 65 unless the participant continues to work for the sponsoring employer. If a participant begins to participate in the plan before he or she reaches age 55 and if the normal retirement age under the plan is below age 65, then he or she must be entitled to his or her benefit at the later of the date he or she reaches the normal retirement age under the plan or the date he or she completes ten years of participation. If the participant begins to participate in the plan after age 55, the plan may require that the participant have ten years of participation in the plan, whether or not continuous, before the participant is entitled to the participant’s benefit.

As discussed in Part C of Section II, the Code also requires that distributions commence no later than April 1 following the calendar year during which the participant attains age 70½, regardless of whether the participant actually has terminated employment.

b. Earlier Distributions.

Regardless of when the participant must receive benefits, qualified retirement plans may provide for the distribution of benefits at an earlier date. It is usual for plans to provide for the distribution of benefits upon the death of the participant; upon the participant’s disability; upon the participant’s early, normal or deferred retirement as defined in the plan; upon the participant’s termination of employment; or upon the termination of the plan itself.

Distributions from pension plans, which include both money purchase pension plans and defined benefit plans, generally are not permitted under the Code before the death of the participant; the participant’s retirement, whether early, normal or deferred; the participant’s disability; the participant’s severance of employment; or the termination of the plan. Such plans may not permit distributions to an active employee before the employee reaches the normal retirement age, unless required to do so because of the required minimum distribution rules. An active employee who has reached normal retirement age under the plan but who is under age 59½ may receive a distribution from the plan, but the distribution will not be eligible for lump sum treatment, since he or she has not reached age 59½. Lump sum treatment will be available with respect to a distribution to an active employee if he or she has reached the normal retirement age under the plan and is over age 59½.

c. In-Service Distributions.

In-service distributions, which are distributions while the participant continues in the sponsoring employer’s employment, are generally prohibited under pension plans. A pension plan may permit the withdrawal of mandatory nondeductible employee contributions and the earnings thereon with respect to an employee who ceases plan participation but does not terminate employment. Mandatory contributions are contributions that are required as a condition of employment, as a condition of participating in the plan, or as a condition of receiving benefits under the plan. A pension plan may permit in-service withdrawals of voluntary nondeductible contributions and the earnings on the contributions at any time, even if the participant continues either to participate in the plan or to work for the sponsoring employer.

d. Profit Sharing Plans.

Profit-sharing plans, on the other hand, may provide for distributions after a fixed number of years (at least two), upon the attainment of a stated age, or upon the prior occurrence of an event such as the participant’s disability, hardship, retirement, death, or severance of employment. Under proposed regulations an integrated profit sharing plan may now permit in-service distributions from such plans.

Although profit-sharing plans generally may permit in-service hardship distributions, distributions of amounts from a 401(k) plan that are attributable to employer contributions made pursuant to a participant’s election to reduce his or her salary or to forgo additional compensation (elective deferrals) are only permitted upon certain circumstances. These circumstances are:

1. The participant’s separation from service, death, disability, or the attainment of age 59½.

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18. IRC §401(a)(14); ERISA §206(a).
19. IRC §401(a)(9)(C).
22. Reg. §1.401-1(b)(1)(i).
24. IRC §411(c)(2)(C), flush language.
The termination of the plan without the establishment or maintenance of another defined contribution plan other than an ESOP, but only if the participant's entire interest is distributed within one taxable year of the participant. 39

(3) The disposition by the sponsoring corporation of substantially all its assets in a trade or business or of its interest in a subsidiary to another corporation, but only if:

(a) The participant continues employment with the purchaser or a subsidiary;
(b) The transferor corporation continues to maintain the plan after the disposition, and
(c) The participant's entire interest is distributed within one taxable year of the participant. 40 or

(4) The financial hardship of the participant. 41 In years beginning after 1988, hardship distributions are limited to the elective deferrals, exclusive of any income earned on the elective deferrals. 42

If a qualified retirement plan provides for the payment of an early retirement benefit, a vested participant who terminates employment after satisfying the service requirement and before satisfying the plan's age requirement for the early retirement benefit must be entitled to begin receiving his or her vested benefit when he or she reaches the early retirement age. 43

e. Consent for Certain Distributions.

A qualified plan generally may not distribute any portion of a participant's benefit before the participant reaches the later of the normal retirement age under the plan or age 62, without the participant's written consent. 44 For the consent to be valid, the participant must be notified of the material features of the plan's optional forms of benefits and of his or her right, if any, to defer the commencement of distributions. 45 This notice must be given no less than 30 and no more than 90 days before benefits are scheduled to begin. 46 The participant's written consent must be given after the notice is given, but no more than 90 days before benefits are scheduled to begin. 47 If the plan is subject to the survivor annuity rules, the notice also must describe the spousal consent rights that are explained in Section V. 48

The consent of the participant is not required if the value of the participant's benefit is $3,500 or less. 49 However, if the plan is subject to the survivor

annuity requirements, the distribution of a benefit with a value of $3,500 or less is not permitted after the participant's annuity starting date, unless the participant and spouse (or where the participant has died, the surviving spouse) consent to the distribution. 50 No consent is required with respect to a distribution after the death of the participant, 51 unless the plan is subject to the survivor annuity requirements. While the spouse of the deceased participant is entitled to receive his or her distribution in the form of a survivor annuity unless he or she consents to another form of distribution, a beneficiary other than the surviving spouse may be forced to take an immediate distribution if the plan so provides. 52

2. Types of Benefit Payments.

Generally, distributions from qualified retirement plans are made pursuant to the options set forth in the plan document. For example, the plan may permit distributions in the form of a life annuity; various forms of joint and survivor annuities; and other types of annuities, whether lifetime or joint and survivor, with a fixed number of payments guaranteed, for example, five or ten. In addition, the plan may provide for the payment of the benefits in installments, or in a lump sum. Although a plan may not condition the availability of an optional form of benefit upon the discretion of the employer, the plan administrator, or the trustee, the plan may condition the availability of an optional form of benefit upon the satisfaction of objective standards that are specifically set forth in the plan and are applied to participants in a nondiscriminatory manner. 53

Distribution rules that specify the maximum period over which the payment of benefits from a qualified plan or IRA may be spread and the minimum amounts which must be distributed each year to avoid a 50 percent tax are discussed in Parts D and E of Section II.

The Internal Revenue Code and ERISA, as amended by REA, generally require that retirement benefits be paid in the form of a qualified joint and survivor annuity and that death benefits be paid in the form of a qualified pre-retirement survivor annuity if the participant dies before he or she begins to receive benefits. 54

A profit-sharing plan or stock bonus plan generally is not subject to these requirements, if certain conditions are met. 55 See Section V for a discussion of the qualified joint and survivor annuity and qualified pre-retirement survivor annuity.


A participant in a qualified retirement plan at

30. IRC §5401(k)(2)(B)(i)(II) and (B) as added by TAMRA §1011(k)(1)(B).
32. IRC §417(e)(2)(B)(i)(IV) as added by TRA 86 §1116(b)(1).
33. IRC §410(a)(14), flush language; Reg. §1.410(a)-14(c).
34. IRC §411(a)(11)(A); Reg. §1.411(a)-11(c)(4).
35. Reg. §1.411(a)-11(c)(2)(i).
37. Reg. §1.411(a)-11(c)(2)(iii).
38. IRC §417(a)(3); Reg. §1.417(a)-1(b)(2).
39. IRC §411(a)(11)(A); Reg. §1.411(a)-11(c)(3).
40. IRC §417(e)(1).
41. Reg. §1.411(a)-11(c)(5).
42. Reg. §1.417(e)(1)(b)(1).
44. Reg. §1.411(a)-1, Q&A 3; Reg. §1.411(d)-4, Q&A 4.
45. IRC §401(a)(11)(A); ERISA §205; REA §§103(a), 202(a).
46. IRC §401(a)(11)(B)(ii).

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any given time is entitled to his or her vested accrued benefit, which is determined under the plan. Accrued benefits may not be decreased by a plan amendment and benefit accruals may not be discontinued because of a participant's age.46


A participant's accrued benefit under a defined benefit plan is the value of the benefits determined in accordance with the normal retirement benefit formula and benefit accrual rules under the plan, using actuarial assumptions and interest rates that are set forth in the plan.48 The interest rate used in determining lump sum distributions cannot exceed the applicable PBGC rate unless the amount of the vested accrued benefit, using the PBGC rate, exceeds $25,000, in which case 120 percent of the PBGC rate may be used.50

The normal retirement benefit is the benefit determined according to the formula in the plan. The part of the normal retirement benefit to which the participant is entitled (the accrued benefit) must be determined under one of three methods.51 The most common method is the fractional method, under which the participant's accrued benefit is determined by multiplying his or her normal retirement benefit by a fraction, the numerator of which is the number of years the participant has participated in the plan, and the denominator of which is the number of years the participant would have participated in the plan had he or she continued to participate until the normal retirement date under the plan.52

For example, assume that the participant's annual normal retirement benefit under the plan is 50 percent of the participant's final average earnings; that the average of the participant's annual earnings during the five-year period ending on his or her retirement is $50,000 (his or her final average earnings); that the participant began participating in the plan at age 25; that he or she is terminating his or her participation in the plan at age 45; and that the normal retirement age under the plan is age 65. The participant's accrued benefit under the fractional method would be equal to an annual benefit of $12,500. This is determined by multiplying the participant's normal retirement benefit as determined under the plan, which would be $25,000 per year (50 percent of his or her final average earnings, assumed for this purpose to be $50,000 per year), times a fraction, the numerator of which is the number of years of participation the participant had when he or she terminated participation in the plan and the denominator of which is the number of years of participation the participant would have completed had he or she remained in the plan until his or her normal retirement age, age 65 (20 over 40).


A participant's accrued benefit under a defined contribution plan is the participant's account balance.53 The account balance is the sum of the employer's contributions, employee contributions, if any, and net earnings or losses on the investment of the account. It may also include forfeitures from nonvested accounts of former participants.

c. Top Heavy Plans.

If the plan is top heavy, the plan must provide a minimum benefit accruable to non-key employees.54 A plan is top heavy if the value of accrued benefits held for the benefit of key employees equals or exceeds 60 percent of the value of the accrued benefits held for the benefit of all employees.55 A key employee is a person who owns more than five percent of the employer, an officer who earns over a certain dollar limit, a person who owns more than one percent of the employer and has compensation over a certain amount, and the ten persons who own the greatest interest in the employer.56 Plans sponsored by small companies and professional practices are likely to be top heavy.

In a defined benefit plan, the minimum benefit that must be accrued each year for a non-key employee is an annual benefit equal to two percent of the non-key employee's compensation each year.57 The minimum benefit that must be provided in a defined contribution plan that is top heavy is three percent of a non-key employee's compensation each year, or the highest percentage allocated to the account of any key employee, whichever is lower.58

d. Vested Benefits.

A participant is vested in his or her benefit if the participant has an unconditional and nonforfeitable right to his or her accrued benefit under the plan. A participant must be 100 percent vested at all times in employee contributions and elective deferrals under a cash or deferred arrangement.59

The vested percentage of a participant's accrued benefit at any given time usually is determined by the years of service that the participant has with the employer (or a related employer).60 If the plan is not top heavy, the plan must provide that participants vest at least as rapidly as either (1) 100 percent after five years, or (2) 20 percent after three years of service, with an additional 20 percent each year thereafter until the participant has seven years of service, when the par-

47. IRC §411(a)(6).
49. IRC §411(a)(7)(A)(i).
50. IRC §§411(a)(11)(B), 417(e)(3).
51. IRC §411(b)(1).
52. IRC §411(b)(1)(C).
53. IRC §411(a)(7)(A)(i).
54. IRC §411(b).
55. IRC §416(b)(1)(A).
56. IRC §411(b)(1).
57. IRC §416(c)(1).
58. IRC §§416(c)(2).
59. ERISA §3(19).
60. IRC §§411(a)(1) and 401(k)(2)(C).
participant must be 100 percent vested. If the plan is too heavy, the participant must be 100 percent vested after three years of service or, in the alternative, at least 20 percent vested after two years of service, with at least an additional 20 percent of vesting each year until the participant has six years of service, when the participant must be 100 percent vested.62

A participant must be 100 percent vested in his or her accrued benefit upon the attainment of his or her normal retirement age.63 For this purpose, the normal retirement age is the earlier of:

1. The date the participant reaches the normal retirement age under the plan; or
2. The later of:
   a. The date the participant reaches age 65; or
   b. The fifth anniversary of the date the participant began to participate in the plan.64
SECTION II
PENALTY TAXES

A. In General.

Due to the favorable tax treatment afforded qualified retirement plans and IRAs, Congress has imposed penalties to ensure that qualified retirement plans and IRAs are being used for retirement purposes and are not being used either as temporary tax-free savings accounts or for limited deferrals of the receipt of taxable income. These penalties include a tax on premature withdrawals from qualified retirement plans and IRAs and a tax on amounts that are otherwise required to be distributed under the minimum distribution rules.

Since 1976 there have been limitations on the amount that can be allocated annually to a participant's account under a defined contribution plan and on the annual benefit that can be provided to a participant under a defined benefit plan. These limitations apply to plans sponsored by the same employer or related employers. Since the limitations do not apply to the individual participant, an individual participant may be able to accumulate benefits in excess of the limitations if the participant participates in plans sponsored by unrelated employers. To penalize those participants who have avoided the limitations on benefits under qualified retirement plans by participating in multiple plans or who have otherwise accumulated very large benefits in qualified retirement plans and IRAs, TRA 86 imposed a 15 percent penalty on excess retirement distributions and excess retirement accumulations.

The advisor must be familiar with all these penalties, since they will affect the timing of the payment of benefits and the form of benefit payment. In addition, the designation of a beneficiary will determine the period over which the payment of the benefits may be made. The balance of this section describes these penalties in detail.

B. Premature Distributions.

The Internal Revenue Code discourages the early withdrawal of benefits by imposing a ten percent penalty on the amount of a distribution from a qualified retirement plan or IRA that is includible in the income of the participant. The penalty does not apply if the withdrawal occurs after the participant has reached age 59½. There are a number of permanent exceptions to this rule as well as several transition rules.

The ten percent penalty tax does not apply to distributions made to a beneficiary or to the estate of a participant after the participant's death. In addition, any distribution attributable to the participant's disability is exempt from the ten percent penalty tax.

A distribution which is part of a series of substantially equal periodic payments made over the life or life expectancy of the participant or the joint lives or joint life expectancies of the participant and his or her designated beneficiary is not subject to the ten percent penalty tax. The payments must not be made less frequently than annually. The beneficiary whose life is used for purposes of determining the period over which the payments must be made must be the same person who is entitled to the benefits upon the death of the participant.

A participant who has begun to receive substantially equal periodic payments under this exception is subject to a recapture of the penalty tax that would have been paid on the distributions had the exemption not been available. The recapture applies if the method of payment is changed other than because of the death or disability of the participant before the later of the date the participant reaches age 59½ or before the end of the five-year period beginning on the date of the first payment. In addition, interest will be payable on the amount of penalty tax owed as a result of the change of method.

For example, if a participant separates from service and begins receiving substantially equal periodic payments at age 54, the participant may not change the method of payment until the participant reaches age 59½. On the other hand, if the participant separates from service and begins receiving substantially equal periodic payments at age 58, the participant may not change the method of payment until the participant reaches age 63.

To qualify for the periodic exception, a participant in a qualified retirement plan must separate from service. Separation from service is not required in the case of distributions from an IRA. Before TRA 86 added this exception, a ten percent penalty applied to amounts withdrawn from an IRA before the participant reached age 59½. Now a participant who has a substantial amount of funds in an IRA and who needs current income may begin to withdraw funds without penalty from his or her IRA under this exception, even though he or she has not retired or reached age 59½.

2. IRC §72(l)(2)(B).
3. IRC §72(l)(2)(C).
4. IRC §72(l)(2)(D).
5. IRC §72(l)(2)(E).
7. IRC §72(l)(2)(G).
8. IRC §72(l)(2)(H).
11. IRC §72(l)(2)(K).
15. IRC §72(l)(2)(O).

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A distribution made to a participant over age 55 after he or she separates from the service of the employer sponsoring the plan is excluded from the ten percent penalty. TAMRA eliminated the requirement that the plan document provide for early retirement. This exception for separation from service after age 55 does not apply to distributions from IRAs. IRAs generally are not sponsored by an employer, so the concept of separation from service is not meaningful except in the case of a simplified employer pension (SEP). Since a SEP consists of IRAs for the benefit of the participants, the use of a SEP would afford participants greater flexibility with respect to withdrawals from IRAs under the periodic payment exception, but less flexibility in connection with the exception for separation from service after age 55.

A distribution that is a dividend with respect to qualifying employer stock which is allocated to the participant's account in an ESOP is not subject to the ten percent penalty. The employer obtains a deduction for the dividend that is paid out to the participant. Dividends to an ESOP represent the only way that a participant can receive current distributions from a qualified retirement plan without the imposition of the ten percent penalty before reaching age 59 1/2, separating from service, or becoming disabled.

Distributions to an alternate payee under a QDRO are not subject to the ten percent tax to the extent that the distributions are includable in the income of the alternate payee. Since IRAs are not subject to QDROs, this exception does not apply to distributions from IRAs that are paid to a spouse, regardless of whether or not the distributions are pursuant to a domestic relations order.

TRA 86 added a little used exception for medical expenses. If the distribution from a plan to a participant does not qualify for any of the other exceptions, then it will qualify for the medical expense exception to the extent that the amount distributed during the participant's taxable year does not exceed the amount that is allowable as a deduction for medical expenses during the taxable year. This exception applies regardless of whether the participant actually itemizes his or her deductions. As a result, a participant with medical expenses in excess of seven and one-half percent of adjusted gross income may receive distributions from a qualified retirement plan that will not be subject to the ten percent penalty. The distributions will be taxable income, however. Withdrawals from an IRA do not qualify for this exception.

The ten percent penalty tax applies only to the amount of the distribution that is included in the participant's income. For example, the ten percent penalty does not apply to nondeductible employee contributions that are withdrawn from a qualified retirement plan or from an IRA. Nor does the penalty apply to the part of a distribution that is rolled over into an IRA.

There are two transition rules that apply to premature distributions. The ten percent penalty does not apply to a participant who separated from service before March 1, 1986 and was receiving benefits as of that date. The transition rule does not apply to a more-than-five-percent owner (a sole proprietor, or a partner or shareholder who owns more than five percent of the sponsoring employer) who received benefits before attaining age 59 1/2 or becoming disabled, since he or she was subject to the penalty before 1987.

The second transition rule exempts from the ten percent penalty benefits that are paid pursuant to a written designation made before January 1, 1984 that satisfied the transition rule under TEFRA. Under the TEFRA transition rule, a distribution pursuant to a written designation of a form of benefit made before January 1, 1984 is not subject to the new minimum distribution rules. The form of payment specified in the designation must have satisfied the incidental death benefit rules that were in existence before the required distribution rules were added by TEFRA, which required that the present value of benefits payable to a participant exceed 50 percent of the present value of the participant's entire benefit unless the spouse was the only beneficiary. The transition rule no longer applies to the benefits if the form of benefit or payment period is subsequently changed.

Employees of certain charitable organizations and public school systems are entitled to participate in tax deferred annuities. Such employees can elect to have their salary reduced and the amount reduced contributed to the annuities. The annuity contract must prohibit distributions attributable to salary reduction amounts before the participant reaches age 59 1/2, separates from service, or becomes disabled. In addition, a distribution on account of hardship may be made from employee contributions but not from the income on those contributions.

The ten percent penalty applies to cash-outs of amounts that do not exceed $3,500. These amounts

27. IRC §72(1)(1).
28. TRA 86 §1123(3)(i)(ii).
29. TRA 86 §1123(3)(ii).  
32. IRC §403(b)(1).
33. IRC §403(b)(1).
34. IRC §403(b)(11)(A).
35. IRC §403(b)(11)(B).
36. Notice 87-13, 1987-1 C.B. 432, Q&A 20; TAMRA §1011A(c)(13).

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do not require the participant’s consent for distribution before the participant reaches age 62 and so may be distributed to the participant against his or her will.\textsuperscript{37} In order to avoid the ten percent penalty, the participant who has terminated employment may roll the distribution into an IRA.

The ten percent penalty applies to distributions from qualified retirement plans (including qualified voluntary employee contributions), annuity plans under §403(a), §403(b) annuities, and IRAs, but not to so-called IRC §457 plans, which are deferred compensation arrangements for employees of tax exempt organizations.\textsuperscript{38} Withholding is not required with respect to the ten percent penalty.\textsuperscript{39}

C. Required Distributions.

One of the principal tax benefits associated with qualified retirement plans and IRAs is the tax-free build-up of income in the plan or IRA. To the extent that a participant in such a plan or IRA does not need the funds, it is advantageous for the participant to leave the funds in the plan or IRA, even though he or she is otherwise eligible to withdraw them. Because the constructive receipt doctrine does not apply to qualified retirement plans or IRAs, the participant may have the right to withdraw the funds at any time without being subject to current income tax on those funds. Before 1982, there was an unlimited exclusion from the federal gross estate for qualified retirement benefits and IRAs, provided that certain requirements were satisfied. This exclusion meant that if the participant deferred the receipt of plan benefits and IRA distributions until after the participant’s death, transfer taxes on such amounts also were eliminated. This exclusion was reduced by TEFRA and eliminated by DEFRA. Nevertheless, for a participant who does not need the funds, the income tax deferral provides a sufficient incentive to leave the funds in a qualified retirement plan or IRA indefinitely.

Before TEFRA, the ability to leave funds in a plan was limited by the incidental death benefit rule. Under this rule, once the participant began to receive payments under the plan, the present value of the benefits payable to the participant during his or her lifetime had to exceed 50 percent of the present value of the accrued benefit of the participant.\textsuperscript{40} This rule did not apply if the distribution was over the joint lives of the participant and his or her spouse and the life of the survivor, even though the participant’s beneficiary was someone other than the spouse.\textsuperscript{41}

TEFRA enacted rules requiring that a participant begin receiving benefits no later than April 1 of the calendar year following the later of the calendar year in which the participant reached age 70½ or the participant separated from service.\textsuperscript{42} A participant owning a more-than-five-percent interest in the sponsoring employer was required to begin receiving benefits by April 1 of the calendar year following the calendar year in which the participant reached age 70½, regardless of whether the participant had actually separated from service.\textsuperscript{43} DEFRA modified these rules, and TEFRA 86 completely revamped them. These rules are discussed in the next two parts of this section.

Since the purpose of these rules is to require recognition of taxable income, any minimum required distribution may not be rolled into an IRA.\textsuperscript{44}

D. Lifetime Distributions.

1. Required Beginning Date.

A qualified retirement plan or IRA must provide that the entire interest of the participant, whether or not he or she is currently employed, retired, or terminated with a vested benefit, be distributed or commence to be distributed on or before the required beginning date, which is April 1 of the calendar year following the calendar year in which the participant attains the age of 70½.\textsuperscript{45} Before TEFRA 86, participants who were not more-than-five-percent owners were not required to begin receiving benefits until they actually separated from service. TEFRA 86 contained a transition rule allowing a participant who reached age 70½ before January 1, 1988 and who was not a more-than-five-percent owner of the sponsoring employer at any time after the calendar year in which he or she reached age 66½ to wait until April 1 after the later of the calendar year in which the participant attained age 70½ or the calendar year in which the participant separated from service to begin receiving benefits.\textsuperscript{46}

Generally, distributions to a participant made prior to the participant’s required beginning date pursuant to the terms of the plan or otherwise are not considered credits against future required distributions.\textsuperscript{47} As a result, if a participant begins to receive benefits before age 70½, once he or she reaches the required beginning date, the minimum distribution amount will be based on his or her account balance as of the valuation date in the preceding calendar year. Earlier distributions will not reduce the required distribution. An exception is made, however, for an irrevocable annuity that commences prior to the required beginning date and otherwise satisfies the minimum distribution requirements.\textsuperscript{48} Furthermore, a participant who has received annual benefit distributions from a qualified retirement plan and who dies after his or her normal retirement date under the plan but before his or her required

\begin{itemize}
\item [\textsuperscript{37}] IRC §411(a)(11).
\item [\textsuperscript{38}] IRC §§72(2)(1) and 4974(c).
\item [\textsuperscript{39}] IRC §§404(a) and (b)(2)(B); Notice 87-13, 1987-1 C.B. 432, 441.
\item [\textsuperscript{40}] Rev. Rul. 74-325, 1974-2 C.B. 127.
\item [\textsuperscript{41}] Rev. Rul. 72-246, 1972-1 C.B. 108.
\item [\textsuperscript{42}] TEFRA §242(a), amending IRC §401(a)(9).
\item [\textsuperscript{43}] IRC §401(a)(9)(C) prior to enactment of TEFRA 86. See TEFRA 86 §182(a)(4)(A).
\item [\textsuperscript{44}] IRC §402(a)(5)(G).
\item [\textsuperscript{45}] IRC §§401(a)(9)(A) and (C).
\item [\textsuperscript{46}] Prop. Reg. §1.401(a)(9)-1, Q&A-2(b) and (d).
\item [\textsuperscript{47}] Prop. Reg. §1.401(a)(9)-1, Q&A B-2(a).
\item [\textsuperscript{48}] Prop. Reg. §1.401(a)(9)-1, Q&A B-2(b).
\end{itemize}
beginning date is deemed to have died prior to having commenced receiving the distribution of his or her benefits under the plan. 49

Although the required beginning date is not until April 1 following the calendar year in which the participant reaches age 70 1/2, it may not be advisable to wait until the required beginning date to begin to receive distributions. As will be discussed, 50 TGRA 86 added a 15 percent penalty on excess retirement distributions. If a participant waits until April 1 of the calendar year following the calendar year in which he or she reaches age 70 1/2, the participant will have to receive two distributions in that year, one distribution on or before April 1 to satisfy the minimum distribution requirement for the year in which the participant reached age 70 1/2, and another distribution before December 31 of the same year to satisfy the minimum distribution requirement for the year following the year in which the participant reached age 70 1/2. 51 The receipt of the two required distributions in the same year may subject part of the distributions to the 15 percent excise tax on excess retirement distributions, even though each of the distributions would not have been subject to the tax if it had been made in a separate taxable year.

2. Transition Rule.

The TEFRA transition rule that applies to the ten percent tax on premature distributions also applies to the required minimum distribution. If the form of benefit and the beneficiary were designated in writing before January 1, 1984, distributions of benefits from qualified retirement plans and IRAs may be made less rapidly and at a later date than permitted under current law. 52 The form of benefit must have satisfied the law in effect before January 1, 1984, including the incidental death benefit rule. 53 If the form of payment or payout period is changed, the transition rule will no longer apply. 54 In addition, the proposed regulations provide that the rule will no longer apply if the benefits are transferred to another plan by the voluntary action of the participant. 55 Once the rule no longer applies, the new minimum distribution rules do apply and may require a substantial amount of the benefit to be paid in the year in which the transition rule no longer applies in order to catch up. 56

It is important for the advisor to determine whether such a written election exists when advising a client about planning for distributions from qualified retirement plans and IRAs. The existence of such an election may give the participant greater flexibility in planning for the receipt of qualified retirement plan and IRA benefits. In addition, the advisor will want to avoid an inadvertent termination of the election.

3. Amount of Distribution.

Commencing at the required beginning date, either the entire value of the benefit must be distributed in a lump sum or in payments over the life of the participant or over the joint lives and the life of the survivor of the participant and a designated beneficiary. 57 In lieu of an annuity, the payments may be made over a period certain not extending beyond the life expectancy of the participant or the joint and last survivor expectancy of the participant and the participant’s designated beneficiary. 58 If more than one beneficiary is selected by the participant, the life expectancy of the beneficiary with the shortest life expectancy is used for purposes of determining the period over which the payments must be made. 59

In the case of individual account plans (IRAs and defined contribution plans), the minimum amount to be distributed during each distribution calendar year (starting with the calendar year in which the participant reaches age 70 1/2) is determined by dividing the amount in all the accounts of the participant by the applicable life expectancy. 60 The amount used to determine the minimum distribution amount is the account balance as of the last valuation date in the calendar year immediately preceding the distribution calendar year, increased by contributions and forfeitures added to the account after the valuation date during the valuation calendar year, and decreased by distributions made after the valuation date during the valuation calendar year. 61

4. Life Expectancies.

Life expectancies are determined by the use of the expected return multiplies in Tables V and VI of the Internal Revenue Code Regulations under §1.72-9. 62 Generally, the participant’s age (and the age of the participant’s beneficiary) reached in the calendar year in which he or she attains age 70 1/2 (the first distribution calendar year) is used for purposes of determining the life expectancy. 63 Consequently, if a participant’s birthday falls on or after January 1 and before July 1, his or her age will be 70 for determining his or her life expectancy; if a participant’s birthday falls after June 30 and on or before December 31, his or her age will be 71 for determining his or her life expectancy.

If the payments are being made in installments over a period equal to the life expectancy of the participant, the life expectancy of the participant may be recalculated annually. 64 As a person survives for another 12-month period, the person’s life expectancy does not diminish by a full year, but rather a somewhat lesser period. In addition, if the period is the joint life and

49. Prop. Reg. §1.401(a)(9)-1, Q&A B-5(c).
50. See Section 167.
51. Prop. Reg. §1.401(a)(9)-1, Q&A A-1(c) and Q&A E-8(c) Example 1.
57. IRC §401(a)(9)(A).
58. IRC §401(a)(9)(A)(1).
60. Prop. Reg. §1.401(a)(9)-1, Q&A F-1(a).
61. Prop. Reg. §1.401(a)(9)-1, Q&A F-5(a), (b) and (c)(1).
63. Prop. Reg. §1.401(a)(9)-1, Q&A E-6.
64. IRC §401(a)(9)(D) and Prop. Reg. §1.401(a)(9)-1, Q&A E-6.
last survivor expectancy of the participant and the participant’s spouse, either or both life expectancies may be recalculated annually.65 If the life expectancy of the participant or the life expectancies of the participant and the participant’s spouse are being recalculated, when one of them dies, the life expectancy of that person is zero for purposes of determining the minimum distribution amount in the year following the year of that person’s death.66 This will increase the minimum distribution required in the following year since only the survivor’s life expectancy will be used in calculating the required distribution. At the death of the survivor of the participant and the spouse, when both life expectancies are being recalculated each year, the balance of the account must be distributed by December 31 of the year following the calendar year of the survivor’s death since there will be a zero life expectancy.67 If the life expectancy was not being recalculated, the payment would continue to be made over the original period determined at the time the participant began receiving benefits. The recalculation of life expectancies will result in a longer payout period if the participant and his or her spouse outlive the original life expectancy, since the payments will continue until after the actual death of the survivor rather than the end of the original period. On the other hand, the recalculation of life expectancies will result in a shorter payout period if they both die sooner than the original life expectancy, since the payments will cease the year after the death of the survivor rather than at the end of the original period. If a qualified plan does not set forth provisions or election procedures relating to the recalculation of life expectancies, the regulations require that the life expectancy of the participant and the spouse must be recalculated.68 After the required beginning date the participant may not change the method of determining life expectancies.

5. Defined Benefit Plans.
In the case of a defined benefit plan, a distribution in the form of an annuity must be made in periodic payments at intervals not longer than one year.69 Under most defined benefit plans, these payments will be made on a monthly basis. The payments must commence on or before the required beginning date70 and, as long as the form of payment meets the minimum distribution rules and payments are made at the scheduled intervals, the excise tax should not apply to any amounts remaining in the plan.71

The method of benefit payment also must satisfy the minimum distribution incidental death benefit rule, as explained in the proposed regulations.72 This rule limits the period over which payments may be made when a person other than the spouse is the designated beneficiary.73 The minimum distribution incidental death benefit rule is designed to ensure that the primary purpose of the plan is to provide retirement benefits to participants.74 The proposed regulations require that the joint and last survivor life expectancies, when the beneficiary is not the participant’s spouse, be calculated using an age that is no more than ten years below the age of the participant.75 This requires a more rapid payout than if the actual life expectancy of a beneficiary more than ten years younger than the participant were used.

E. Distributions After Death of Participant.

1. In General.
If a participant dies before the participant has received his or her entire benefit under a qualified retirement plan or an IRA, the remaining benefit must be paid to the beneficiary or beneficiaries in a form that satisfies the minimum distribution rules. The amount that must be paid depends upon whether the participant died before or after the participant’s required beginning date, which is April 1 of the calendar year following the calendar year in which the participant reaches 70½.

2. Death After Payments Begin.
If the participant dies after the payments have begun, and after the required beginning date, but before the participant’s entire interest has been distributed, the remaining portion of the benefits must be paid out at least as rapidly as under the method of distribution in effect at the date of the participant’s death.76 In the case of a distribution which begins before the employee’s death and which is being paid out over the lives of the participant and a designated beneficiary (or a period not exceeding the joint and last survivor expectancies of the participant and a designated beneficiary), the designated beneficiary whose life expectancy was being used to determine the period must be entitled to receive the remaining portion of the participant’s benefit after the participant’s death.77

If the benefit was being paid over the life expectancy of the participant, or over the joint life expectancies of the participant and the participant’s spouse, and the life expectancy of the participant or the life expectancies of both were being recalculated each year, the entire balance must be distributed before December 31 of the calendar year immediately following the death of the participant, in the first case, or the last to die of the participant and the spouse, in the second case.78

65. IRC §401(a)(9)(D) and Prop. Reg. §1.401(a)(9)-1, Q&A E-6.
66. Prop. Reg. §1.401(a)(9)-1, Q&A E-8(a).
68. Prop. Reg. §1.401(a)(9)-1, Q&A E-7(a).
69. Prop. Reg. §1.401(a)(9)-1, Q&A F-2(a).
70. Prop. Reg. §1.401(a)(9)-1, Q&A F-1(c).
71. Prop. Reg. §1.401(a)(9)-1, Q&A F-3.
72. IRC §401(a)(9)(G); Prop. Reg. §1.401(a)(9)-2, Q&A 4.
76. IRC §401(a)(9)(B)(i).
77. Prop. Reg. §1.401(a)(9)-1, Q&A B-4.
78. Prop. Reg. §1.401(a)(9)-1, Q&A E-8(a), See Section II.D.
If the participant dies before the required beginning date, the participant’s entire benefit in all plans must be distributed by December 31 of the calendar year that contains the fifth anniversary of the death of the participant, unless either the designated beneficiary exception or the spousal exception applies. Under the five-year rule, the entire amount of the participant’s benefit may be held until December 31 of the fifth year following the calendar year of his or her death. If the participant is receiving his or her benefits in a form other than under an irrevocable annuity, the five-year rule will apply if the participant dies before the required beginning date, even though distributions have been made to the participant before such date.  

The designated beneficiary exception permits the remaining benefits to be paid over the life expectancy of the designated beneficiary if the payments begin no later than December 31 of the calendar year following the calendar year of the participant’s death. Under the spousal exception, if the benefits are to be paid to the participant’s spouse over the life of the spouse or over a period not extending beyond the spouse’s life expectancy, the commencement of payments may be deferred until the later of December 31 of the calendar year following the death of the participant or December 31 of the calendar year in which the participant would have attained age 70½. If the spouse dies before the distribution has begun, then the five-year distribution rule and the designated-beneficiary exception to the five-year rule will apply as if the surviving spouse were the participant. When the original surviving spouse dies, however, the spousal exception will not apply, so that his or her new spouse may not defer the commencement of benefit payments until the original surviving spouse would have attained the age of 70½.  

A payment to a child is treated as a payment to the surviving spouse if the payment of benefits from the plan will be made only to the spouse after the child reaches majority. Consequently, if a minor child is the recipient of benefit payments until the child reaches age 21, and the surviving spouse is the only beneficiary of the remaining benefits, the form of benefit payments will qualify under the spousal exception to the five-year rule.  

The proposed regulations provide rules for determining whether the five-year rule or one of the exceptions applies. In the case of a plan that does not specify the method that will apply, if the surviving spouse is the beneficiary, the spousal exception to the five-year rule applies. If the beneficiary is other than the surviving spouse, the five-year rule applies. The plan may adopt a provision specifying which of the two methods applies after the death of the participant. In addition, a plan may permit a participant or a beneficiary to elect irrevocably the method of payment. The election must be made not later than the earlier of December 31 of the calendar year in which the benefit would be required to commence or December 31 of the calendar year which contains the fifth anniversary of the death of the participant. Consequently, to elect irrevocably out of the five-year rule, the election must be made by December 31 of the calendar year following the death of the participant unless the designated beneficiary is the spouse. Otherwise, the five-year distribution rule will apply, requiring all the benefits to be paid within five years. In the case of the spousal exception, the election must be made within five years, rather than at the time the deceased participant would have reached age 70½, unless the participant died after reaching age 66½.  

4. Designation of Beneficiary.

The designation of a beneficiary is extremely important since it may determine the period over which payments must be made. The designation may be made by the participant pursuant to the terms of the plan. If the participant fails to name a beneficiary, or the one named is no longer alive or otherwise capable of receiving the benefits, the terms of the plan may establish the beneficiary, such as the spouse, children, or estate. The proposed regulations set forth specific rules to determine whether a beneficiary named by the participant or according to the terms of the plan will be treated as a designated beneficiary for purposes of the required distribution rules. If the named beneficiary does not qualify as a designated beneficiary, only the participant’s life expectancy can be used for determining the period over which his or her benefits must be paid. In addition, if the participant dies before the participant’s required beginning date, and there is no designated beneficiary, the entire benefit must be distributed by the end of the calendar year that contains the fifth anniversary of the participant’s death.  

In order to be treated as a designated beneficiary, the beneficiary must be determined as of the required beginning date, except in the case of annuity payments that begin before the required beginning date. In such a case, the beneficiary must be designated at any time during the 90-day period ending before the annuity starting date. Any individual or

76. IRC §§401(a)(9)(B)(ii), (iii) and (iv).
77. Prop. Reg. §1.401(a)(9)-1, Q&A B-5(e).
78. IRC §§401(a)(9)(B)(ii); Prop. Reg. §1.401(a)(9)-1, Q&A C-3(a).
79. IRC §§401(a)(9)(B)(iv)(i); Prop. Reg. §1.401(a)(9)-1, Q&A C-3(b).
80. IRC §§401(a)(9)(B)(v) (B).
82. IRC §401(a)(9)(B)(v) (B).
83. IRC §401(a)(9)(B)(v).
84. Prop. Reg. §1.401(a)(9)-1, Q&A C-5.
85. IRC §401(a)(9)(B)(i).
86. IRC §401(a)(9)(B)(ii).
87. Prop. Reg. §1.401(a)(9)-1, Q&A C-4(a)(1).
88. Prop. Reg. §1.401(a)(9)-1, Q&A C-4(a)(2).
89. Prop. Reg. §1.401(a)(9)-1, Q&A C-4(a).
90. Prop. Reg. §1.401(a)(9)-1, Q&A C-4(c).
91. Prop. Reg. §1.401(a)(9)-1, Q&A C-4(c).
92. Prop. Reg. §1.401(a)(9)-1, Q&A C-4(d).
93. Prop. Reg. §1.401(a)(9)-1, Q&A C-4(d).
certain trusts may be designated as a beneficiary. An estate or charitable organization may not be a designated beneficiary for purposes of avoiding the five-year rule.

If there are multiple beneficiaries, including those that qualify as designated beneficiaries and at least one beneficiary that does not qualify as a designated beneficiary (such as a charitable organization) and separate accounts or shares are not established for each beneficiary, the proposed regulations treat the participant as if having selected a designated beneficiary. Consequently, it is important that the participant not select as a beneficiary an estate or charitable organization if separate accounts are not to be established and the participant wants to avoid the five-year distribution rule.

5. Trust as Designated Beneficiary.

The beneficiaries of a trust will be treated as designated beneficiaries only if the trust meets the following requirements at the later of the date the trust is named as a beneficiary or the required beginning date:

(1) The trust must be a valid trust under state law or would be a valid trust except for the fact that there is no corpus;

(2) The trust must be irrevocable;

(3) The beneficiaries of the trust who are beneficiaries with respect to the trust’s interests in the participant’s benefit must be identifiable from the trust instrument; and

(4) A copy of the trust instrument must be provided to the plan administrator.

The first and third requirements will not be difficult to satisfy. Most states require that a trust be valid if it is to be recognized under state law, for example, as a permissible beneficiary under a will. Many states treat a trust as valid if the trust is named as the beneficiary of a life insurance policy even though it has no corpus. In a state that does not treat such a trust as valid, the trust should still qualify under the first requirement if the only reason the trust is not valid is the lack of a corpus. A testamentary trust will not satisfy this requirement before the death of the participant since it only becomes a valid trust after the death of the participant.

Because most trust instruments will identify the beneficiaries or class of beneficiaries of the trust, the requirement that the beneficiaries be identifiable should usually be met. This requirement, however, may prevent the creator of the trust from giving another person the power to add beneficiaries at a later date. Although this type of power is not commonly granted, its use can provide flexibility.

The requirement that the trust be irrevocable may cause a practical problem. If the participant dies before the required beginning date, then the trust presumably would become irrevocable and satisfy this requirement. A testamentary trust or a revocable lifetime insurance trust, however, will not be irrevocable when a participant begins to receive his or her benefits after his or her required beginning date. Such a trust only becomes irrevocable upon the death of a participant, and since this occurs after the required beginning date, the trust would not satisfy the second requirement. Consequently, the five-year distribution rule would apply.

Presumably, the regulations take the position that the trust must be irrevocable to prevent manipulation with respect to the designated beneficiary once the payments have begun. This manipulation may be prevented in some manner other than requiring that the trust be irrevocable. For example, the regulations could require that the designated beneficiary or beneficiaries of the trust be named at the required beginning date. Although additional beneficiaries of the trust could be added later, the designated beneficiary or beneficiaries for determining the payout period and entitlement to plan benefits would not change. Unfortunately, the drafters of the proposed regulations appear not to have considered usual practices in estate planning when devising these rules.

The requirement that the trust instrument be provided to the plan administrator, while not impossible to comply with, is an unnecessary administrative burden on both the participant and the plan administrator. As long as the plan has been provided with a properly executed beneficiary designation, naming the trust as the beneficiary, there should be no need to furnish the actual trust agreement. The requirement could be construed to require the participant to furnish the plan administrator with copies of amendments to the trust agreement each time one is made. This requirement easily may be overlooked by a participant or the participant’s advisor.

6. Separate Accounts or Shares.

A designated beneficiary of a separate account or a separate share will be treated as a participant’s designated beneficiary with respect to the separate account or separate share. Consequently, the payments from the separate account or separate share may be made over the life expectancy of the beneficiary of the separate account or share rather than over the life expectancy of the beneficiary with the shortest life expectancy. A separate account in an individual account plan (a defined contribution plan or IRA) is a portion of a participant’s benefit determined by an acceptable separate accounting, including allocating investment gains and losses and contributions and forfeitures on a pro rata basis in a reasonable and consistent manner between such portion and any other benefits. A benefit in a defined benefit plan is segregated into separate shares if the benefit consists of

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96. Prop. Reg. §1.401(a)(9)-1, Q&A D-2A(a).
97. Prop. Reg. §1.401(a)(9)-1, Q&A D-2A(a).
98. Prop. Reg. §1.401(a)(9)-1, Q&A D-2A(a).
100. Prop. Reg. §1.401(a)(9)-1, Q&A H-2A(a).
separate identifiable components that may be separately distributed. 102

7. Penalty Tax.

If the required distribution is not made or is made only partially, a 50 percent tax on the amount by which the minimum required distribution exceeds the actual distribution is imposed on the participant.103

F. Excess Retirement Distributions.

TRA 86 imposed a 15 percent excise tax on excess retirement distributions and excess retirement accumulations.104 The tax is designed to penalize those participants who are able to avoid the limitation on contributions or benefits that apply to all plans sponsored by the same employer or related employers. Since these limitations are not applied on an individual basis, an individual may avoid these limitations by participating in plans sponsored by more than one employer.

Unless the grandfathers election, which is discussed in H below, applies, a 15 percent excise tax is imposed on benefit payments received during a calendar year in excess of the greater of $150,000 or the indexed amount.105 The indexed amount began as $112,500, which applied for 1987. This amount is indexed at the same time and in the same manner as the dollar limit on annual benefits under a defined benefit plan. The indexed amount for 1990 is $128,228.106

In some cases a distribution may be subject to both the 15 percent excise tax on excess retirement distributions and the ten percent excise tax on premature distributions. In such a case, the 15 percent tax on excess retirement distributions is reduced by any tax imposed because of a premature distribution.107 Simply stated, the total tax because of both penalties can never exceed 15 percent.

The following amounts are not taken into account in applying the excise tax on excess retirement distributions.108

1. Distributions not includible in income because of a rollover into an IRA or another qualified retirement plan.109

2. A distribution that is made after the death of the participant.110 The present value of the deceased participant's retirement benefits may be subject to the 15 percent excise tax on excess retirement accumulations.

3. Distributions to an alternate payee under a QDRO that are includible in the income of the alternate payee.111 The alternate payee must combine such distributions with distributions from qualified retirement plans and IRAs in which he or she participates in determining whether he or she is subject to the 15 percent excise tax on excess retirement distributions.112

(4) Distributions attributable to the participant’s investment in the contract.113 These amounts would include nondeductible employee contributions and amounts reported as income by the participant because of life insurance protection provided by life insurance policies owned by the plan.

(5) A distribution to an individual of an annuity contract if the value is not includible in the gross income of the participant at the time of the distribution.114 Distributions from the annuity contract, as well as proceeds from the sale or exchange of the contract, will be subject to the excise tax.115

(6) Distributions to an individual of excess deferrals, excess contributions, and excess aggregate contributions, as well as income allocable to these excess deferrals and contributions.116 Excess deferrals are deferrals in excess of the $7,000 limit, as indexed, applicable to cash or deferred arrangements under 401(k) plans or in excess of the $9,500 limit, as indexed, applicable to salary reductions under tax deferred annuities for employees of charitable organizations and public school systems. Excess contributions are salary reductions or forgone bonuses contributed to a cash or deferred arrangement made on behalf of highly compensated employees that exceed a certain percentage of similar contributions made on behalf of nonhighly compensated employees. Excess aggregate contributions are nondeductible employee contributions of highly compensated employees that exceed a certain percentage of similar contributions made by nonhighly compensated employees.

(7) Any health coverage or any distribution of medical benefits to the extent that these benefits are excludible under the Code sections that exempt employer-provided health benefits from an employee's adjusted gross income.117

(8) Distributions that are after-tax contributions made by the recipient to an IRA.118 These non deductible contributions119 are permitted after 1986.

Distributions are subject to the excise tax even though the plan may not be qualified at the time the distributions are made, as long as the plan was at any time qualified.120

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102. Prop. Reg. §1.401(a)(9)-1, Q&A H-2A(b)
103. IRC §4974(a)
104. IRC §§4980A(a), (d)(1); Temp. Reg. §54.4981A-1T. TAMRA §1011A(g)(1)(A) redesignated IRC §4981A as §4980A.
119. See Section I.C.
120. Temp. Reg. §54.4981A-1T, Q&A a-3(c).
If the individual elects lump sum treatment, the annual threshold amount applicable to the lump sum is increased to five times the normal annual threshold amount ($750,000, or $562,500, as indexed). 121 The indexed amount for 1990 is $641,140. A lump sum election includes an election of five or ten-year averaging or capital gain treatment. 122 If a lump sum distribution is received from one plan and installment payments are received under a different type of plan, both the lump sum limit and the annual threshold amount are available in the same year. 123 As a result, up to six times the annual limit can be received in one year, which means $900,000 currently.

G. Excess Retirement Accumulations.

An additional 15 percent excise tax is imposed on a deceased participant's excess retirement accumulation. 124 A deceased participant's excess retirement accumulation is the excess, if any, of the value of the deceased participant's interest in all qualified retirement plans, annuity plans, tax sheltered annuities, and IRAs, over the present value of a single life annuity with annual benefits equal to the annual threshold amount (as in effect in the year in which the death occurs) based on the decedent's life expectancy the day before he or she died. 125 The present value is to be determined under rules prescribed by the Treasury. 126 The annual threshold amount is the greater of $150,000 or $112,500 as indexed ($128,228 for 1990). 127

Excluded from the definition of excess retirement accumulations are the decedent's investment in the contract and any amounts payable to an alternate payee under a QDRO to the extent the payments are included in the income of the alternate payee. 128 Also excluded is the value of any death benefits payable by the plan. 129 The amount of death benefits is defined as the excess of the sum of any death benefits payable under the plan plus other benefits payable with respect to the deceased participant over the total value of benefits that would have been payable with respect to the deceased participant immediately prior to his or her death. 130 For example, if a defined contribution plan carries a whole life insurance policy on the participant, upon the death of the participant the amount paid to the participant's beneficiary will include not only the participant's accrued benefit prior to death, but also the face amount of the life insurance proceeds. Since the participant's accrued benefit before death included only the cash surrender value of the whole life policy, the excessible death benefit with respect to the policy will be the excess of the face amount of the policy over the cash surrender value.

The excise tax on excess retirement accumulations is not offset by any credits against the estate tax, such as the unified credit or credit for state death taxes paid. 131 The tax is not deductible for income tax purposes when the benefits are received by the estate or beneficiary. 132 Although the excess retirement accumulations tax is not reduced by the marital or charitable deduction, the tax itself is deductible from the gross estate as an expense. 133 Consequently, if the marginal tax rate applicable to an estate is 50 percent, the effective rate of the excise tax on excess retirement accumulations is seven and one-half percent (50 percent x 15 percent).

A surviving spouse may elect not to have the estate-level tax apply to distributions that are paid to the surviving spouse, provided that the surviving spouse is entitled to receive at least 99 percent of the present value of the deceased participant's benefits. 134 If the surviving spouse makes the election, distributions with respect to the deceased participant's benefits will be aggregated with retirement distributions made to the surviving spouse with respect to qualified retirement plans and IRAs in which he or she participates for purposes of determining the excise tax on excess retirement distributions to him or her. 135 On the other hand, if the surviving spouse does not make the election to treat the distribution as his or her own benefit, but rolls the distribution into an IRA, distributions from the spousal IRA will not be subject to the excess distributions tax unless he or she comingles his or her own contributions or rollovers with the benefits of the deceased participant. 136

The amount of excess retirement accumulations is determined without regard to community property laws; a surviving spouse's interest in the deceased participant's benefits is included in the calculation of the present value of the deceased participant's benefits in determining the excise tax. 137

The excise tax, added by TRA 86, applies to estates of decedents dying after December 31, 1986. 138 The excess retirement accumulations tax is reported on Schedule S of Form 706. 129

H. Grandfather Election.

An individual whose accrued benefit as of August 1, 1986, exceeded $562,500 may have elected to be

124. IRC §4980A(d)(1).
125. IRC §4960A(d)(3).
126. IRC §4980A(d)(3)(B).
127. IRC §4980A(c)(1).
129. IRC §4980A(d)(3)(C).
130. IRC §4980A(d)(3)(C).
131. IRC §4980A(d)(2).
132. IRC §691(a)(1)(C).
133. IRC §2055(c)(1)(B).
134. IRC §4980A(d)(5).
135. IRC §4980A(d)(5)(A)(i).
137. IRC §4980A(d)(4)(A).
138. TRA 86 §1133(c)(2).
139. Temp. Reg. §54.4981A-1T, Q&A c-7(b).
covered by a special grandfather rule with respect to the excise tax on excess retirement distributions and excess retirement accumulations. The grandfather rule exempts the plan benefits accrued on August 1, 1986 from the tax. In determining whether the accrued benefit exceeded $562,500 on August 1, 1986, the value of the accrued benefit is reduced by amounts that are payable to an alternate payee under a QDRO and amounts attributable to the participant's investment in the contract, since these amounts are not subject to the excess retirement distribution or accumulation tax.

The election must have been made on Form 5329 filed with the individual's income tax return filed for a year ending before January 1, 1989, including extensions. For most taxpayers, the election must have been made by the due date for the 1988 income tax return, including extensions. The election was revocable until the deadline for making the election had passed. If the individual died before the due date for the 1988 income tax return, the executor could have made the election.

If the grandfather election has been made, the annual threshold amount is limited to the $112,500 amount, as indexed. Consequently, the $150,000 amount does not apply. Likewise, with respect to a lump sum distribution, the $562,500 amount, as indexed, will apply rather than the $750,000 amount. It is anticipated that by 1994 the indexed annual threshold amount will exceed the $150,000 amount, assuming a four percent inflation rate. If the grandfather rule has been elected, any distributions received in 1986 after August 1, 1986 are treated as a recovery of the grandfathered amount, even though these distributions were not subject to the 15 percent tax.

The Treasury has issued temporary and proposed regulations dealing with the excise tax that establish two methods for recovering the grandfathered amount.

Under the discretionary method, ten percent of the total distributions received during any calendar year is treated as a partial recovery of the grandfathered amount. At any time, the individual may elect irrevocably to have the total amount received during the year treated as a recovery of the grandfathered amount. This election accelerates the rate of recovery to 100 percent of all distributions during the year the election is made and subsequent years until the grandfathered amount is completely recovered.

For example, assume a grandfathered amount of $1,000,000, a distribution in the calendar year 1990 of $250,000, and an indexed annual threshold amount of $128,228. The amount subject to the 15 percent tax will be $121,772. This is determined by subtracting from the total distribution the greater of $128,228 (the indexed amount) or $25,000. The $25,000 is ten percent of $250,000, and is deemed to be a recovery of part of the grandfathered amount. If the individual elects to accelerate the recovery to 100 percent in 1991, then all distributions in 1991 and thereafter will first be treated as grandfathered amounts, up to $975,000, which is the balance of the original $1,000,000 grandfathered amount less the $25,000 amount recovered in 1990.

Under the attained age method, the total distribution received during any year that is treated as a recovery of an individual's grandfathered amount is calculated by multiplying the individual's aggregate distribution during the calendar year by a fraction. The numerator of the fraction is the individual's attained age (in months) as of August 1, 1986, less 420, and the denominator is the individual's attained age (in months) as of the end of the calendar year of the distribution, less 420. Only an individual who has reached age 35 on or before August 1, 1986, may use this method.

For example, assume a grandfathered amount of $1,000,000, a distribution in calendar year 1990 of $250,000, and an individual whose attained age on August 1, 1986 was exactly 60, and on December 31, 1990 was 64 and five months. The numerator of the fraction would be 300 (60 x 12 = 720, 720 - 420 = 300). The denominator of the fraction would be 455 (420 + 45 = 465, 465 - 420 = 45). The fraction would be 300/455, or 66 percent. The amount subject to the 15 percent tax would be $57,500, which is the total distribution reduced by the greater of $128,228 (the indexed annual threshold amount) or the grandfathered amount deemed to be recovered in 1990 which is $212,500 (85 percent x $250,000). The remaining grandfathered amount would be $767,500, the original $1,000,000 grandfathered amount less the $212,500 recovered in 1990.

143. Temp. Reg. §54.4981A-1T, Q&A b-3(c).
144. Temp. Reg. §54.4981A-1T, Q&A b-2(d).
145. Temp. Reg. §54.4981A-1T, Q&A b-3(c).
149. Temp. Reg. §54.4981A-1T, Q&A b-12(a).
150. Temp. Reg. §54.4981A-1T, Q&A b-12(b).
SECTION III
INCOME TAXATION OF BENEFITS

A. In General.

1. Ordinary Income Treatment.

Distributions from qualified retirement plans and IRAs are taxed as ordinary income under Code §72 unless special averaging or capital gain treatment applies. The distributions are taxed when actually received. The constructive receipt doctrine does not apply to undistributed benefits, even though the benefits may be subject to the participant's unrestricted right of withdrawal.

The participant's basis in the benefits is recovered tax free over the period of the distribution. A participant may have a basis, referred to as an "investment in the contract" by Code §72, in the benefits for nondeductible contributions the participant has made to the plan or the IRA. In addition, if the plan provided life insurance coverage to the participant (not permitted in an IRA) then the participant must include in gross income the value of that coverage (known as P.S. 58 costs) while participating in the plan. That aggregate amount included in the participant's income also is treated as an investment in the contract.

2. Distribution General Rule.

The general rule treats a part of each distribution as a nontaxable return of the participant's investment in the contract, until the total investment is recovered. For a fixed period annuity, the participant's total investment in the contract is divided by the number of months in the fixed period to determine the amount of each monthly payment that will be nontaxable. For lifetime and joint and survivor annuities, actuarial tables must be used to determine the life expectancy or expectancies of the beneficiaries. Adjustments are also made if there is a refund feature (such as a guaranteed number of payments). In addition, if part or all of the $5,000 income tax-free death benefit is available with respect to the periodic payments, the amount of this benefit available is added to the investment in the contract. Detailed instructions for calculating the tax-free amount of each payment are contained in Publication 575, Pension and Annuity Income, issued periodically by the Internal Revenue Service. The most recent edition was issued for use in preparing 1989 returns.

If the participant dies before recovering the entire investment in the contract, the balance of the unrecovered basis is allowed as an itemized deduction on the participant's last tax return and is not subject to the two percent floor on miscellaneous itemized deductions. If the plan or IRA benefits are payable to other beneficiaries after the death of the participant, then the unrecovered basis will not be allowed as a deduction until the death of the last beneficiary entitled to a payment.

3. Distribution Simplified Rule.

A simplified general rule may be available to persons receiving lifetime or joint and survivor annuity payments whose annuity starting date occurs after July 1, 1986. To qualify for the simplified general rule, the annuity payments must be either the life of the participant or the lives of the participant and one beneficiary. The payments must be from a qualified retirement plan, an employee annuity, or a tax sheltered annuity. In addition, as of the annuity starting date, the participant must be either under age 75, or if not under age 75, the number of years of guaranteed payments must be fewer than five. The simplified general rule eliminates the necessity of calculating the number of payments actuarially. Instead, the number of monthly payments is determined according to the following table:

<table>
<thead>
<tr>
<th>If the Participant Is:</th>
<th>Number of Monthly Payments Assumed:</th>
</tr>
</thead>
<tbody>
<tr>
<td>55 and under</td>
<td>300</td>
</tr>
<tr>
<td>56 to 60</td>
<td>260</td>
</tr>
<tr>
<td>61 to 65</td>
<td>240</td>
</tr>
<tr>
<td>66 to 70</td>
<td>170</td>
</tr>
<tr>
<td>71 and over</td>
<td>120</td>
</tr>
</tbody>
</table>

For example, if a participant begins receiving payments at age 62 with his or her investment in the contract equal to $48,000, $200 of each monthly payment would be treated as a nontaxable recovery of the investment in the contract ($48,000 - 240). If the participant died after receiving 120 payments, the unrecovered amount, $24,000, would be deductible on his or her final income tax return as a net operating loss.

1. IRC §402(a)(1), IRC §408(c).
3. IRC §72(b)(2).
4. Taxable rate reportable is either that based on insured participants' age under IRS P.S. 58 table under Rev. Rul. 65-747, 1965-2 C.B. 228 or, if lower, insured one year individual yearly renewable term rate under Rev. Rul. 60-119, 1960-1 C.B. 12.
5. IRC §72(1).
6. IRC §72(b)(1).
7. IRC §72(c)(5)(B).
8. IRC §72(c)(3)(A).
9. IRC §72(c)(2).
10. IRC §101(b)(2)(D).
11. IRC §72(b)(3)(A).
12. IRC §72(b)(3)(C); see also Internal Revenue Service Publication 575, for use in preparing 1989 returns, page 8.
4. Three Year Recovery Rule.

TRA 86 repealed the three-year recovery rule. That rule permitted a person to treat annuity distributions received during the first three years as a recovery of investment in the contract if the entire amount of the participant's investment was recoverable within the first three years after the annuity starting date.

5. Distributions Involving Employee Contributions.

Withdrawals from a qualified retirement plan by a participant who has made nondeductible contributions to the plan before a participant's annuity starting date are treated partly as a recovery of investment in the contract and partly as a distribution of earnings on those amounts and, in some cases, a withdrawal of employer contributions. The part treated as earnings and employer contributions is subject to current income tax and also may be subject to the ten percent tax on premature withdrawals and the 15 percent tax on excess retirement distributions. See Section II.B. for a discussion of the tax on premature withdrawals and Section II.F. for a discussion of the tax on excess retirement distributions.

In the case of a defined contribution plan or a defined benefit plan having separate accounts for nondeductible employee contributions and earnings on such contributions, the taxable part of a withdrawal of those employee contributions includes only the earnings on the employee contributions and does not include employer contributions and earnings on employer contributions. For example, if a plan participant during employment withdrew $3,000 of his $15,000 nondeductible employee contribution account, all of which was contributed after January 1, 1987, with $5,000 of this account applicable to earnings, only $1,000 of the withdrawal distribution would be taxable ($3,000 x $5,000 / $15,000).

A transition rule provides that nondeductible employee contributions made before January 1, 1987 and available for withdrawal by the participant before separation from service under the terms of the plan as of May 2, 1986, may be withdrawn by the participant without any part of the distribution being treated as taxable earnings if withdrawn before the participant's annuity starting date. For example, under the preceding example, no portion of the $3,000 distribution would be taxable to the participant if all of the employee contributions predated January 1, 1987 and the plan as of May 2, 1986 permitted such withdrawal. Consequently, withdrawals of grandfathered nondeductible employee contributions are nontaxable.

6. Annuity Starting Date.

"Annuity starting date," referred to in the preceding and following discussions, is important in determining how and when distributions are taxable to a participant. Distributions from qualified retirement plans and IRAs are governed by Code §72. That section defines annuity starting date as the first day of the first month for which an amount is received as an annuity under the "contract." That date would presumably occur following a participant's retirement or termination of employment and commencement of the receipt of annuity payments applicable to the plan or IRA under Code §72. Under Code §72, the term "contract," as applicable to distributions from qualified retirement employee trusts and plans, includes the entire interest of an employee in each such trust or plan. Also for Code §72 purposes all of an individual's IRAs are treated as one "contract." 24

7. Distribution of Life Insurance Proceeds.

Life insurance policies are often held under a qualified retirement plan (not IRA) for plan participants. The difference between the face amount of insurance proceeds paid to a beneficiary upon the death of an insured participant and the cash surrender value of the life insurance policy held by the plan (not IRA) is income tax free to the beneficiary, provided the insurance cost (P.S. 58 cost) for the policy was paid with nondeductible employee contributions or was taxable to the participant.

8. Distributions to Disabled Participants.

Distributions from a qualified retirement plan (not IRA) to a participant terminating employment due to disability may possibly qualify for income tax exclusion. Code §105(c) exempts from income tax payments received under an accident or health plan by an employee on account of the permanent loss or loss of the use of a member or function of the body or permanent disfigurement computed solely with reference to the nature of the injury, not the length of the employee's time off work. In cases involving participants terminating employment and receiving lump sum distributions from profit-sharing plans following permanently disabling injuries, courts in the Ninth and Seventh Circuits have exempted those payments from income tax in reliance upon Code §105(c). In doing so, those courts found that the participants became entitled under the plan documents to those payments as a result of their disabilities, since the plan authorized distribution in that circumstance, and that the amounts received were for the permanent loss of a bodily function.

In contrast, the Circuit Court in the Second Circuit under similar circumstances also involving a profit sharing plan reached the opposite conclusion. While recognizing that a qualified retirement plan can serve a dual purpose of providing both retirement and accident or health benefits, it held that the plan document in question although authorizing distribution on a

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19. IRC §1122(c)(1), amending IRC §72(d).
20. IRC §§72(e)(2)(B), (e)(8).
22. IRC §72(d).
23. IRC §72(e)(6)(D).
24. IRC §408(d)(2).
25. IRC §§1.72-3(a)(1) and 1.72-16(c)(4). Payment may be direct or indirect via payment to plan trustee for distribution to participant's beneficiary.
participant’s permanent disability did not state that one of its purposes was to serve as an accident or health plan nor did it otherwise contain language the court stated expectantly would be present in a plan of that nature. In finding that the disability provision was merely one of several events in the plan triggering early distribution to a participant, the court also noted that the plan administrative committee based its payout authorization on the participant’s fully vested service and did not follow the plan procedure by requesting a formal medical determination finding of disability for that participant. These cases suggest that with proper plan language and proper adherence to procedures, the desired goal of income tax exclusion for the payment of qualified plan benefits to a disabled participant may be achievable.

B. Qualifying for Lump Sum Treatment.

1. In General.

Certain lump sum distributions may qualify for special averaging and capital gain treatment.38 In addition, if a distribution qualifies as a lump sum, it may be rolled into an IRA or another qualified retirement plan.39 There are other types of distributions that qualify for rollover treatment, which will be discussed in more detail later in Part F of this section. Lump sum treatment is available only for distributions from qualified retirement plans.30 Distributions from IRAs do not qualify for special averaging or capital gain treatment, but may be rolled over into another IRA and, if the distribution is from a conduit IRA, into a qualified retirement plan.31 Conduit IRAs are discussed in more detail in Part F of this section.

In this regard, it is important to keep in mind that distributions relating to simplified employee pension plans (“SEPs”) are subject to the IRA rules, not the qualified retirement plan rules. A SEP is an employer sponsored qualified retirement plan utilizing IRA accounts or annuities for eligible employees.32 In recent years many small businesses with fewer than 25 employees have opted either to initially adopt or to replace their previous qualified defined contribution retirement plans with SEPs to avoid continual expenses in restating those plans for TRA 86 and subsequent tax law changes. A SEP is easily adopted through Form 5305-SEP without requirement of IRS approval with maximum annual employer contribution levels per employee equal to that of a defined contribution plan. However, since the contributions as made are not collectively held in one plan trust, as applicable to a defined contribution plan, but instead are directly credited to individual IRAs maintained for each eligible employee of the employer, distributions from those accounts are subject to all limitations applicable to IRAs, including non-qualification for special averaging or capital gain treatment.

2. Lump Sum Distribution Definition.

A lump sum distribution is a distribution within one taxable year of the recipient (whether the recipient is the participant or other beneficiary) of the balance to the credit of an employee which becomes payable to the recipient: (1) on account of the employee’s death; (2) after the employee attains age 59½; (3) on account of the employee’s separation from service (but not in the case of a self-employed person); or (4) after the employee has become disabled (but only in the case of a self-employed person).34 A self-employed person is a partner in a partnership or a sole proprietor.35 The distinction in the rules for qualifying for lump sum treatment between common law employees and self-employed individuals now has little significance. A payment made to a common law employee who becomes disabled usually will qualify for lump sum treatment because the employee has separated from service as a result of the disability. As later discussed, averaging and capital gain treatment methods are no longer available for persons under age 59½ receiving lump sum distributions regardless of termination circumstances, unless the employee qualifies under the transition rule for participants who reached age 50 before January 1, 1986.36 Thus, a common law employee not meeting the transition rule who separates from service before 59½ and receives a lump distribution is not entitled to special averaging.

The “balance to the credit of an employee” required to be totally distributed within one taxable year after occurrence of a qualifying event includes both employer contributions and nondeductible employee contributions. This was adversely emphasized to a taxpayer in a recent Private Letter Ruling.37 In that ruling, the taxpayer who had separated from service during 1983 at age 49 and withdrew all of his own nondeductible savings contributions from a plan during 1983-86 was denied lump sum treatment on payment of the remainder of his account balance during 1987. The Internal Revenue Service held his prior withdrawals during 1983-86 after his employment service termination occurred represented part of his “balance to the credit,” hence fatally tainting qualification for lump sum treatment because the payment was made over more than one taxable year.


If an employee has formally separated from service, but continues to perform services on behalf of the former employer, the Internal Revenue Service may claim that the individual has not actually separated from service unless the individual is in substance an independent contractor.38 Therefore, a former employee

33. IRC §402(e)(4)(A).
34. IRC §401(c)(1).
35. IRC §402(e)(4)(B) and TRA 86 §1122(h) re age 50 transition rule.
37. Rev. Rul. 69-647, 1969-2 C.B. 100. See also Roy G. Edwards, TC Memo 1989-409, where the lump sum tax treatment for special averaging denied former full time employee working part time following plan termination on finding Congressional intent is that a complete separation of service is mandated.
who desires lump sum treatment in connection with a distribution from a qualified retirement plan sponsored by the former employer must be careful when entering into a contract to perform new services for the former employer not to be treated as continuing in the same position as before his or her separation from service. This more restrictive approach to non-employment for lump sum distribution qualification is in contrast to the more liberal approach taken for avoidance of the early distribution penalty. Congress recently exempted from the ten percent tax on premature withdrawals (see Section II.B. discussion) early retirement distributions made to plan participants age 55 or over after separation from service. In doing so, the Senate Committee Report stated this exemption will continue to apply if the employee returns to work to perform the same services for the same employer later as long as the employee separated from service in fact before the plan distribution, indicating that short term separations will be closely scrutinized to determine if bona fide and of indefinite nature. The separation-from-service issue also arises in the case of a sale of a subsidiary or a division by a sponsoring employer when the purchaser discontinues the plan and the employee is seeking to have the distribution from the terminated plan treated as a lump sum distribution. The Internal Revenue Service will maintain that the employee has not separated from service even though the employee now is working for a different employer.


A distribution of an annuity contract from a trust or an annuity plan will be treated as part of a lump sum distribution if the other requirements are satisfied. This prevents the distribution from failing to satisfy the requirement that the entire amount be distributed within one taxable year of the participant, even though the payments from the annuity will be made over more than one taxable year.

For purposes of determining the tax under the averaging methods, the actuarial value of the annuity is added to the other amount distributed. The tax on the lump sum (including the actuarial value of the annuity) is then reduced by the tax on the actuarial value of the annuity (after reducing the value by a pro rata portion of the minimum distribution allowance). For example, assume a lump sum distribution of $100,000, including an annuity with an actuarial value of $30,000. The tax using five-year averaging on the $100,000 would be $16,347.50, which would be reduced by $4,500, the tax on the $30,000 value of the annuity, again using five-year averaging. The inclusion of the annuity in the initial calculation has the effect of taxing the non-annuity balance of the distribution at a higher marginal rate.

5. Special Rules for Income Averaging.

A participant may make only one election with respect to five-year averaging and only after the employee has attained age 59 1/2. Therefore, a participant who separates from service because of disability but has not reached 59 1/2 is not entitled to five-year averaging nor is a beneficiary of a deceased participant who dies before attaining age 59 1/2. A transition rule under TRA 86 permits a participant who had reached age 50 on January 1, 1986 to elect five or ten-year averaging or capital gain treatment, even though the participant has not reached age 59 1/2. Averaging may be elected by an individual, an estate, or a trust with respect to an employee who had attained age 59 1/2 before death. If the employee had not attained age 59 1/2 before death, special averaging is not available unless the transition rule applies.

In determining the balance to the credit of the account of an employee, all trusts that are part of a plan sponsored by the same employer are treated as a single trust. For this purpose, all pension plans maintained by the same employer are treated as a single plan; all profit-sharing plans maintained by the same employer are treated as a single plan; and all stock bonus plans maintained by the same employer are treated as a single plan. Nonqualified trusts and nonqualified annuity contracts are disregarded for purposes of determining the balance to the credit of the account of an employee. Consequently, if a participant participated in both a defined benefit plan (a pension plan) and a profit-sharing plan, the participant may elect lump sum treatment with respect to a total distribution of the benefits from the profit-sharing plan while receiving the benefits in the pension plan in the form of an annuity or installment payments.

If a participant separates from service and receives the balance to the credit of his or her account, the potential increase in vesting that accrued benefit upon reemployment will not disqualify the earlier distribution for special averaging. If the participant is reemployed and as a result there is an increase in the vested benefit that accrued before the separation, then the tax savings that resulted from special averaging or capital gain treatment will be recaptured. In such a case, the previous election will not be considered in determining whether the participant may make another election for special averaging or capital gain treatment.

In order for a participant to elect five-year averaging, the participant must have participated in the plan that provides the plan.

References:
38. TAMRA §1011(a)(7); amending IRC §72(t)(3)(A).
39. TAMRA §1011(a), Senate Committee Report.
41. IRC §402(e)(2).
42. IRC §402(e)(2).
43. Prop. Reg. §1.402(e)-2(c).
44. IRC §402(e)(4)(B).
45. TRA 86 §1222(h).
46. TAMRA §1011(a)(6); amending IRC §402(e)(4)(B).
47. IRC §402(e)(4)(C)(I).
49. IRC §402(e)(4)(C)(I).
50. IRC §402(e)(6)(A).
51. IRC §402(e)(6)(B).
52. IRC §402(e)(6)(B).
for five or more taxable years before the taxable year in which the amounts are received. An advisor must be certain to determine whether the participant has the requisite period of service to qualify for lump sum treatment when advising the participant. The participant may be deciding whether to elect five-year averaging or to roll the distribution into an IRA. The participant may mistakenly assume eligibility for five-year averaging, and therefore may not roll the distribution into an IRA within the required 60-day period. Later, when the participant finds out that he or she does not qualify for special averaging, it will be too late to make the rollover. Consequently, the entire distribution will be taxed as ordinary income in the year of receipt. The five-year participation requirement does not apply to beneficiaries of an employee.


The participant must include any other lump sum distributions for which income averaging was elected that were received during the six-year period ending on the last day of the taxable year of the current distribution for purposes of determining the applicable tax rate (but not the tax itself). The tax on the previous distributions will be subtracted from the total tax on the sum of the current distribution plus all distributions during the six-year look-back period. The six-year look-back rule will have diminishing application since IRA 86 limits a person to one election during a lifetime. Consequently, only distributions received prior to 1993 will be subject to the look-back rule.

C. Special Averaging and Capital Gain Treatment.

1. Five-Year Averaging.

Under five-year averaging, a lump sum distribution from a qualified retirement plan is taxed separately from the other income of the recipient. The amount of tax is determined as follows. First, the amount of the distribution is reduced by the $5,000 death benefit exclusion if the payment is made on account of the death of the participant. The actuarial value of any annuity that is distributed as part of the distribution is included, as described in Section III.B. If the amount of the distribution, as adjusted, is less than $70,000, it is reduced by the minimum distribution allowance. The minimum distribution allowance is equal to (a) the lesser of 50 percent of the amount distributed or $10,000, reduced by (b) 20 percent of the amount of the distribution in excess of $20,000. For example, if the total distribution is $40,000, the minimum distribution allowance is equal to $6,000. This is determined by subtracting from $10,000 (50 percent of the amount distributed or $10,000, whichever is less) $4,000, which is 20 percent of the amount of distribution in excess of $20,000 ($40,000 – $20,000 = $20,000 x 20 percent = $4,000).

The amount remaining after the reduction for the minimum distribution allowance then is reduced by any federal estate tax attributable to the distribution. This amount then is divided by five and the tax on this amount is determined using the tax rate schedule for single taxpayers. Then the tax is multiplied by five. The result is reduced by the tax on any annuity contract that is distributed as part of the lump sum distribution. See Section III.B.

2. Ten-Year Averaging.

Ten-year averaging, which applied to qualified lump sum distributions received before 1987 by participants from qualified retirement plans, was determined in the same way as for five-year averaging except that the amount of the lump sum distribution after the deductions for the minimum distribution allowance and estate tax was divided by ten, and the tax on this amount, using the single taxpayer rate, was multiplied by ten.

3. Capital Gain Treatment.

Before 1987, capital gain treatment was available for the portion of a lump sum distribution received prior to that year by a participant from a qualified retirement plan attributable to years of participation in the plan before 1974. The amount attributable to participation in the plan before 1974 was determined by multiplying the total distribution by a fraction, the numerator of which was the number of years of participation in the plan before 1974 and the denominator of which was the total number of years of participation in the plan. For example, if the participant had participated in the plan from 1964 through 1984, 50 percent of the distribution would qualify for capital gain treatment, determined by dividing the total number of years of participation, 20, by the number of years of participation before 1974, ten (assuming full calendar years of participation in each case).

4. Transition Rule for Averaging or Capital Gain Treatment.

A transition rule permits a participant who had reached age 50 before January 1, 1986 to make a one-time election to use five-year averaging (under the current income tax rates) or ten-year averaging (under the 1986 income tax rates) without regard to the requirement that the participant must have reached the age of 59 1/2. The transition rule also permits such a participant to elect capital gain treatment at the 20 percent income tax rate that applied in 1986 for capital gains with respect to the portion of the lump sum distribution that would have qualified for capital gain treatment under

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53. IRC §402(e)(4)(H).
54. IRC §402(e)(4)(H).
55. IRC §402(e)(2).
56. IRC §402(e)(2).
57. IRC §402(e)(1).
58. IRC §101(b).
59. IRC §§402(e)(1)(B) and (C).
60. IRC §402(e)(1)(C).
61. IRC §402(e)(1)(B).
62. IRC §402(e)(2).
63. IRC §402(e)(1)(C) before amendment by TRA 86 §1122(a)(2)(A), (B).
64. IRC §402(e)(4)(E) before repeal by TRA 86 §1122(b)(2)(D).
65. IRC §402(e)(4)(E) before repeal by TRA 86 §1122(b)(2)(D).
66. TRA 86 §1122(h)(3).
the rules in existence before TRA 86. This capital gain election is in lieu of the five-year phase-out discussed below. The election may be made by a trust, estate or beneficiary as long as the deceased participant had reached age 50 on or before January 1, 1986.

A distribution that qualifies under the transition rule may not qualify for an exception from the ten percent excise tax on premature distributions. For example, a participant who separates from service at age 54 and who had reached age 50 on or before January 1, 1986 would qualify to elect five- or ten-year averaging or capital gain treatment, but would be subject to the ten percent penalty, since he or she has not reached age 55.

There also is a five-year phase-out of capital gain treatment. The percentage of the distribution that would have qualified for capital gain treatment under the rules in effect before TRA 86 that may still be treated as capital gain is determined according to this schedule:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
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</thead>
<tbody>
<tr>
<td>1987</td>
<td>100</td>
</tr>
<tr>
<td>1988</td>
<td>95</td>
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<tr>
<td>1989</td>
<td>75</td>
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<tr>
<td>1990</td>
<td>50</td>
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<tr>
<td>1991</td>
<td>25</td>
</tr>
<tr>
<td>1992</td>
<td>0</td>
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</tbody>
</table>

It is not clear at what rate the capital gain portion will be taxed. The Internal Revenue Service has taken the position that the 20 percent rate available for persons who reached age 50 before 1986 is not available under this phase-out provision. The maximum rate is currently 33 percent, which applies to the adjusted gross income in the phase-out range, that is, the adjusted gross income in excess of a certain dollar limit necessary to eliminate the benefits of the 15 percent tax rate and the personal exemptions available to the taxpayer. The effective rate on all income, including capital gains, can never exceed 28 percent under current law.

Under current law, because of the elimination of any different rate on long-term capital gain, the phase-out rule really does not reduce the tax rate on the capital gain portion. The election may enable the taxpayer to offset the capital gain portion with capital losses the taxpayer may have recognized in the same year the taxpayer receives the distribution or may have available by carryover from a prior year. An election to use the capital gain phase-out rule is treated as an election to receive favorable averaging treatment, and precludes the participant from electing favorable averaging at a later time. A recipient other than the employee on behalf of whom the benefit is being paid who makes the election with respect to the employee's benefit may make a subsequent election with respect to distributions from the recipient's own qualified plans.

Clients eligible for the transition rule often inquire of the advisor whether, if special averaging is to be elected, to do so under the new five-year or old ten-year averaging method. The tables in the box below illustrate that ten-year averaging using 1986 income tax rates remains favorable over five-year averaging using 1990 income tax rates for a single taxpayer on distributions less than $465,700, equal to that amount, and then more costly on distributions exceeding that amount.

<table>
<thead>
<tr>
<th>FIVE-YEAR AVERAGING (1990 rates — single taxpayer)*</th>
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</thead>
<tbody>
<tr>
<td>If the adjusted total</td>
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<tr>
<td>taxable amount is:</td>
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<tr>
<td>at least</td>
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<tr>
<td>$ 20,000</td>
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<td>97,250</td>
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<td>235,250</td>
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<tr>
<td>150</td>
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<tr>
<td>1,500</td>
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<td>97,250</td>
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<tr>
<td>488,100</td>
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<td>this amount</td>
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<tr>
<td>Zero</td>
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<tr>
<td>150</td>
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<td>1,500</td>
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<td>235,250</td>
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<td>235,250</td>
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<tr>
<td>488,100</td>
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<tr>
<td>plus this %</td>
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<td>28.0</td>
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<td>235,250</td>
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<td>488,100</td>
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</table>

* Table reflects phase-out of 15 percent bracket as clarified by TAMRA

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<thead>
<tr>
<th>TEN-YEAR AVERAGING (1966 rates — single taxpayer)</th>
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<tr>
<td>If the adjusted total</td>
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<td>taxable amount is:</td>
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<td>$ 20,000</td>
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<td>700</td>
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</table>

67. TRA 86 §1122(h)(3)(B).
68. TRA 86 §1122(h)(3) flush language.
69. TAMRA §1011A(b)(15), amending TRA 86 §1122(h)(5).
70. TRA 86 §1122(h)(4).
72. IRC §1(g).
73. IRC §1.
74. TRA 86 §1122(h)(4)(C).
D. Employer Securities.

1. Plan Ownership Limitations.

A qualified retirement plan which is not an ESOP or stock bonus plan generally may not invest more than ten percent of the value of the plan assets in employer securities.  However, in the case of an eligible individual account plan, such as a profit-sharing plan, the plan document may permit the plan to invest more than ten percent of the value of the plan assets in employer securities.  It appears that the type of employer securities permissibly acquirable by a plan differs for ESOPs and stock bonus plans from other types of plans.  An ESOP or a stock bonus plan is designed specifically to acquire "qualified employer securities."  Qualified employer securities means common stock readily tradeable on an established securities market, or non-traded common stock having voting and dividend rights equal to or greater than the class of common stock having the greatest voting and dividend rights, or non-callable preferred stock freely convertible for a reasonable conversion price in a common stock meeting the prior requirements.  Qualified employer securities for ESOPs or stock bonus plans also include non-voting common stock that is not traded and which has been outstanding for 24 months and issued by an employer regularly engaged in publishing.  In contrast, employer securities held by other types of plans means shares of stock, bonds or debentures issued with interest coupons or in registered form by the employer corporation or by a parent or subsidiary of the employer corporation.  Presumably, "stock" would include common or preferred.

2. Distribution Effect.

Employer securities distributed from a qualified retirement plan to a participant are entitled to special treatment in certain circumstances.  The treatment of employer securities included in a distribution depends upon whether the distribution qualifies as a lump sum distribution and whether the securities were purchased with employer contributions or employee contributions.  In the case of a distribution that does not qualify for lump sum treatment, the net unrealized appreciation of employer securities that were purchased with employee contributions is not subject to current income tax.  In the case of a qualified lump sum distribution, all net unrealized appreciation is excluded from current taxation.

The amount of the net unrealized appreciation is the difference between (1) the market value of the securities of the employer corporation at the time of the distribution and (2) the cost or other basis of the securities to the plan.  If the plan purchases securities, the basis will be the purchase price.  If the employer contributed the securities to the plan, then the cost basis is the fair market value at the date that the securities were transferred to the plan.  This would be the same value used by the employer for purposes of deducting the contribution.  As a result of a change made by TRA 86, the amount of net unrealized appreciation is determined without regard to certain exchanges, as well as dispositions and reacquisitions made within 90 days.  This permits the plan to retain the basis the plan had in employer securities before a corporate reorganization or other corporate restructuring.

As a result of TRA 86's elimination of the long term capital gain deduction, a participant may desire to forgo the deferral of the income on the net unrealized appreciation of employer securities.  This may be beneficial if the participant has elected special averaging treatment.  The tax on the net unrealized appreciation may be less if taxed currently at the lower rate applicable under special averaging, rather than when the stock eventually is sold by the participant.  Fortunately, TRA 86, as amended by TAMRA, allows the recipient to elect on the return filed for the taxable year in which the employer securities were received to forgo the deferral of the gain on the net unrealized appreciation.  An election waiving deferral of the gain does not preclude an election for income averaging or capital gain treatment previously discussed.

The amount of net unrealized appreciation is taxable as long term capital gain to the extent recognized in a subsequent disposition of the employer stock, unless the participant has elected to forgo the nonrecognition treatment.  Any realized gain in excess of the net unrealized appreciation is taxable either as short-term or long-term capital gain, depending on how long the participant holds the securities.

If the value of the lump sum distribution of employer securities is less than the amount the participant contributed to the plan, no loss is recognized at the time of the distribution.  Instead, the basis of the securities for resale will be the amount of the participant's contributions to the plan.

Even though the net unrealized appreciation currently is not taxed, unless the participant elects otherwise, the cost basis to the plan is included in the participant's taxable income unless the participant rolls the distribution into an IRA.  If the distribution is rolled into an IRA, and the participant then withdraws the securities from the IRA, the special deferral treatment no longer will apply, since distributions from IRAs are

75. ERISA §407(a)(2).
76. ERISA §407(b)(1).
77. IRC §4975(e)(7)(A).
78. IRC §4975(e)(8).
80. IRC §402(a)(1).
81. IRC §402(e)(4)(J).
82. Reg. §1.402(a)-1(d)(2)(I).
83. IRC §1012.
85. IRC §402(j).
86. IRC §402(e)(4)(J); TRA §1.22(h)(1).
not eligible for lump sum treatment.\textsuperscript{90} Note that securities purchased with employee contributions may not be rolled into an IRA. See Section III.F.

\section*{E. Income in Respect of Decedent.}

1. \textbf{In General.}

The taxable amount of distributions from qualified retirement plans and IRAs received by an estate or a beneficiary of a deceased participant is taxed as an item of income in respect of a decedent.\textsuperscript{91} Income in respect of a decedent is income that the decedent would have recognized as taxable income if the income had been received before death. In addition to distributions from qualified retirement plans and IRAs, items of income in respect of a decedent include amounts received pursuant to an installment sale entered into before the death of the participant and unpaid salary and deferred compensation paid to the decedent or beneficiaries.\textsuperscript{92}

2. \textbf{Non-Step-Up.}

Since distributions from qualified retirement plans and IRAs are items of income in respect of a decedent, there is no step-up in basis with respect to such amounts.\textsuperscript{93} The basis of an asset, other than an item of income in respect of a decedent, that is included in a decedent's gross estate for federal estate tax purposes is adjusted to the fair market value of the asset at the date of death, or the alternate valuation date if elected on the estate tax return.\textsuperscript{94} The alternate valuation date is the date that is six months after the date of death or the date the estate disposes of the asset, if sooner.\textsuperscript{95} Consequently, since distributions from qualified retirement plans and IRAs do not get a step-up in basis, the entire amount of the distribution is subject to income tax, except for the amount treated as the participant's investment in the contract.

3. \textbf{IRD Deduction.}

The recipient of the payments, whether the estate or another beneficiary, is entitled to a deduction for the estate tax paid with respect to the amount (IRD deduction).\textsuperscript{96} The amount of the deduction is determined by multiplying the estate tax attributable to all items in respect of a decedent by the ratio of the amount of such income included in the recipient's income over the total amount of such income included in the decedent's federal gross estate, less any expenses deducted from the gross estate attributable to such income.\textsuperscript{97} The estate tax attributable to all items in respect of a decedent is the difference between the estate tax computed including such items and the estate tax computed excluding such items.\textsuperscript{98} If the decedent's estate plan called for the use of the unlimited marital deduction to eliminate any federal estate tax, there will be no deduction available.

\section*{4. Taxable Disposition.}

A taxable disposition of the right to receive distributions of a deceased participant's benefit under a qualified retirement plan or IRA may result in immediate recognition of taxable income by the estate equal to the present value of the benefits over the estate's basis in the benefits.\textsuperscript{99} The basis of the estate in the right to the benefit will be zero, except to the extent that the decedent had a basis in the benefits (investment in the contract), because of either participant contributions to the plan or the P.S. 58 costs included in the decedent's income on account of life insurance protection provided under the plan.\textsuperscript{100} The transferee receives a basis in the payments equal to the amount of income recognized by the estate.\textsuperscript{101}

A taxable disposition of the right to receive qualified plan benefits and IRAs includes a transfer pursuant to a pecuniary marital deduction formula.\textsuperscript{102} In such a formula, the surviving spouse is entitled to a fixed dollar amount equal to the amount of the marital deduction the decedent wished to use. Since such a bequest is treated as an obligation of the estate, if the estate uses appreciated property to satisfy the bequest, the estate will recognize gain to the extent that the fair market value of the asset exceeds its basis. Therefore, the executor or trustee of a deceased participant should not use qualified retirement plan benefits and IRAs to satisfy a pecuniary marital deduction bequest. The same concern also applies to using qualified retirement plan or IRA benefits to fund a credit shelter trust that uses a pecuniary share formula. On the other hand, a specific bequest of such rights is not a taxable disposition.\textsuperscript{103}

\section*{5. Life Insurance Exclusion.}

Under the rule excluding life insurance proceeds from taxable income, life insurance proceeds paid from a policy on a deceased insured participant owned by a qualified retirement plan will be excludible from taxable income to the extent the proceeds exceed the cash value of the policy provided the insurance cost (P.S. 58 cost) for the policy either was paid with nondeductible employee contributions or was taxable to the participant.\textsuperscript{104}

\section*{6. $5,000 Death Benefit Exclusion.}

The $5,000 death benefit may be excluded from taxable income. This $5,000 benefit will offset otherwise taxable qualified retirement plan benefits of a deceased participant employee to that extent if not

\footnotesize{\textsuperscript{90} IRC §402(e)(d)(A).\textsuperscript{91} IRC §691(a)(1).\textsuperscript{92} IRC §691(a)(4).\textsuperscript{93} IRC §1014(a).\textsuperscript{94} IRC §1014(a).\textsuperscript{95} IRC §2032.\textsuperscript{96} IRC §691(c)(1).\textsuperscript{97} IRC §691(c)(2)(A).\textsuperscript{98} IRC §691(c)(2)(C).\textsuperscript{99} IRC §691(a)(2) and (3).\textsuperscript{100} See footnote \textsuperscript{99} for Section III.A.\textsuperscript{101} IRC §691(b)(2)(C).\textsuperscript{102} IRC §691(a)(2)(A).\textsuperscript{103} Rev. Rul. 80-57, 1980-1 C.B. 286.\textsuperscript{104} IRC §72(m)(3)(C).}
otherwise applied against any non-plan payment made by an employer to that employee's beneficiaries or estate by reason of the employee's death. If this benefit is available to offset plan benefits and there are multiple beneficiaries, the $5,000 amount is allocated among the beneficiaries in proportion to their shares of the distribution.

F. Rollovers.

1. In General.

One of the principal tax benefits afforded to distributions from qualified retirement plans is the ability of the recipient to transfer or "rollover" distributions into IRAs and other qualified retirement plans. Rollovers permit the recipient to defer the payment of income tax on rolled-over amounts until the participant later makes a withdrawal from the IRA or other qualified retirement plan.

A rollover also defers current income tax earnings on the amount rolled over. On the other hand, if the recipient does not roll over the distribution but instead includes it in income, the earnings on the investments made with the balance after the payment of income tax are subject to current income tax, unless a tax-exempt investment is purchased, which generally produces a lower yield than a taxable investment.

A rollover also can avoid the ten percent penalty on premature distributions and the 15 percent tax on excess retirement distributions. In the case of the 15 percent tax on excess retirement distributions, however, later withdrawals from the IRA will be subject to the penalty if the total amount received in the year of withdrawal from all qualified plans and IRAs exceeds the annual threshold amount, either $150,000 or $112,500, as indexed.

One disadvantage of making a rollover to an IRA is the loss of the ability to elect favorable averaging and capital gain treatment with respect to distributions from the IRA. A rollover to another qualified retirement plan instead of an IRA does not disqualify a future distribution of the amount rolled over for favorable averaging and capital gain treatment.

2. 60-Day Deadline Requirement.

In order to roll over a distribution from a qualified retirement plan or a withdrawal from another IRA, the recipient must transfer the amount to an IRA or other qualified retirement plan within 60 days after actual receipt. The Internal Revenue Service has been extremely strict in applying the 60-day requirement and the tax results from missing this deadline may be disastrous. The recent Michel Tax Court case is an apt example. In that case, Mr. Michel deposited several thousand shares of Mobil stock received by him from a qualified retirement plan into a Paine Webber IRA account more than 60 days after his receipt of the stock. This resulted in the fair market value of those shares being taxed to Mr. Michel. It also resulted in the fair market value of those shares on the contribution date being subjected to the excise tax on excess contributions to an IRA account. The Tax Court held that a valid IRA was created notwithstanding that the custodian improperly accepted the untimely stock rollover in violation of its written IRA account, rejecting Mr. Michel's argument in that circumstance that a valid IRA could not be created.

The Internal Revenue Service has disqualified transfers to an IRA for rollover treatment where the transfer was not completed within 60 days because of clerical error in a variety of circumstances, such as an error made by the transferring plan sponsor in issuing a Form 1099-R, or from a clerical error made by the IRA sponsor in establishing the IRA account or from a clerical error by the participant's bank resulting in the bank improperly denying payment on the check used to establish the IRA account. Therefore, it is imperative that the advisor instruct the recipient to act promptly in making the transfer. The recipient should not wait until the last day to make the transfer, since last minute problems could cause the transfer to miss the deadline.

If, through clerical error, the deadline is missed, a recent Tax Court case, William Wood, may save the day. In that case the Internal Revenue Service's position that the 60-day deadline is absolute and cannot be excused by bookkeeping or clerical errors, because no relief is recognized by the Code or Regulations, was rejected by the Tax Court. The Tax Court stated that bookkeeping entries are no more than evidential, being neither indispensable nor conclusive and that the decision must rest on the actual facts surrounding the transactions. So finding, the Tax Court determined that Mr. Wood had done all required of him with the IRA plan sponsor, Merrill-Lynch, within the 60-day period via transfer of all rollover cash and other property and signing of all IRA account forms and that the plan sponsor's subsequent failure through clerical error in temporarily crediting securities transferred for the IRA to the customer's personal account would not affect the substance of the transfer as a valid IRA rollover. In so finding, the Tax Court for the same reason rejected the Internal Revenue Service's argument that because Mr. Wood selected the plan sponsor he should be bound by its bookkeeping error, finding nothing in the Code, legislative history, or case law that would support such a position.

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105. IRC §101(b)(2).
107. IRC §402(a)(5)(A) and Reg. §54.4961A-1T, Q&A a-4(a)(4).
108. Reg. §54.4961A-1T, Q&A a-2, Q&A a-3.
109. IRC §402(e)(4)(A) and 403(d)(3)(A)(ii).
110. IRC §5402(a)(5)(A), (C).

In determining the "amount" that must be rolled over clients frequently ask the question of whether the same property received, when non-cash, must be rolled over, and if a life insurance policy is received, whether the policy can be rolled over into an IRA. Regarding the first question, there is a statutory exception that provides that the rollover to an IRA of the proceeds from the sale, including any gain realized on that sale, of property received in a qualified plan distribution is treated as a rollover of the property itself. However, the Service has ruled that a participant cannot keep non-cash property received in a qualified distribution and rollover instead the cash fair market value of the retained property to an IRA. As to the second question, the Internal Revenue Service has ruled that a life insurance contract received as a qualified plan distribution cannot be rolled over into an IRA and its value is taxable to the participant. However, nothing prohibits a participant from surrendering the policy and rolling over its cash value received to an IRA.

4. Other Rollover Requirements.

In addition to the 60-day rule, to qualify for rollover treatment the distribution must satisfy one of the following three requirements. First, the distribution will qualify if it is a distribution within one taxable year of the employee on account of the termination of the plan from which the distribution is made or, in the case of a profit-sharing or stock bonus plan, on account of a complete discontinuance of contributions to the plan. In profit-sharing and stock bonus plans, a complete discontinuance of contributions to the plan is treated as a constructive termination of the plan entitling the participants to 100 percent vesting in the accrued benefits under the plan.

Second, the distribution qualifies for rollover treatment if it qualifies as a lump sum distribution as previously discussed, except that the distribution will qualify as a lump sum for this purpose even if the participant may then be under age 59-1/2, and even if the participant does not have five years of plan participation. Since a rollover is not treated as an election for special averaging, the fact that the participant has made a previous election for special averaging does not preclude a rollover and a rollover does not preclude a future election for special averaging if one has not been made before.

Third, a distribution qualifies for rollover treatment if it is a distribution of the employee's accumulated deductible contributions that were permitted before TRA 86. Before TRA 86, a participant could make a tax deductible contribution to a qualified retirement plan of up to $2,000 a year. The $2,000 limit was reduced by the amount that the participant made as deductible contributions to an IRA.

5. Partial Distribution Rollovers.

A rollover may also be made with respect to a partial distribution if at least 50 percent of the balance to the credit of the participant is distributed and the distribution would otherwise qualify as a lump sum distribution. A distribution after the participant has reached age 50-1/2 will not qualify for partial rollover treatment unless the participant also separates from service. A self-employed person who separates from service may make a partial distribution rollover and a common law employee who becomes disabled but does not separate from service may also make a partial distribution rollover, although neither would be eligible to elect favorable averaging. A participant may make a partial distribution rollover regardless of whether special averaging treatment has been elected previously.

A partial distribution rollover can be made only to an IRA. In addition, if the employee makes a partial distribution rollover, the employee may not elect special averaging treatment with respect to subsequent distributions from the same plan. The amount of the net unrealized appreciation of employer securities will be treated as a taxable amount with respect to the distribution and therefore will be taxable unless rolled over.


TRA 86 requires an ESOP to permit a participant to diversify 25 percent of his or her account after completing ten years of plan participation and reaching age 55, and up to 50 percent of his or her account five years later. These diversification requirements can be satisfied by distributing the applicable percentage to the participant. Such a distribution is eligible for rollover, even if less than 50 percent of the account balance, and the distribution will not prevent the participant from electing special averaging treatment for a subsequent lump sum distribution from the same plan.

7. Spousal Beneficiary Rollovers.

If a participant's distribution from a qualified retirement plan, including an IRA, is paid to the spouse as beneficiary of the participant after the participant's death, the spouse may roll over the distribution to an IRA but not to another qualified retirement plan or qualified annuity. The Internal Revenue Service to date has been generous in allowing such rollovers even

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114. IRC §402(a)(6)(D)(ii).
117. IRC §402(a)(5)(E)(ii).
118 IRC §402(a)(5)(E)(i).
119. IRC §402(a)(5)(E)(ii).
120. IRC §402(a)(5)(E)(iii).
121. IRC §219(b)(3) as in effect before TRA 86.
122. IRC §402(a)(5)(D)(i).
123. IRC §402(a)(5)(D)(ii), TAMRA repealed certain requirements added by TRA 86 §1122(e)(1) including the rule requiring the aggregation of plans of the same type for purposes of determining whether at least 50 percent of the balance to the credit of the employee was distributed. TAMRA §101A(b)(4)(A).
124. IRC §402(a)(5)(D)(ii).
125. IRC §402(a)(5)(D)(ii).
126. IRC §402(a)(5)(D)(ii).
127. IRC §402(a)(5)(D)(iii).
128. IRC §402(a)(5)(D)(ii) flush language.
129. IRC §402(a)(7); see also IRC §402(d)(3)(C)(ii)(I).

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where the spouse has not been designated as the beneficiary. For example, a recent private letter ruling permitted a spouse, who was the sole beneficiary under a participant’s will, to roll over the distribution into an IRA, even though the participant had not designated the spouse as the beneficiary of the IRA. Another recent private letter ruling allowed a spouse to roll over a distribution that was made to a trust under a participant’s will for which the surviving spouse held an unconditional lifetime right over trust principal. A spousal rollover enables the surviving spouse to postpone the taxable receipt of the benefits until the spouse reaches the age of 70 1/2. If a spousal rollover is not made and the benefits are held in the plan, the spouse must begin receiving the benefits when the deceased participant would have reached age 70 1/2. See Section II.E.

8. Non-Spousal Beneficiary Rollovers.

If a participant’s distribution from a qualified plan, including an IRA, is paid to a non-spouse beneficiary after the participant’s death, that beneficiary unlike a spouse may not roll over the distribution to an IRA.

9. Qualified Domestic Relations Order Rollovers.

A distribution to an alternate payee pursuant to a qualified domestic relations order may be rolled over into an IRA of the alternate payee if the entire distribution is received within one taxable year of the alternate payee.

10. Conduit IRA Rollovers.

Although distributions from IRAs generally are not entitled to lump sum treatment, special averaging or capital gain treatment may be preserved if an amount that is rolled from a qualified retirement plan into an IRA is rolled subsequently into another qualified plan. The amount in the “conduit” IRA may be rolled into another qualified plan only if no other amounts are contributed by the participant to that IRA. The participant must transfer the distribution within 60 days after receipt from the conduit IRA. A conduit IRA may not be used by a participant’s spouse. Consequently, the spouse forgoes forever special averaging treatment and capital gain treatment by rolling a distribution from the deceased participant’s qualified retirement plan into an IRA. Before TRA 86, a person who owned more than five percent of the sponsoring employer was not entitled to make a conduit rollover. TAMRA clarified that this rule no longer applies to more-than-five-percent owners.

11. Rollovers After Age 70 1/2.

Rollovers may be made after the participant reaches age 70 1/2, but the minimum distribution required to be made after age 70 1/2 may not be rolled over.

132. IRC §402(a)(7) and IRC §408(d)(3)(C)(ii).
133. IRC §402(a)(6)(F).
134. IRC §408(d)(2)(A).
135. IRC §408(d)(3)(B).
136. IRC §408(d)(3)(A) flush language as in effect before TAMRA; TAMRA §1011A(a)(2), amending IRC §408(d)(3)(A).
SECTION IV
TRANSFER TAXES

A. Gift Taxation.

A spouse of a participant in a qualified retirement plan (but not an IRA) is entitled to a survivor annuity under the Retirement Equity Act of 1984 ("REA") if the participant dies before or after beginning to receive payments of benefits from the plan, except in the case of certain defined contribution plans.1 The spouse, however, may elect to waive the survivor annuity in either case. Although the waiver of the spouse's right could be viewed as a gift by the spouse of the value of the survivor annuity to the other beneficiaries named by the participant in the waiver, TRA 86 specifically exempts such waivers from the gift tax.2 Code §2503(f) provides that if an individual, prior to the death of the participant, waives any survivor annuity that would otherwise be available, the waiver will not be treated as a transfer of property for gift tax purposes.

Generally, it is not advisable for a participant in a qualified retirement plan or an IRA to make an irrevocable beneficiary election. Such an election may require the designated beneficiary to agree to any future change in the beneficiary designation and may also mean that the designated beneficiary will have to agree to any change in the form of benefit selected. Nonetheless, in special situations, it may be necessary or appropriate for a participant to make an irrevocable election to a spouse, a former spouse or other family member or relative.

An irrevocable election by a participant to have any part of the participant's benefit payable to someone other than the participant is treated as a taxable gift as a result of TRA 86, which repealed Code §2517.3 Before TRA 86, Code §2517 exempted irrevocable elections from the gift tax.4 An irrevocable beneficiary election does not qualify for the annual exclusion because it is not a present interest. To be eligible for the annual exclusion, the donee (recipient of the gift) must be entitled to the immediate enjoyment of the property.5 An irrevocable election with respect to a benefit under a qualified retirement plan or IRA will not entitle the donee to receive anything until the death of the participant or the retirement of the participant, depending upon the plan and the form of designation.

Before TAMRA it was generally believed that an irrevocable election of a joint and survivor annuity would not qualify for the gift tax marital deduction. The survivor annuity could be viewed as a nondonatable terminable interest since the participant making the election may possess or enjoy the property after the termination of the interest transferred to the donee spouse if the donee spouse dies first.

TAMRA provided that a transfer to a spouse of an interest in a joint and survivor annuity, in which only the spouses have any right to receive any payments prior to the death of the last spouse to die, qualifies for the gift tax marital deduction as QTIP property.6 Consequently, the value of any residual payment that will be made to someone other than the nonparticipant spouse at the spouse's death will be includible in that spouse's estate for estate tax purposes if the nonparticipant spouse survives the participant.7 If the nonparticipant spouse dies before the participant, no amount with respect to the annuity will be included in the nonparticipant spouse's estate.8 A transfer of the nonparticipant spouse's interest in the joint and survivor annuity will not be treated as a disposal of all of the QTIP property (the value of the spouse's interest); only the value of the transferred participant's interest will be a taxable gift.9 Normally, if any interest in QTIP property is transferred during the spouse's lifetime to anyone other than the spouse, the transfer is treated as a taxable gift of the entire QTIP property.10

The participant may elect not to have the joint and survivor annuity qualify as QTIP property.11 The election out of QTIP treatment is irrevocable12 and must be made before November 11, 1990 or by the due date of the return, whichever is later.13 These provisions are effective for transfers made after December 31, 1981.14 For a gift tax return filed before November 11, 1988, in which a joint and survivor annuity is treated as not qualifying for the marital deduction, the new rule will apply if an election is made before November 11, 1990 to treat the joint and survivor annuity as QTIP property.15

B. Estate Taxation.

The value of retirement benefits payable to the participant's estate or to the participant's beneficiaries on death is includible in the participant's gross estate for federal estate tax purposes.16 Before 1982, the amount of all such benefits was excludible from the gross estate, as long as special averaging treatment was not elected and the benefits were not payable directly or indirectly to the estate. The exclusion was particularly

1. See Section V.A.4.a.
2. IRC §2503(f).
3. TRA 86 §1523(e)(2)(A), repealing IRC §2517.
4. See former IRC §2517.
5. IRC §2503(b); Reg §25.2503-3.
6. TAMRA §512(b) which added §2532(l)(6) to the IRC.
7. IRC §2044.
8. IRC §2532(l)(6)(C).
10. IRC §2519.
11. IRC §2532(l)(6)(B).
12. IRC §2532(l)(6)(D).
13. TAMRA §512(c)(3).
14. TAMRA §512(c)(1)(B).
15. TAMRA §512(c)(2). See Temp Reg §51.512(b), published in the Federal Register on September 22, 1989 (54 FR 38979) for the requirements for making these elections.
16. IRC §2039(a).
beneficial to individuals who had amassed large sums of money in qualified retirement plans and IRAs.

TEFRA reduced the amount of the estate tax exclusion to $100,000, but retained the requirements that special averaging treatment not be elected and that the retirement benefits not be payable directly or indirectly to the estate. 17 A transition rule continued to exclude the entire amount of retirement benefits payable to a decedent who was a participant in any plan, who was receiving benefits on December 31, 1982, and who had elected irrevocably the form of benefit before January 1, 1983. 18

TRA 86 amended this transition rule to permit an unlimited exclusion to the estate of an individual who separated from service before January 1, 1983, even though the benefits were not payable pursuant to an irrevocable election and the individual was not receiving benefits, as long as the individual did not change the form of benefit before his or her death. 19

DEFRA repealed the $100,000 exclusion for participants dying after December 31, 1984. DEFRA also contained a transitional rule that preserved the $100,000 exclusion for a decedent who was receiving benefits on December 31, 1984, and who, before July 19, 1984, irrevocably elected the form of retirement benefit. 20 TRA 86 amended this transition rule to permit the $100,000 exclusion to the estate of an individual who separated from service before January 1, 1985, even though the benefits were not payable pursuant to an irrevocable election and the individual was not receiving benefits, as long as the individual did not change the form of benefit before his or her death. 21

The estate planning advisor should be sure that a plan participant who is eligible for a transition rule does not inadvertently change the form of benefit before his or her death. In some cases, it may be advisable to change the form of benefit, but the advisor and the plan participant or beneficiary should be aware of the consequences. The advisor should determine whether either of the transition rules is available when preparing the federal estate tax return.

In a community property state, the nonparticipant spouse’s interest in the participant spouse’s accrued benefit is included in the gross estate of the nonparticipant spouse, even though the nonparticipant spouse has no control over the disposition of the nonparticipant spouse’s interest in the participant spouse’s accrued benefit. 22 In addition, the nonparticipant spouse’s interest may not qualify for the marital deduction, depending on the terms of the plan, although the entire value of the participant spouse’s accrued benefit may be includible in the participant spouse’s estate if the participant spouse survives the nonparticipant spouse.

Qualifying the participant’s accrued benefit for the marital deduction may be an important planning objective if the value of the combined estates of the husband and wife exceeds $600,000. There are a number of ways that the participant can insure that the marital deduction will be available for his or her accrued benefits.

The simplest way to qualify retirement plan benefits for the marital deduction is to have them distributable directly to the spouse in a lump sum. Such a lump sum payment designation avoids the need for spousal consent to some other beneficiary designation and allows the surviving spouse to choose to elect special averaging treatment or to roll the distribution into a spousal IRA. 23 The surviving spouse also may elect not to have the 15 percent excise tax on excess retirement accumulations imposed on the participant’s accrued benefit if he or she is entitled to at least 99 percent of the decedent’s retirement accumulations. 24

Before TAMRA, it was widely held that a survivor annuity should qualify for the marital deduction, since no one else had the right to receive the property upon the death of the spouse. TAMRA clarified this point by providing that a survivor annuity will be treated as QTIP property as long as no one else but the surviving spouse has any interest in the annuity until the death of the surviving spouse. 25 The deceased participant’s executor is presumed to have made the QTIP election unless the executor affirmatively and irrevocably elects to include the value of the annuity in the deceased participant’s federal gross estate. 26 Since the annuity is treated as QTIP property, any residual benefit payable to another beneficiary after the death of the surviving spouse will be includible in the gross estate of the surviving spouse. 27

The executor may elect not to have the survivor annuity qualify as QTIP property. 28 The election out of QTIP treatment is irrevocable 29 and must be made before November 11, 1990 or by the due date of the return, whichever is later. 30 These provisions are effective for estates of decedents dying after December 31, 1981. 31 For an estate tax return filed before November 11, 1988, the new rule only applies if an election is made before November 11, 1990 to change the treatment of the annuity to coincide with the rule. 32

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17. TEFRA §245(a), adding IRC §2039(g).
18. TEFRA §245(c).
19. TRA 86 §1652(a)(3).
20. DEFRA §525(a).
21. TRA 86 §1652(a)(3).
22. TRA 86 §1652(a)(1)(A) repealed IRC §2039(c) which excluded the interest of the nonparticipant spouse from the nonparticipant spouse’s gross estate.
23. IRC §402(a)(7).
24. IRC §4980A(d)(5).
25. TAMRA §6152(a), adding paragraph (7)(C) to IRC §2056(b).
26. IRC §2056(b)(7)(C)(i) and flush language.
27. IRC §2044.
29. IRC §2056(b)(7)(C), flush language.
30. TAMRA §6152(c)(3).
31. TAMRA §6152(c)(1).
32. TAMRA §6152(c)(2). See Temp. Reg. §55.6, published in the Federal Register on September 22, 1989 (FR 58979), for the requirements for making these elections.
Generally, the designation of accrued benefits to a marital deduction trust, such as a power of appointment trust, a QTIP trust, or an estate trust, may qualify for the marital deduction. In each case, care must be taken to avoid the creation of a nondeductible terminable interest or to meet the requirements of one of the exceptions to the terminable interest rule. Since the accrued benefits constitute income in respect of a decedent and carry an eventual income tax liability, it may be advisable for the income tax to reduce the surviving spouse’s estate rather than for it to reduce the value of the assets in the credit shelter share.

Under proposed regulations, in order for a trust to be treated as a designated beneficiary under the minimum distribution rules, (1) the trust must be valid under state law, (2) the trust must be irrevocable, (3) the trust must have identifiable beneficiaries, and (4) a copy of the trust instrument must be provided to the plan administrator. These requirements must be satisfied no later than the date the trust is named as a beneficiary or the participant’s required beginning date. See the discussion in Section II.E.5.33

If the assets attributable to the participant’s benefit under a qualified retirement plan are retained in the plan under a subtrust that meets the requirements of either a general power of appointment trust, a QTIP trust, or an estate trust, the assets in the subtrust may qualify for the marital deduction. The payments from the subtrust also will have to satisfy the minimum distribution rules discussed in Section II.E.

If someone other than the spouse is entitled to receive payments after the death of the spouse and the interest is not payable in the form of a survivor annuity, the interest may still qualify for the marital deduction under the QTIP rules. The Technical Corrections Act of 1982 amended the QTIP rules to permit an annuity to be treated as an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified) to the extent provided in the regulations.34

Under proposed regulations, the value of the deductible interest is determined by comparing the amount that is paid to the surviving spouse to a hypothetical yield on the property using the current interest rate under Code §2031, which is 120 percent of the federal midterm rate.35 If the annual payment is equal to or greater than the hypothetical yield using the federal midterm rate, the entire present value of the benefit will be deductible. If the annual payment is less than the hypothetical yield using the federal midterm rate, the deduction will be less than the present value of the benefit.36

In Rev. Rul. 89-89, IRB 1989-27, the deceased participant designated the trustee of a testamentary trust as the beneficiary of an IRA, and selected a distribution option under which (1) the account balance was to be distributed to the trust in equal annual installments over the surviving spouse’s life expectancy, and (2) the income earned on the undistributed portion of the account balance during the calendar year was to be distributed to the trust. Since the trust agreement required that income earned on the IRA and the income earned by the trust be paid currently to the surviving spouse, the Service held that the IRA benefits payable to the trust qualified for the marital deduction under IRC 2056(b)(7).38

The marital deduction is not allowed if the surviving spouse is not a citizen of the United States, effective for decedents who died after November 10, 1988, unless the property passes to a qualified domestic trust.39 A surviving spouse may transfer any property, probate or nonprobate, that the surviving spouse receives to a qualified domestic trust and have such property qualify for the marital deduction.40 Nonprobate property would include benefits paid directly to the spouse pursuant to a beneficiary designation under a qualified retirement plan or IRA. In addition, a qualified retirement plan or IRA may have a properly drafted beneficiary designation satisfy the requirements for a qualified domestic trust.41

If the participant is not survived by a spouse or the plan benefits have been designated (with any necessary spousal consent) to a trust or other nonspousal beneficiary, the income tax rollover opportunity will not be available. In addition, the 15 percent excess retirement accumulations tax will be imposed on any excess retirement accumulations.42 The excess retirement accumulations tax is deductible for purposes of the regular estate tax.43 The excess retirement accumulations tax is not deductible for purposes of the income tax and may not be offset by the unified credit against federal estate taxes. The accumulated benefits may qualify for special 5 year averaging for income tax purposes (or 10 year averaging or capital gains treatment under certain transitional rules) if distributable in a lump sum. See discussion under Section III.B.

The death benefits from the qualified plan may be used to fund the participant’s credit shelter trust. The governing instrument may provide that the surviving spouse as primary beneficiary may disclaim plan benefits, which will then pass to the children or the credit shelter trust. Similarly, the credit shelter trust may be designated by the participant to receive a portion, amount, or percentage of the plan benefits and the spouse or the marital trust is then designated to receive

34. IRC §2056(b)(7)(B)(ii) (flush language).
35. IRC §2056(b)(7)(B)(ii).
36. TAMRA §5031, adding IRC 7520
39. TAMRA §5031, adding IRC §2056(b)(7).
40. IRC §2056(b)(7)(B) as amended by RRA 89 §7615(d)(1)(A).
41. IRC §7615(b)(1), added by RRA 89 §7615(d)(1)(A), authorizes the Treasury to issue regulations that would treat annuities or other payments over a period of years (including qualified retirement plan benefits) as a qualified domestic trust.
42. IRC §408(a).
43. IRC §2053(c)(1)(B).
the balance.

In the event the trustee of a revocable trust containing formula marital deduction and credit shelter trust language is designated by the participant as the beneficiary of qualified retirement plan benefits, the trustee may allocate the benefits to fund the credit shelter or marital deduction bequests. Such a beneficiary designation should not be used if the formula for determining the amount of either the marital or credit shelter share is a pecuniary formula bequest and if the death benefits may be paid in installments. If the benefits are payable in installments, the satisfaction of the pecuniary bequest with the right to receive future payments will accelerate the recognition of income for federal income tax purposes before the payments have been actually received.44

If a fractional share formula is used in the governing instrument to determine the marital and credit shelter shares, and the instrument gives the trustee discretion to select individual assets to fund the shares, the trustee apparently would have the flexibility to allocate the income in respect of the decedent to either the marital or credit shelter share without accelerating the recognition of income.45 A true or pure fractional share formula may create administrative problems for the trustee and the plan administrator, since the fraction may not be finalized until some time after the participant's death. Care should be taken in each case to assure that the marital share qualifies for the marital deduction, the required payments from both shares meet the minimum distribution rules, and opportunities to elect life expectancy payments or lump sum distributions are maximized.

C. Employee Stock Ownership Plans.

TRA 86 added an exclusion from the value of the gross estate equal to 50 percent of the proceeds from a sale of employer securities by an estate to an ESOP, for sales occurring after October 22, 1986 and before January 1, 1992.46 The Revenue Reconciliation Act of 1989 ("RRA 89") repealed this provision for estates of decedents dying after December 19, 1989, the date of enactment.47

The ESOP estate tax exclusion initially permitted an estate to avoid the payment of any estate tax by continuing to purchase additional securities and reselling them to an ESOP until the exclusion equaled the value of the taxable estate.48 The Revenue Act of 1987 made substantial modifications to the requirements for the exclusion retroactive to the original effective date of October 22, 1986, and limited the amount that could be excluded, as described further below.49

Under former law as amended by the 1987 Act, the decedent had to own the stock at death.50 After the sale to the ESOP, the securities had to be allocated to plan participants.51 The sale of securities owned by a trust qualified for the exclusion only if the securities were included in the decedent's gross estate; under the original legislation, any sale by an estate qualified.

The amount of the deduction was limited to 50 percent of the taxable estate.52 The amount of the estate tax could not be reduced by more than $750,000.53

There were additional limitations on the source of funds used to purchase employer securities. The exclusion did not apply to a sale of securities if the ESOP used proceeds received either from the disposition of securities by the ESOP within one year preceding the sale or from assets transferred to the ESOP from other plans.54 The exclusion did not apply to proceeds received by the estate from a sale to an ESOP after the due date of the estate tax return.55 In addition, the exclusion did not apply to a sale of securities that were received by the deceased participant from other qualified plans or pursuant to certain stock option plans.56

In order for the exclusion to apply, the securities had to be issued by a domestic corporation that did not have any outstanding stock traded on an established securities market, and the securities must have been owned by the decedent for either the five-year period ending on the date of his or her death or for the period beginning on October 22, 1986, and ending on the date of death, whichever was shorter.57

A 30 percent excise tax was imposed on the ESOP if the ESOP disposed of the employer's securities within three years of the acquisition from the decedent's estate, except for certain distributions to participants.58 In addition, a 50 percent tax was imposed on the sponsoring employer if there was an allocation of such securities to persons who were either related to the decedent or who owned more than 25 percent of the stock of the sponsoring employer.59

Prior to RRA 89, an ESOP could also assume the estate tax liability of an estate in exchange for a transfer to the ESOP of employer securities.60 This provision was repealed by RRA 89.

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44. IRC §691(a)(2); see also Rev. Rul. 60-67, 1960-1 C.B. 286.
46. IRC §2057(a).
47. RRA 89 §7350(a)(1) and (3).
48. See the original version of IRC §2057, before it was amended by RA 87 §10412(a).
49. RA 87 §10412(a).
50. RA 87 §10412(b)(3) and IRC §2057(d)(1)(B).
51. RA 87 §10412(b)(2); IRC Notice 87-13, 1987-1 C.B. 432.
52. RA 87 §10412(b)(2).
53. IRC §2057(b)(2).
54. IRC §2057(b)(1).
55. IRC §2057(c)(1) and (2).
56. IRC §2057(c)(3)(A).
57. IRC §2057(c)(3)(B).
58. IRC §2057(d)(1)(A).
59. IRC §2057(d)(1)(C).
60. IRC §4979A.
61. IRC §§409(n) and 4979A.
62. IRC §2210(b).
after July 12, 1989. In order to qualify, more than 35 percent of the value of the gross estate, less expenses and losses, must have consisted of interests in closely-held businesses. The ESOP, if it assumed the liability for paying part or all of the estate taxes under this proviso, was entitled to pay the estate tax over 14 years and 9 months, in the same way that the estate could have paid the tax. If the ESOP elected to pay the tax in installments, the interest on the estate tax attributable to the first million dollars in value of interests in closely-held businesses was four percent rather than the normal rate that would apply to unpaid taxes.

D. Generation-Skipping Transfer Tax.

TRA 86 completely revamped the generation-skipping transfer ("GST") tax. The generation-skipping transfer tax may apply to benefits from qualified retirement plans and IRAs if a participant has designated as the beneficiary of his or her accrued benefits someone who is in a generation more than one generation below the participant (a "skip person"). The generation-skipping transfer tax rate is equal to the highest estate tax rate (currently 55 percent). This rate is applied to the value of any benefits passing to the skip person, in addition to the estate tax and the 15 percent tax on excess retirement accumulations. The value of the benefits also would be subject to income tax, since they would be income in respect of a decedent described in Code §691. There would be an income tax deduction for the estate tax and generation-skipping transfer tax paid on the value of the benefit, but there is no deduction for income tax purposes for the 15 percent excise tax on accumulated retirement accumulations. Generation-skipping transfers also may occur if the benefit is paid to a trust in which one or more beneficiaries in the trust are skip persons, such as grandchildren or great grandchildren of the participant.

If the participant makes an irrevocable beneficiary designation that includes one or more skip persons, the participant should consider allocating some or all of his or her $1 million GST exemption to the amount transferred. If the transfer is irrevocable and will not be includible in the participant’s estate, then the allocation of part of the $1 million GST exemption will eliminate any generation-skipping transfer tax in connection with the benefit, even though the value of the benefit may increase after the irrevocable beneficiary designation has been made. Since additional gifts will occur as the participant accrues benefits during years of participation after the irrevocable designation, the participant may have to allocate additional amounts of his or her generation-skipping transfer exemption to the additional benefit accruals.

If the value of the benefit will be included in the participant’s estate because he or she has retained a right to income or some other interest over the benefit, then the allocation of the exemption may not be made until the first to occur of (a) the participant’s death, (b) the relinquishment of any such rights, or (c) the transfer of some or all of the benefit to a skip person, in which case the allocation can be made only to the amount transferred to the skip person.

The participant’s executor or personal representative also may consider allocating some or all of the decedent’s GST exemption to accrued benefits that are passing or may pass upon the participant’s death for the benefit of skip persons.

63. RRA 89 §7304(b).
64. IRC §§2210(a)(2) and 6166.
65. IRC §2210(c)(1).
66. IRC §2613.
67. IRC §§2641(a) and 2001(c)(2)(D).
68. See IRC §2611 for the definition of a generation-skipping transfer.
70. See IRC §2632 for rules concerning the allocation of the generation-skipping transfer exemption.
71. IRC §2642(f).
SECTION V
SPOUSAL RIGHTS

A. Survivor Annuities.

1. In General.

REA created for a participant’s spouse rights to two kinds of survivor annuities. First, the surviving spouse of a vested participant is entitled to a qualified joint and survivor annuity (QJSA) if the participant dies after the annuity starting date. Second, the surviving spouse of a vested participant is entitled to a qualified preretirement survivor annuity (QPSA) if the participant dies before the annuity starting date. The annuity starting date is the first day of the first period for which an amount is payable as an annuity.

A plan may, but is not required to, provide a survivor annuity for a spouse if the participant and such spouse have not been married throughout the one-year period ending on the earlier of the annuity starting date or the date of the participant’s death. A surviving spouse will be treated as eligible for an annuity if such spouse married the participant within one year before the annuity starting date and if such spouse was married to the participant for at least one year ending on or before the participant’s death.

a. Qualified Joint and Survivor Annuity.

A QJSA is a form of retirement and death benefit which provides an annuity for the life of the participant with a survivor annuity for the life of the spouse if the spouse survives the participant. The survivor annuity must not be less than 50 percent nor more than 100 percent of the amount of the annuity which is payable during the joint lives of the participant and spouse. The annuity payable during the joint lives of the participant and spouse must have a value at least as great as the present value of a single life annuity payable to the participant under the plan’s normal retirement benefit formula.

b. Qualified Preretirement Survivor Annuity.

A QPSA is a form of death benefit that provides an annuity for the life of the surviving spouse of the participant. The amount of the annuity depends upon when the participant dies. If the participant dies after reaching the earliest retirement age under the plan, the survivor annuity is equal to the survivor annuity that would have been payable to the surviving spouse under a QJSA determined as if the participant had retired the day before he or she died and had elected to receive an immediate QJSA.

If the participant dies before the earliest retirement age under the plan, the survivor annuity is equal to the survivor annuity that would have been payable to the surviving spouse under a QJSA determined as if the participant (i) separated from service on the date of his or her death, (ii) survived to the earliest retirement age under the plan, (iii) retired with an immediate QJSA at the earliest retirement age, and (iv) died on the day after the day on which he or she would have attained the earliest retirement age.

In the case of a defined contribution plan, such as a money purchase pension plan or a profit-sharing plan, that does not meet the safe harbor requirements discussed below, a QPSA means an annuity for the life of the surviving spouse, the actuarial equivalent of which must not be less than 50 percent of the nonforfeitable portion of the participant’s account balance as of his or her date of death. A defined contribution plan that does meet the safe harbor requirements is not subject to the annuity requirements. However, a 100 percent spousal benefit upon the participant’s death is mandatory under such a plan.

2. Waiver and Spousal Consent.

A participant must have the right to waive the QJSA and the QPSA and must be furnished with notices explaining such annuity forms and benefits, unless the plan fully subsidizes the cost of such annuity and unless the benefit may not be waived or another beneficiary selected. A plan fully subsidizes the cost of the annuity if a participant’s failure to waive the annuity does not result in a decrease in his or her plan benefits or an increase in his or her contributions. Even if the plan fully subsidizes the cost of the benefit, spousal consent is required if someone other than the spouse may be designated as the beneficiary under the terms of the plan.

If the participant wants to waive the QPSA or the QJSA, the participant’s spouse must consent to the waiver in writing. The waiver must designate a beneficiary or a form of payment that may not be changed without the spouse’s consent, unless the form expressly permits the participant to change either or both without the spouse’s consent. In addition, a spouse may only give a consent that allows the participant to change the form of benefit and the designated beneficiary in the future without the spouse’s consent if the

2. IRC §401(a)(11)(A)(ii).
4. IRC §417(e)(1).
5. IRC §417(d)(2).
6. IRC §417(b)(1).
7. IRC §417(b)(2).
8. IRC §417(c)(1).
9. IRC §417(c)(2).
10. IRC §417(c)(1)(A)(i).
12. IRC §417(c)(2).
13. IRC §417(a)(1)(A); IRC §417(a)(3); IRC §417(a)(5)(A).
15. IRC §417(a)(5)(A).
17. IRC §417(a)(2)(A)(ii); Reg. §1.401(a)-20 Q&A 31(b).
plan specifically permits it. Such a consent must include an acknowledgment by the spouse that he or she has the right to limit the consent to a specific form and a specific beneficiary but that he or she voluntarily elects to relinquish the right.\textsuperscript{18} The spouse’s consent must acknowledge the effect of the election and must be witnessed by a plan representative or a notary public.\textsuperscript{19}

A participant’s waiver of the QJSA or the QPSA and the spousal consent to the waiver will be valid only if made during specific election periods set forth in the Code.\textsuperscript{20} In addition, the notices explaining the annuity forms must be provided during certain periods that also are set forth in the Code.\textsuperscript{21}

3. Loans and Spousal Consent.

A spouse’s rights to the QJSA and the QPSA are also protected in the loan context if the plan is required to provide such annuities under IRC §401(a)(11). Even if a plan allows the participant to borrow a portion of his or her vested accrued benefit, the participant’s spouse must consent as described above if the accrued benefit is used as security for the loan. Since most plans require that 50 percent of the participant’s vested accrued benefit be pledged as security for a loan, a spouse can effectively allow or prohibit borrowing by the participant.\textsuperscript{22}

4. Exceptions.


The only retirement plans that are not required to provide the QJSA and QPSA are defined contribution plans, other than money purchase pension plans or target benefit plans, if the following conditions are met: (i) the plan must provide that the participant’s nonforfeitable accrued benefit (reduced by any security interest held by the plan by reason of a loan outstanding to the participant) is payable in full, on the death of the participant, to the participant’s surviving spouse (if there is no surviving spouse or if the surviving spouse consents as discussed above, such accrued benefit must be payable to a designated beneficiary);\textsuperscript{23} (ii) the participant must not elect a payment of his or her benefit in the form of a life annuity;\textsuperscript{24} and (iii) with respect to such participant, the plan must not be a direct or indirect transferee of a transfer of assets after December 31, 1984, from a plan that is required to provide the QJSA and QPSA.\textsuperscript{25} The safe harbor requirements do not give a participant’s spouse any right to determine the form of benefit payable at the participant’s retirement. As noted below, this creates some estate planning opportunities.

In sum, 100 percent of the death benefit under a qualified defined benefit plan or defined contribution plan meeting the safe harbor requirements and 50 percent of the death benefit under all other qualified defined contribution plans must be paid to a participant’s spouse unless he or she consents otherwise. In other words, the nonparticipant spouse has a federally created vested property interest in the plan benefits of the participant at his or her death. In addition, at the participant’s retirement, 100 percent of the retirement benefits under a qualified defined benefit plan and a qualified defined contribution plan not meeting the safe harbor requirements must be in the form of a QJSA unless the spouse consents otherwise. However, retirement benefits under a defined contribution plan meeting the safe harbor requirements are not so limited and may be offered in many forms, subject only to the election of the participant and not to the consent of the participant’s spouse. There is no indication in the law or legislative history to explain why spousal death and retirement rights differ so much depending upon the type of qualified retirement plan involved.


If upon termination of employment a participant’s accrued benefit is under $3,500, the plan can require an immediate lump sum distribution of the accrued benefit, and in that event the QJSA and QPSA rules do not apply.

c. IRA.

The rules requiring the payment of benefits in the form of a QPSA or a QJSA do not apply to IRAs. If the participant receives a distribution from a qualified retirement plan in the form of a lump sum, he or she may roll the distribution into an IRA, and it will not be subject to the survivor annuity rules. The participant’s spouse, however, must have consented to the distribution in the form of a lump sum before the rollover unless the plan was not required to provide survivor annuities because it was a defined contribution plan which met the safe harbor requirements.

B. Qualified Domestic Relations Orders.

1. Background.

A qualified retirement plan must provide that benefits under the plan may not be assigned or alienated.\textsuperscript{26} An exception permits a participant who is in pay status (i.e., the participant has retired and begun to receive benefits) to make a voluntary and revocable assignment of up to ten percent of any benefit payment, except for the purpose of defraying plan administration costs.\textsuperscript{27} An additional exception permits a participant to secure a loan from the plan with his or her vested accrued benefit if the loan is not treated as a prohibited transaction under Code §4975.\textsuperscript{28} A loan will be exempt from the prohibited transaction provisions if the loan: (1) is available to all participants or beneficiaries on a reasonably equivalent basis; (2) is not made available to highly compensated employees in an amount greater than the amount available to other employees; (3) is

\textsuperscript{18} Reg. §1.401(a)-20 Q&A 31(c).
\textsuperscript{19} IRC §417(a)(2)(A)(ii).
\textsuperscript{20} IRC §417(a)(6); Reg. §1.401(a)-20 Q&A 33.
\textsuperscript{21} IRC §417(a)(9); Reg. §1.401(a)-20 Q&A 35.
\textsuperscript{22} IRC §417(a)(4).
\textsuperscript{23} IRC §401(a)(11)(B)(i)(ii)(B).
\textsuperscript{24} IRC §401(a)(11)(B)(ii)(B).
\textsuperscript{25} IRC §401(a)(11)(B)(ii)(B).
\textsuperscript{26} IRC §401(a)(13)(A).
\textsuperscript{27} IRC §401(a)(13)(A).
\textsuperscript{28} IRC §401(a)(13)(A).
made in accordance with specific provisions regarding such loans set forth in the plan; (4) bears a reasonable rate of interest; and (5) is adequately secured. 29

Before the enactment of REA, courts disagreed on whether the prohibition on assignment or alienation preempted state court orders in domestic relations cases. 30 REA resolved the issue by creating an additional exception to the non-alienation rules for payments made pursuant to a qualified domestic relations order (QDRO). 31 REA provided that a qualified retirement plan may not comply with domestic relations orders that do not satisfy the requirements of a QDRO. 32

2. Qualified Domestic Relations Order.

In general, a QDRO is a domestic relations order that creates, or recognizes the existence of, an alternate payee’s right to receive or assign all or part of the benefits payable with respect to a participant under a qualified retirement plan. 33 A QDRO must specify certain facts set forth below and may not alter the amount or form of benefit. 34 A QDRO may not require the payment of benefits to an alternate payee which are required to be paid to another alternate payee under another order previously determined to be a QDRO. 35

a. Alternate Payee.

A domestic relations order involves the payment of child support, alimony payments, or marital property rights to an alternate payee. 36 An alternate payee is defined as a spouse, former spouse, child, or other dependent of the 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 a participant. 37 In addition, the order must be made pursuant to a domestic relations law (including community property law). 38


A QDRO must specify clearly the following facts: (i) the name and the last known mailing address (if any) of the participant and the name and mailing address of each alternate payee covered by the order; (ii) 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; (iii) the number of payments or period to which such order applies; and (iv) each plan to which the order applies. 39

c. Form of Payment.

Generally, a QDRO may require that the

payment to the alternate payee be made in any form in which the participant’s benefits may be paid under the plan. 40 However, a QDRO may not require that the payment be made in the form of a joint and survivor annuity with respect to the alternate payee and his or her subsequent spouse. Such payments must be restricted to the former spouse and other alternate payees. 41 A QDRO may provide that a former spouse of a participant is to be treated as a surviving spouse of the participant for purposes of a QJSA or QPSA. 42 Upon the death of the participant, the former spouse would be entitled to a survivor annuity, just as if he or she were a surviving spouse. The QDRO must be carefully drafted and must indicate the amount or percentage of the participant’s benefits to which the QJSA or QPSA applies. Otherwise, litigation will likely result, particularly if the participant remarries, dies and leaves a new surviving spouse who claims a QJSA or QPSA.

d. Timing of Payment.

A QDRO may not require a plan to provide a type or form of benefit, or an option, not otherwise provided under the plan. 43 However, a QDRO may require that benefits be paid to the alternate payee before a participant has separated from service if the participant has reached the earliest retirement age under the plan. 44 The earliest retirement age means the earlier of (i) the date on which the participant is entitled to a distribution under the plan or (ii) the later of the date the participant reaches age 50 or the earliest date on which the participant could begin receiving benefits under the plan if the participant separated from service.

e. Amount of Benefit.

The amount of the benefit will be determined as if the participant had retired on the date on which the payment begins under the QDRO. The amount will be determined by taking into account the present value of the benefits actually accrued but excluding the present value of any employer subsidy for early retirement. 45 The interest rate assumption in determining the present value must be the interest rate specified in the plan or, if no rate is specified, five percent. 46

f. Procedures.

The plan must establish a procedure for determining whether a domestic relations order qualifies as a QDRO. 47 The plan administrator must notify the participant and each alternate payee of the receipt of the order and the plan’s procedures for determining whether the order is a QDRO. 48 The plan administrator

...
also must determine within a reasonable period after the receipt of the order whether the order is a QDRO and notify the participant and each alternate payee of the determination.50

C. Planning Considerations.

The QJSA and QPSA requirements generally restrict the flexibility of a participant in planning for both retirement and death distributions from qualified retirement plans. Plans which are not subject to the QJSA and QPSA rules generally have more flexibility for death distributions.

1. Children by a Prior Marriage.

If a participant has children by a prior marriage whom he or she wants to benefit at death, the results of the spousal rights created by REA can be harsh. If the benefits are payable from a defined benefit plan, the participant will need the consent of his or her spouse to avoid the QJSA and QPSA requirements. If the spouse does not consent, all of the benefits passing to the spouse will be exhausted upon his or her death, since the form of benefit will be either a QJSA or a QPSA which ends on the spouse's death. No benefits will remain for the children by a prior marriage.

A defined contribution plan which does not meet the safe harbor requirements has a different result. In such a plan, the value of the QPSA payable to the surviving spouse must equal only 50 percent of the vested account balance of the participant. Consequently, the participant could designate his or her children from a prior marriage or some other person as beneficiary of 50 percent of his or her vested account balance.

In a defined contribution plan which meets the safe harbor requirements, 100 percent of the vested account balance must be paid to the surviving spouse upon the death of the participant unless he or she consents otherwise. However, no spousal consent is necessary to elect the form of retirement benefit. There are estate planning opportunities in selecting the form of retirement benefit. For example, a participant could take a lump sum retirement distribution from a defined contribution plan which meets the safe harbor requirements, roll over the distribution to an IRA and then name his or her children from the prior marriage as beneficiaries of the IRA. Spousal rights to any death benefit have clearly been eliminated.

2. State Law.

The potential harsh result for children by a prior marriage is accentuated by the law of many states which entitles a surviving spouse to a portion of the participant's probate estate, usually one-third to one-half. On the other hand, if the surviving spouse is entitled to a percentage of the augmented estate that includes nonprobate assets, the qualified retirement plan benefits payable to the surviving spouse may reduce the amount that the surviving spouse is entitled to from other assets.

3. Nuptial Agreements.

Spousal rights under REA also must be taken into account when drafting prenuptial and postnuptial agreements. Such agreements may not control a surviving spouse's rights to a QJSA and QPSA. ERISA preempts state law in many areas. If the spouse consents to a waiver of the QJSA and QPSA in a nuptial agreement but later (during the prescribed election period) refuses to do so, the participant may have no recourse under ERISA. However, the participant's intended beneficiaries may be able to enforce the agreement under state law after the participant has died and the spouse begins receiving the benefits. On the other hand, the Regulations governing QJSA and QPSA make clear that an prenuptial agreement or similar contract entered into prior to marriage does not satisfy the applicable consent requirements.51

4. Separate Counsel.

If the estate plan of the participant warrants a waiver by the spouse of his or her rights to a QJSA and QPSA in order to provide a different beneficiary or form of benefit, the advisor should inform the nonparticipant spouse to seek the advice of independent counsel. The advisor is ethically bound to do so. In addition, the failure to inform the participant's spouse to seek independent counsel may jeopardize the validity of the waiver. Such advice may not be necessary if the participant is designating a trust that only benefits the nonparticipant spouse while he or she is alive and the trust and the designation cannot be amended or changed without the nonparticipant spouse's consent.

50. IRC §414(p)(6)(A)(i).

51. Reg. §1.401(a)-20, Q&A 28.
SECTION VI
PLANNING

A. Planning Objectives.

When the advisor is asked to assist a client in determining the appropriate beneficiary designation or form of payment, the advisor needs to consider the client's desires, the avoidance of penalty taxes, income tax liability, the deferral of the receipt of the benefits for as long as possible, and the reduction or avoidance of transfer taxes.

The client's desires need to be determined with respect to the distribution of his or her benefits both during lifetime and after death. The client's objectives will be restricted by the provisions in the plan that may limit the methods of payment available and the times when payments may be made. In addition, the client's objectives may be restricted by the Retirement Equity Act, which requires the client's spouse to consent to beneficiary designations if they do not name him or her as the primary beneficiary of any death benefits, and to any form of payment during the client's lifetime other than a qualified joint and survivor annuity (except for certain defined contribution plans).

Once the client's objectives have been determined, the advisor should plan to avoid the penalties that may apply to distributions from qualified retirement plans and IRAs. A ten percent penalty applies to premature distributions, generally distributions before the client reaches age 59 1/2, unless an exception applies. If the client needs the money, and the penalty tax is incurred, the client will still be better off than if he or she had not been a participant in the plan or made contributions to an IRA. After a few years, the benefit of having the amount in the qualified retirement plan or IRA accumulate tax-free will offset the penalty. In addition, the client will probably be in a lower income tax bracket if he or she needs money that badly, and therefore the amount of the penalty and the income tax may not be more than the income tax that would have been paid if the participant had received the money or had not contributed the money to the IRA.

In addition to the ten percent penalty, there is a 15 percent penalty that applies to excess retirement distributions and excess retirement accumulations. Note that the 15 percent penalty is reduced by the ten percent penalty if both penalties apply to the same distribution. While careful planning can help to avoid receiving an excess retirement distribution in a particular year, it may be impossible to avoid the penalty altogether because of the minimum distribution rules. In addition, if the client dies before the entire amount of his or her qualified retirement plan benefits and IRA accounts have been distributed, the excess retirement accumulation tax may apply. This estate tax may be deferred if the surviving spouse is the primary beneficiary of the benefits and makes an election to have the qualified retirement plan benefits and IRA accounts treated as his or her own for purposes of the excess retirement distribu-

B. Before Retirement.

When a participant first becomes eligible to participate in a plan, the participant generally will be requested to complete a beneficiary designation form in which he or she names the beneficiary or beneficiaries of his or her benefits if he or she dies before all of the benefits have been paid. The form may also designate the method of payment; however, the participant, in most cases, should wait until he or she retires to designate a form of payment and should not restrict the beneficiary as to the method of payment unless there is some compelling reason, such as protecting the beneficiary from his or her spendthrift habits.

The advisor must review information with respect to all plans in which the client participates in order to determine both the amount of the client's benefits under
the plan and the options available to the client or his or her beneficiary. In order to determine the amount of benefits, as well as the available options, the advisor should request from the client, or the client's employer, as much of the following information as possible.

1. A copy of the plan as well as all amendments to the plan. In addition, the advisor should keep in mind that some of the already mandated provisions, such as the changes in the vesting rules of the Tax Reform Act of 1986 will, in some cases, not be inserted into a plan document until 1991 or later.

2. A copy of the Summary Plan Description (SPD), as well as any material modifications to the SPD. The SPD may not be current; however, it describes the benefits and options in more easily understood language.

3. The Summary Annual Report (SAR). This is a short form of the Annual Report Form 5500 for the plan and gives the advisor some financial and general information concerning the plan.

4. The Statement of Accrued Vested Pension Benefit. This is an individual statement of the client's accrued vested pension benefits plus benefits that may be forfeited on the client's death. This statement is available upon the written request of the client, if still a plan participant, or automatically given to terminated employees. The advisor should always request a copy of this form for a defined benefit plan. In the instance of a defined contribution plan, it is almost always available to a participant on a yearly basis.

5. The Explanation of Preretirement Survivor Benefits. This form explains to a participant what rights he or she has to have a benefit paid to a beneficiary if he or she dies before retirement. This form is usually given to the client after he or she attains age 32.

6. The Qualified Domestic Relations Order ("QDRO"). If the client has been divorced then it is possible that he or she has received a benefit or lost a benefit as part of a property settlement. The advisor should review the QDRO to determine the effect of the settlement and what options are available to the client.

7. The Form 5329, if any, filed for the client with his or her 1987 or 1988 federal income tax return making the "grandfather" election. The advisor should ask of the client if a grandfather election was made and should obtain a copy for review.

8. A copy of any current beneficiary elections which have been executed by the client. The advisor should have a copy of the actual beneficiary form signed and dated by the client as well as a copy of the beneficiary designation forms of each plan being reviewed.

In determining the appropriate beneficiary designation, the participant's overall estate planning objectives should be considered. The advisor should review the participant's current financial situation, the projected future financial needs of the participant and the participant's beneficiaries, and the participant's will and other estate planning documents.

There are a number of issues involved in designating a beneficiary or beneficiaries of benefits payable at the death of the participant. If the benefits are to be paid to the surviving spouse who is a citizen of the United States, the benefits should qualify for the marital deduction for estate tax purposes, unless there is a possibility of payments to someone other than the spouse after the spouse's death and the form of payment does not qualify as QTIP property. If the spouse is not a citizen of the United States, the benefits will not qualify for the marital deduction unless the benefits are payable or are transferred to a qualified domestic trust.

If the participant's qualified retirement plan benefits represent a substantial portion of the participant's estate, there may not be other assets of sufficient value to fund the credit shelter trust if all the benefits are to be paid to the spouse. The underfunding of the credit shelter trust would waste some of the participant's unified credit.

The spouse may disclaim the receipt of the benefits if appropriate. The Internal Revenue Service, however, may take the position that a surviving spouse cannot disclaim a qualified preretirement survivor annuity and qualified joint and survivor annuity under REA, although a recent case held that a spouse could waive her right to a benefit pursuant to a divorce decree. If the benefits are paid to the surviving spouse in a lump sum, he or she may roll the benefits into an IRA, thereby deferring the payment of income tax until the surviving spouse reaches age 70 1/2. In addition, the spouse may elect five-year averaging with respect to the benefits (or ten-year averaging or capital gain treatment if the transition rule applies). If the benefits are to be paid in a lump sum, the spouse must consent to waive his or her right to the qualified preretirement survivor and joint and survivor annuities. Finally, the spouse may elect not to have the benefits subject to the 15 percent excise tax on excess retirement accumulations.

The surviving spouse may not be capable of investing the excess of the benefits he or she receives over the amount required for current living expenses. In such cases it may be advisable to have the benefits paid to a trust with a bank or other institution as trustee. Alternatively, the surviving spouse may engage advisors or transfer the funds to a trust or custodial account.

Designating the spouse as the sole beneficiary may not be appropriate if the participant has children by a prior marriage. Spousal consent, however, will be required to elect out of the qualified preretirement survivor annuity and qualified joint and survivor annuity to ensure that some or all the benefits are paid to the children of a prior marriage.


2. See Section III.F. for a discussion of rollovers.

3. See Section III.C. for a discussion of favorable averaging, capital gain treatment, and the transition rule.

4. See Section II.G. for a discussion of the tax on excess retirement accumulations.

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The participant may want to designate a trust that qualifies for the marital deduction as the beneficiary of his or her qualified retirement benefits. Spousal consent will be required under REA if payments are to be made to a trust rather than in the form of a qualified preretirement survivor annuity and qualified joint and survivor annuity. Designating a trust will preclude rollover treatment, but five-year averaging (and ten-year averaging and capital gain treatment, if the transition rule applies) will still be available. The advisor should be certain that the trust qualifies for the marital deduction and, if the payments are not to be made to the trust in a lump sum, that the trust serves merely as a conduit with respect to the distributions from the plan that represent current income and the form of benefit payment satisfies the requirements for the marital deduction, particularly the requirement that all income be distributed to the surviving spouse at least annually. If the marital deduction trust is overfunded or if other tax or nontax considerations warrant, the spouse may disclaim his or her interest in the trust and the right to the benefits may then pass to a credit shelter trust or to other beneficiaries.

Finally, the participant may designate as a beneficiary either a credit shelter trust or individuals other than the spouse. In such a case, the marital deduction will not be available. Rollover treatment also will not be available. Five-year averaging will be available, as well as ten-year averaging and capital gain treatment if the transition rule applies. Naming a credit shelter trust or other beneficiaries will require spousal consent since the payments are not being made in the form of a qualified preretirement survivor annuity or qualified joint and survivor annuity.

C. At Retirement.

When the participant is considering retirement, he must decide what method of payment to elect and when to begin receiving the payments. In addition, if the participant has not elected a lump sum distribution or a life annuity, he or she must designate a beneficiary for any benefits that remain payable at his or her death.

The advisor again must review the same information that was reviewed in connection with planning before retirement, including the summary plan description for the plan, the benefit statements, the plan itself, the current financial information of the participant, the projected current financial needs of the participant and the participant's beneficiaries, and the participant's will and other estate planning documents.

Income tax consequences will be of prime concern to the participant. If the plan permits, the participant will have a choice between receiving the payments in a lump sum or over a period of time, either in installments or in some form of an annuity. In the case of a lump sum distribution, a person who is eligible under the transition rule because he or she had reached age 50 before January 1, 1986 will have four methods available for taxing the distribution:

(1) Ten-year averaging plus long-term capital gain treatment on the pre-1974 portion (at a 20 percent maximum rate);
(2) Five-year averaging plus long-term capital gain treatment on the pre-1974 portion (at a 20 percent maximum rate);
(3) Ten-year averaging on the entire amount; or
(4) Five-year averaging on the entire amount.

If the participant prefers to receive the payments over a period of time, the participant may leave the assets in the plan, have the plan purchase a commercial annuity that will be distributed to the participant, or have the benefits distributed and rolled into an IRA. Subsequent payments under any of these methods will be taxed in the same way.

The payment of the benefits over a period of time will have two significant tax benefits not available if the participant chooses to pay tax on the entire amount at one time. First, since the payment of the tax on the amount of benefit will be deferred until the payments are received, the deferred tax will remain invested for the benefit of the participant until actually paid. For example, a $500,000 distribution to a participant would result in $140,000 of federal income tax being paid, using current maximum rates. This would leave the participant with $360,000 to invest. If the $500,000 were retained in the plan or rolled into an IRA, the entire $500,000 would continue to be invested for the benefit of the participant.

Second, the earnings on the amount retained in the plan or rolled into an IRA will not be subject to current tax. This will allow the earnings to compound income tax-free until they are actually distributed to the participant. If an annuity is purchased, the result will be similar, since the internal build-up of value in the annuity is not currently taxed to the participant. Only distributions from the annuity to the participant are subject to current tax.

Assuming that the participant’s goal is an equal amount of monthly income over a specified number of years and that the same rate of return will be available with respect to the investment of either the net proceeds after a lump sum distribution or the amount left in the plan or placed in the IRA, then the following observations can be made. Larger amounts should be kept in the plan, put into an IRA, or used to purchase an annuity; a lump sum distribution is not advisable unless it will help to avoid the 15 percent tax on excess retirement distributions and accumulations. As the rate of return or pay-out period increases, the IRA-rollover and leave-it-in-the-plan options produce higher after-tax monthly payments because the benefit of the tax deferral is enhanced. As the tax rate increases in the future, the lump sum treatment becomes more valuable. For example, a lump sum distribution today would be taxed at a maximum 28 percent rate. If the maximum rates increased to 33 percent or 40 percent, then future distributions from the plan, the IRA, or the annuity will be taxed at the higher rate.

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5. See Parts F and G of Section II for a discussion of the excise tax on excess retirement distributions and accumulations.
In most cases, the advisor should calculate the tax consequences using various assumptions to assist the advisor and the participant in making the proper decision. There are computer programs available for this purpose. Because the calculations are based on assumptions, the actual results may differ considerably. Nevertheless, in many cases the choice will be obvious. For example, when the participant is entitled to a lump sum distribution in his or her late 50's or early 60's and does not currently need the cash, a deferral of the tax until age 70 1/2 will generally be in his or her best interest.

In any event, the participant must begin to receive payments by April 1 of the calendar following the calendar year in which he or she reaches age 70 1/2 or face a 50 percent tax on the amount of the required minimum distribution that is not distributed. In addition, the participant may want to avoid the 15 percent excise tax on excess retirement distributions and excess retirement accumulations. In some cases, however, avoiding the 15 percent excise tax may be outweighed by the benefit of deferring the tax and continuing to have the earnings accumulate income tax free.

Nontax considerations also will play a role in deciding the form of benefit and the timing of the payment of the benefits. Spousal rights may prevent the participant from electing lump sum treatment or rolling the distribution into an IRA. The financial needs of the participant may require that distributions be made sooner than would otherwise be desirable from a tax standpoint.

Whatever choice the participant makes must be coordinated with the participant's estate plan. In addition, the health of the participant, his or her spouse, and other beneficiaries may determine the form of benefit. If the participant or spouse has a terminal illness, a lifetime annuity should not be elected. If the participant is concerned about the future educational needs of young children by a prior marriage, the participant may want a guaranteed number of payments. If the participant dies before the guaranteed number of payments have been made, funds will be available for the children's needs.

D. After Death.

In administering any estate, the advisor must ascertain whether the estate or other persons are entitled to benefits from qualified retirement plans and IRAs. If the participant was in pay status, that is, if he had retired before his death and had begun to receive benefits, the existence of benefits may be determined from income tax returns filed for prior years. If the participant had not retired or was not in pay status, a more extensive search may be required to determine the existence of qualified retirement plan benefits and IRAs. In this regard, the participant before his or her death could help ease the administration of the estate by listing all qualified retirement plans and IRAs in which he or she participated at any time.

Once the advisor has determined the existence of qualified retirement plan benefits and IRAs, the advisor should review the relevant plan information, including the plan itself. The advisor should determine whether there are any valid beneficiary designations in effect and, if not, ascertain the beneficiary or beneficiaries as determined under the plan itself. Normally, if there is no valid beneficiary designation and the plan or IRA does not specify a beneficiary, the benefits would be payable to the deceased participant's estate.

The advisor then should review the will and any trust created under the will or outside the will to determine whether the deceased participant specified a different disposition of the benefits. In addition, the advisor should determine whether there are any prenuptial or postnuptial agreements, QDROs, or other documents affecting the rights of a surviving spouse.

The advisor should determine quickly whether the beneficiary or beneficiaries should consider disclaiming the benefits. In order to be valid for transfer tax purposes, a qualified disclaimer must be made within nine months of the decedent's death.

Once the identity of each beneficiary has been determined, the income tax consequences must be considered. For example, if the beneficiary is the surviving spouse, he or she may want to roll the benefits into a spousal IRA. This would defer the payment of current income tax on the benefits until the surviving spouse reaches age 70 1/2.

If the plan permits a distribution of the entire value of the benefits at one time, the beneficiary may consider electing a lump sum treatment. If the deceased participant had attained age 50 before January 1, 1986, the beneficiary will have the same options available as discussed earlier. Specifically, the beneficiary may elect ten or five-year averaging, and capital gain treatment with respect to the pre-1974 portion of the distribution.

Qualified retirement plan benefits and distributions from IRAs are items of income in respect of a decedent and are therefore subject to income tax. The beneficiary is entitled to a deduction for the estate tax attributable to the benefit.

Finally, certain accounting issues must be addressed if the deceased participant's estate, or any trust created by the deceased participant, will receive plan benefits. For example, a lump sum distribution from a qualified retirement plan or a distribution of the entire amount in an IRA may be treated as principal for trust accounting purposes. A portion of a periodic payment from a qualified retirement plan or IRA also may be treated as principal. This will affect the amount that the trust is.

6. See Parts C, D and E of Section II for a discussion of the required minimum distribution rules.
7. See Parts F and G of Section II for a discussion of the excise taxes on excess retirement accumulations and distributions.
8. See Section V.
9. See Part F of Section III for a discussion of rollovers.
10. See Part B of this Section.
11. See Part B of Section III for a discussion concerning the qualifications for lump sum treatment and Part C of Section III for a discussion of special averaging and capital gain treatment.
12. See Part E of Section III.
required to distribute to current income beneficiaries. Treatment of a distribution as income or principal also may affect the availability of the marital deduction, since general power of appointment trusts and QTIP trusts must pay out all of the income to the surviving spouse at least annually in order to qualify for the marital deduction.
FOR CORRECT PAGINATION ON THE FOLLOWING UPDATED PAGES OF STUDY 20, PLEASE REFER TO THE REVISED TABLE OF CONTENTS DATED 7/28/92.
SECTION VII
CREDITORS' RIGHTS


In furtherance of the goal of assuring that retirement plan benefits will be preserved so they will be available at retirement, ERISA § 206(d)(1) requires that all private employee pension benefit plans contain an anti-alienation provision, making pension plans classic “spendthrift trusts.” For this purpose, “pension plans” include pension, profit-sharing, and 401(k) plans. Pension plans do not include IRAs, self-employed H.R. 10 or “Keogh” plans covering only partners or sole proprietors, some Code § 403(b) tax-deferred annuity plans, or employee welfare benefit plans. The Secretary of Labor is given specific authority to enforce ERISA § 206(d)(1). There are criminal and civil penalties for the failure to include the anti-alienation provision in a pension plan. In addition, Code § 401(a)(13) requires that plans contain anti-alienation provisions as a condition of plan qualification for income tax purposes.

Accordingly, the federal labor and tax laws purport to shelter ERISA plan benefits from state law attachment, execution, or seizure for the satisfaction of any debt or obligation of the participant, except for permitted voluntary assignments of up to 10 percent of any interest in a participant in pay status, for purposes of securing certain plan loans to participants, for purposes of satisfying “qualified domestic relations orders” or “QDROs,” and for satisfying federal tax levies and judgments resulting from unpaid federal tax assessments.

In light of the clear legislative mandate of ERISA, the federal pre-emption doctrine, and the spendthrift language contained in “employee pension benefit plans,” a participant may not pledge his interest in qualified plan benefits to secure debts, and general creditors may not attach such benefits to satisfy claims against a participant, either in a non-bankruptcy context or in bankruptcy, as discussed further below.


Employee benefits under ERISA-qualified plans have become an increasingly significant asset in the estates of many individuals. Consequently, creditors have become more aggressive in their attempts to reach these assets, particularly in the bankruptcy context.

Section 541(a)(1) of the Bankruptcy Code of 1978 (the “Bankruptcy Code”) broadly defines property of the estate as “all legal or equitable interests of the debtor in property as of the commencement of the case.” Although this definition arguably includes the debtor’s benefits under qualified employee benefit plans, ERISA § 206(d)(1) requires that all qualified plans contain a provision prohibiting the assignment or alienation of plan benefits.

The Bankruptcy Code contains provisions dealing with an exclusion and an exemption for plan benefits in bankruptcy. Bankruptcy Code § 541(c)(2) excludes from the bankruptcy estate the debtor’s beneficial interest in a trust subject to transfer restrictions enforceable under “applicable non-bankruptcy law.” Prior to the holding of the United States Supreme Court in Patterson v. Shumate, federal circuit courts of appeal for the 5th, 7th, 8th, 9th, and 11th Circuits concluded that the ERISA anti-alienation provision is not “applicable non-bankruptcy law” so that ERISA plan benefits are includable in the bankruptcy estate. These courts reasoned that the Bankruptcy Code controls by virtue of ERISA § 514(d), which provides that ERISA is not to be construed to “alter, amend, modify, validate, impair, or supersede any laws of the United States.” Under this interpretation of Bankruptcy Code § 541(c)(2), plan benefits are not excluded from the bankruptcy estate unless the plan constituted a valid spendthrift trust under state law. Many qualified plans contain provisions that arguably cause them to fail as spendthrift trusts under state trust law (e.g., loan provisions, withdrawal provisions, self-settled trust or control position, etc.). Another line of cases in the 3rd, 4th, 6th and 10th Circuits held that ERISA is “applicable non-bankruptcy law” and ERISA plan benefits are excludable from the bankruptcy estate under the Bankruptcy Code § 541(c)(2).

Bankruptcy Code § 522 sets forth the exemptions available to the debtor in bankruptcy. Bankruptcy Code § 522(b)(2)(A) permits debtors to take exemptions existing under local, state, and federal law other than the Bankruptcy Code (“other federal law”). Debtors and plan trustees have argued that the anti-alienation provision of ERISA creates an exemption for plan benefits under “other federal law.” One bankruptcy court reasoned that the reference to other federal law in Bankruptcy Code § 522(b)(2)(A) includes the ERISA anti-alienation provision. However, several circuit courts held that “other federal law” does not include ERISA for purposes of Bankruptcy Code § 522(d)(2)(A), based in part on the statutory interlock and the legislative history, which did not include ERISA in a long listing of specific federal exemption statutes.

Bankruptcy Code § 522 permits each state to provide whether debtors are limited to state law exemptions in bankruptcy (“opt-out” state exemptions) or whether debtors may use the federal exemptions set forth in Bankruptcy Code § 522(d). Under Bankruptcy Code § 522(d)(10)(E), a debtor in a state permitting the federal exemptions is entitled to exempt ERISA-qualified plan benefits, but only “to the extent reasonably necessary for the support of the debtor.”

A court finding that pension plan benefits are includable in the bankruptcy estate did not always result in a turnover order. At least one federal district
court held that the bankruptcy trustee is not entitled to any distribution of the debtor's plan benefits that the debtor is not entitled to receive as a distribution at the time of the filing of the petition in bankruptcy.21

C. The Internal Revenue Service Position.

The IRS ruled in several private letter rulings that a plan will be disqualified from its tax-exempt status as to all participants if the plan trustee turns over assets of the plan to the bankruptcy trustee in violation of the anti-alienation provision of ERISA, regardless of whether the plan trustee may be held in contempt for failure to release such assets.22

For example, in PLR 9109051, the IRS took the position that compliance with bankruptcy orders to pay a bankruptcy estate debtor's vested account balance in a pension plan to the bankruptcy trustee will disqualify the plan under Code § 401(a)(13). In the ruling, plan participant D was a debtor in a bankruptcy case. D was an employee of X and also participated in the X 401(k) profit-sharing plan. D's vested account balance was $1,300. The bankruptcy trustee ordered the plan administrator to pay over to the bankruptcy trustee D's entire vested account balance. At the time of the order, the plan did not allow D to take loans of his vested balance nor was he eligible to receive a hardship distribution. In order to comply with the bankruptcy order, the plan administrator proposed to amend the plan to allow D to receive a maximum loan and a hardship distribution of the remainder of his vested account balance. In addition, the plan administrator proposed to issue checks to D but mail them to the bankruptcy trustee where D agreed to endorse them over to the bankruptcy trustee. The IRS indicated that the strong anti-garnishment/anti-alienation language found in Code § 401(a)(13) is intended to bar most voluntary and involuntary transfers of benefits. The ruling provided that since there is no provision in the Bankruptcy Code indicating that Congress intended to supercede or modify in any way the provisions of Code § 401(a)(13), such section provides the exclusive law on alienability of pension benefits in bankruptcy proceedings.

The IRS ruling concluded that any amounts actually distributed pursuant to a request for a loan or due to a hardship should be removed from the protection of Code § 401(a)(13). In addition, the proposed plan of endorsement of checks over to the bankruptcy trustee would not violate Code § 401(a)(13). The IRS ruling clearly indicated, however, that any direct transfer of plan assets to the bankruptcy trustee at a time when the participant has no right to receive a distribution of his account would disqualify the plan.

Furthermore, the IRS publicly urged plan trustees to resist the turnover orders of the bankruptcy courts, promising that the IRS will support plan sponsors who appeal the orders to the federal appellate level.23 Privately, the Internal Revenue Service indicated that it would not disqualify a plan if the trustee had, in good faith, defended against a turnover order.

D. Rationale of Cases Excluding Pension Benefits from Bankruptcy Estate.

As noted above, the 3rd, 4th, 6th, and 10th Circuit Courts of Appeals held that ERISA plan benefits were excludable from the bankruptcy estate under the Bankruptcy Code § 541(c)(2) exclusion for property subject to transfer restrictions that are enforceable under "applicable non-bankruptcy law." The U.S. Bankruptcy Court for the Western District of Texas held that ERISA creates a valid federal exemption for debtors electing the "state and other federal law" exemption scheme under Bankruptcy Code § 522(b)(2)(A).24 The 5th and 8th Circuits have further upheld state shield statutes exempting ERISA benefits under Bankruptcy Code § 522(b)(2)(A).25

1. Exclusion of Employee Pension Plan Benefits Under Bankruptcy Code § 541(c)(2) (ERISA is "applicable non-bankruptcy law").

Carving out an exclusion from the broad definition of property of the estate under Bankruptcy Code § 541(a), Bankruptcy Code § 541(c)(2) states that "a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title." Early decisions narrowly interpreted this reference to "applicable non-bankruptcy law" and limited its scope to encompass only state spendthrift trust law.26 In Anderson v. Raine (In re Moore),27 hereinafter "Moore", the 4th Circuit adopted a broad interpretation of Bankruptcy Code § 541(c)(2), excluding ERISA-qualified plan benefits from the bankruptcy estate. The 4th Circuit held that ERISA-qualified plan benefits fall within the Bankruptcy Code § 541(c)(2) exclusion by virtue of the federally mandated anti-alienation provision contained in all ERISA employee pension benefit plans.

In Moore, the 4th Circuit addressed the issue of whether the interests of several debtors participating in profit-sharing and pension plans covered by ERISA were includable property of their bankruptcy estates. The bankruptcy trustee contended that the plan did not qualify as a valid spendthrift trust under South Carolina law and that, therefore, the benefits were not exempt from the bankruptcy estate under Bankruptcy Code § 541(c)(2). Affirming the holding of the bankruptcy court, the 4th Circuit held the ERISA plan benefits to be excluded by virtue of the anti-alienation provisions of ERISA, without addressing the status of the plans under South Carolina spendthrift trust law.

The 4th Circuit adopted a broad interpretation of the reference to "applicable non-bankruptcy law" based on the clear and literal language of Bankruptcy Code § 541(c)(2). The court held that the phrase "means exactly what it says: all laws, state and federal, under which a transfer restriction is enforceable;" the court found that "[n]othing in the phrase ‘applicable non-bankruptcy law’ or in the remainder of Code § 541(c)(2) suggests that the phrase refers exclusively to state law, much less to state spendthrift trust law."28

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In addition to relying on the plain and literal language of the statute, the 4th Circuit noted that the narrower interpretation was inconsistent with other uses of the same phrase throughout the Bankruptcy Code, which contains numerous references to "applicable non-bankruptcy law" that encompass both federal and state law. For example, other references to "applicable non-bankruptcy law" in Bankruptcy Code §§ 1125(d) and 106(a) specifically include federal securities law and the Racketeer Influenced and Corrupt Organization Act ("RICO"), respectively.

Citing the U.S. Supreme Court, the 4th Circuit reiterated the rule of statutory construction that the same words used throughout different sections of a statute are presumed to have the same meaning in all subsections of the same statute. Furthermore, the 4th Circuit noted that Congress specifically limited references to state law where Congress so intended.

The 4th Circuit acknowledged that several other circuit courts had interpreted the phrase "applicable non-bankruptcy law" narrowly based on an analysis of the legislative history of Bankruptcy Code § 541(c)(2). The 4th Circuit declined to follow these decisions, first, on the basis that legislative history is irrelevant where the statute is plain and clear on its face, and secondly, based on its conclusion that the legislative history is inconclusive in any event. The 4th Circuit also noted that, whereas the other cases generally involved a self-settled trust in which the settlor was the primary beneficiary with the power to amend or terminate the trust without penalty, the debtors in Moore did not control the plan and could not make unrestricted withdrawals from it, borrow against it, or amend it.

Finding that the reference in Bankruptcy Code § 541(c)(2) to "applicable non-bankruptcy law" was not limited to state law, the 4th Circuit construed the provisions of ERISA and the Bankruptcy Code in order to give full effect to both statutes. Noting that "the overriding purpose of ERISA is to guarantee the security of employees' retirement income," the 4th Circuit concluded that the anti-alienation provision of ERISA is a fundamental requirement of ERISA.

The court noted that the anti-alienation provision of ERISA § 206(d)(1) prevents both voluntary and involuntary assignment or alienation of employee benefits. Focusing on the fact that the anti-alienation provision protects plan benefits from creditors in a non-bankruptcy context, the 4th Circuit found "no evidence that Congress intended to invite a creditor to push the debtor into involuntary bankruptcy in order to reach his ERISA funds." The 4th Circuit held that "under the plain and simple language of § 541(c)(2), if the ERISA anti-alienation provisions are enforceable against general creditors, they are enforceable against the bankruptcy trustee."

The 4th Circuit pointed out that its interpretation of Bankruptcy Code § 541(c)(2) supports the broader purpose of ERISA, that is, to ensure national uniformity and to ensure that substantive pension benefits not be subject to the vagaries of state law.

Noting that a narrow interpretation of the reference to "applicable non-bankruptcy law" would subject the security of employee benefits to the vagaries of state spendthrift trust laws, the court held that Congress did not intend that "a state that did not recognize spendthrift trusts at all could nullify the anti-alienation provision of ERISA — a result that is contrary to ERISA's general pre-emptive force granted under ERISA § 514.

In conclusion, the 4th Circuit focused on the dilemma created for plan trustees under the narrow interpretation of Bankruptcy Code § 541(c)(2), or, if the petition of the IRS that any payor of qualified employee benefit plan funds to the bankruptcy trustee would cause the plan to lose its tax-exempt status. Finding that Congress did not intend that a bankruptcy trustee could disqualify an entire plan by virtue of seeking turnover of the plan benefits of a single participant filing bankruptcy proceedings, the 4th Circuit held that "[w]e can best harmonize ERISA, the Bankruptcy Code, and the Internal Revenue Code by reading 'applicable non-bankruptcy law,' 11 U.S.C. § 541(c)(2), to include ERISA."

In Forbes v. Holiday Corp. Savings and Retirement Plan (In re Lucas) (hereinafter "Lucas"), the 6th Circuit adopted the rationale of Moore and reversed a bankruptcy court decision that a debtor's interest in an employee benefit plan was the property of the bankruptcy estate under Bankruptcy Code § 541(m)(1). In Lucas, the debtor filed a petition for bankruptcy under Chapter 7, listing funds in a retirement plan account on the schedule of exempt property. The debtor subsequently began to withdraw funds from the plan, and the trustee sought the portion of benefits received after the bankruptcy filing. The bankruptcy court ruled that the pension benefits were not excluded from the bankruptcy estate and that the trustee should recover post-petition distributions.

Following the rationale of the opinion of the 4th Circuit in Moore, the 6th Circuit ruled that ERISA is "applicable non-bankruptcy law" under Bankruptcy Code § 541(c) so that ERISA plan benefits are not includable in the bankruptcy estate. The 6th Circuit rejected the narrow interpretation of "applicable non-bankruptcy law," that it only applies to state spendthrift trust law. Under the clear and unambiguous language of Bankruptcy Code § 541(c), the ERISA anti-alienation provisions are enforceable against both general creditors and the bankruptcy trustee. The Supreme Court failed to grant certiorari in Lucas.

In Shumate v. Patterson, the 4th Circuit rejected the contention of the bankruptcy trustee that Moore did not stand for "an iron-clad proposition that ERISA creates an automatic exclusion in bankruptcy, but that such an exclusion must turn on 'state law governing spendthrift trust or public policy.'" The 4th Circuit held that Moore precludes any fact-based state law inquiry. "We think it is not giving Moore undue weight to say that it stands for the proposition that all ERISA-qualified plans, which by definition have a non-alienation
provision, constitute 'applicable non-bankruptcy law' and contain enforceable restrictions on the transfer of pension interests.' Accordingly, the interest of a participant who is a 96-percent shareholder of the employer, who could vote in or out all of the board of directors, when the board could terminate the pension plan at any time, and when the participant would personally benefit from any reversion from the plan upon termination, was held to be excluded from the bankruptcy estate under Bankruptcy Code § 541(c)(2). Footnote 4 of the 4th Circuit's opinion points out that creditors concerned with the debtor's control of a plan can void a transfer to a plan made within the prior 12 months with the intent to hinder, delay, or defraud creditors under Bankruptcy Code § 548 as a voidable transfer. "In this way, creditors can block a debtor in Shumate's position from actually taking advantage of his control position and depleting the estate." The U.S. Supreme Court granted certiorari in Shumate and affirmed the 4th Circuit's opinion, as discussed in more detail below.

The 3rd Circuit followed the 4th and 6th Circuits in Velis v. Kardanis and held that applicable non-bankruptcy law under Bankruptcy Code § 541(c)(2) encompasses other federal laws such as ERISA. The court noted that Congress differentiated between federal, and state or local laws elsewhere in the Bankruptcy Code, and where it meant to refer only to state or local laws it did so clearly and unambiguously. Other references to the phrase "applicable non-bankruptcy law" in the Bankruptcy Code clearly encompass federal laws. The 3rd Circuit reasoned that specific exemption of Bankruptcy Code § 522(d)(10)(E) of the right to receive benefits from qualified retirement plans to the extent necessary for the support of the debtor applied to distributions made from a plan, so that it was not inconsistent with a broader exclusion of ERISA plan benefits under Bankruptcy Code § 541(c)(2).

The 10th Circuit followed the rationale of Moore and cited Lucas, Shumate and Velis in holding that qualified ERISA plans are excluded from the bankruptcy estate under Bankruptcy Code § 541(c)(2) in Gladwell v. Harline (In re Harline). The Bankruptcy Court of the Western District of Texas interpreted Bankruptcy Code § 522(b)(2)(A) broadly to recognize a federal exemption for ERISA-qualified pension plan benefits in In re Komet (hereinafter "Komet").

The debtors in Komet, having elected the "state and other federal law" exemptions under Bankruptcy Code § 522(b)(2)(A), claimed as exempt their pension and profit-sharing plan benefits under a Texas state exemption statute for retirement plans. The court first determined that ERISA pre-empts the Texas state exemption statute in light of the U.S. Supreme Court holding in Mackey v. Lanier Collections Agency & Service, Inc. In Mackey, the Supreme Court held that state exemption statutes that sufficiently "relate to" ERISA are pre-empted by ERISA § 514(a), and furthermore, any state statute that specifically refers to ERISA is per se pre-empted by ERISA, regardless of whether that statute comports with the substantive requirements and intent of ERISA. This rule effectively pre-empts all state statutes that attempt to protect ERISA-covered benefit plans from creditors, thus making the availability of an exemption under ERISA as "other federal law" all the more crucial.

Having reaffirmed that ERISA pre-empts the Texas state exemption statute under Mackey, the Komet bankruptcy court held the debtor's qualified plan benefits to be exempt from creditors in bankruptcy by virtue of the anti-alienation provision of ERISA. The bankruptcy court found that the mandatory anti-alienation provision, contained in all qualified retirement plans under ERISA, effectively insulated plan benefits from creditors in bankruptcy pursuant to Bankruptcy Code § 522(b)(2)(A), which recognizes existing exemptions under "other federal law." Relying on the prevailing view of most courts, that the anti-alienation language mandated by ERISA effectively prevents creditors from reaching plan benefits under non-bankruptcy law, the court reasoned that the "body of federal common law" that has developed around ERISA demonstrates that the ERISA anti-alienation requirement creates a valid federal exemption for qualified plan benefits. To buttress its finding that ERISA creates a valid "federal law" exemption under Bankruptcy Code § 522(b)(2)(A), the Komet bankruptcy court relied heavily on Congressional intent regarding its enactment of ERISA. The bankruptcy court noted that the Supreme Court in Mackey observed that Congress adopted ERISA § 206(d)(1) precisely because otherwise "ERISA plan benefits could be attached and/or garnished." The bankruptcy court emphasized that the Supreme Court in Mackey did not "shrink from characterizing ERISA § 206(d) as, functionally, a federal exemption.

The Komet bankruptcy court concluded that it is the federally mandated anti-alienation provision in ERISA-qualified plans — not state spendthrift trust laws — that "ultimately" exempts plan benefits from the bankruptcy estate. The bankruptcy court reasoned that Congress could not have achieved national uniformity with respect to the treatment of private employee benefit plans if "the efficacy of anti-alienation turned on the vagaries of state spendthrift trust law."

E. State Shield Statutes.

Since the assault on qualified plan benefits in bankruptcy began, most of the states adopted "shield statutes" designed to protect qualified plan benefits as well as IRAs, simplified employee pensions (SEPs), and similar plans. In most cases, the state legislatures recognized that ERISA's anti-alienation provisions protected employee pension plans outside of bankruptcy, and anticipated that the shield statutes would protect those plans within the context of a bankruptcy proceeding, while also protecting other non-ERISA covered plans both within and without
bankruptcy. Bankruptcy Code § 522(b)(1) permits states to “opt out” of the federal bankruptcy exemption scheme and requires debtors in the state to use only the state exemptions. The most common state shield statutes exempt the plans expressly described from execution by creditors to satisfy claims against participants. Other state shield statutes provide that qualified plans are spentthrift trusts under state law. Based upon the ERISA pre-emption analysis of Moore, Lucas, Shumate, and Komet, as well as the Supreme Court opinions in Mackey, supra, and Ingersoll-Rand, state shield statutes would be pre-empted by ERISA with respect to employee pension plans. On the other hand, the courts have generally held that state shield statutes that purport to shelter IRAs are effective and are not pre-empted.

A recent 5th Circuit decision, Heitkamp v. Dyke, (hereinafter “Heitkamp”) followed the earlier 5th Circuit decision In re Goff on ERISA pre-emption and yet gives the debtor the benefit of the Texas state shield statute exempting qualified plan benefits. Heitkamp held that the ERISA anti-alienation provision is not “applicable non-bankruptcy law” under § 541(c)(2) of the Bankruptcy Code (which would operate to exclude qualified plan assets from the bankruptcy estate), and further that the ERISA anti-alienation provision is not “other federal law” under § 522(b)(2)(A) of the Bankruptcy Code (which would operate to exempt qualified plan assets from the bankruptcy estate). However, the Court found that since ERISA does not pre-empt the Texas property code exemption for qualified retirement plan assets, the debtor is entitled to claim the state exemption and thereby exclude the assets from the claims of creditors in bankruptcy. Similarly, the 8th Circuit held that ERISA did not pre-empt a Missouri state law exemption for benefits reasonably necessary for the debtor’s support in Checkett v. Vickers.

F. Supreme Court Excludes Pension Plan Benefits From Bankruptcy Estate — Patterson v. Shumate.

Affirming the 4th Circuit, the U.S. Supreme Court held unanimously in Patterson v. Shumate that the plain language of the Bankruptcy Code and ERISA establishes that an anti-alienation provision in a qualified pension plan constitutes a restriction on transfer enforceable under “applicable non-bankruptcy law” for purposes of Bankruptcy Code § 541(c)(2).

The Court held that Bankruptcy Code § 541(c)(2) encompasses any relevant non-bankruptcy law, including federal law such as ERISA. The Bankruptcy Code contains no limitation on the meaning of the phrase “applicable non-bankruptcy law.” The source of the law and its text nowhere suggest that that phrase refers exclusively to state law. Other sections in the Bankruptcy Code reveal that Congress knew how to restrict the scope of applicable law to “state law.”

The anti-alienation provision contained in Shumate’s ERISA-qualified plan satisfies the literal terms of Bankruptcy Code § 541(c)(2). The anti-alienation sections of ERISA and the Internal Revenue Code requiring a plan to provide that benefits may not be assigned or alienated clearly impose a “restriction on the transfer” of a debtor’s “beneficial interest” within Bankruptcy Code § 541(c)(2)’s meaning, and the terms of Shumate’s plan comply with those requirements. Moreover, the transfer restrictions are “enforceable,” as required by Bankruptcy Code § 541(c)(2), since ERISA gives participants the right to sue to enjoin acts that violate that statute or the plan’s terms.

Given the clarity of the statutory text, the Court held that the petitioner trustee in bankruptcy bears an “exceptionally heavy” burden of persuasion that Congress intended to limit the Bankruptcy Code § 541(c)(2) exclusion to restrictions on transfer that are enforceable only under state spentthrift trust law. The trustee did not satisfy that burden, since his several challenges to the 4th Circuit’s interpretation of Bankruptcy Code § 541(c)(2) — that it is refuted by contemporaneous legislative materials, that it renders superfluous the Bankruptcy Code § 522(d)(10)(E) debtor’s exemption for pension payments, and that it frustrates the Bankruptcy Code’s policy of ensuring a broad inclusion of assets in the bankruptcy estate — were unpersuasive.

Notwithstanding the Shumate decision, creditors will continue to be able to reach a debtor’s assets in plans not subject to ERISA’s anti-alienation provision (such as government and church plans, Keogh (H.R. 10) plans covering only partners or sole proprietors, IRAs, and welfare benefit plans) unless such plans or assets are covered by state law exemptions. For most retirement plans, however, Shumate provides much needed certainty with respect to creditors’ rights to plan benefits.
NOTES

1. 29 U.S.C. § 1056(d)(1) (ERISA § 206(d)(1)).
2. 29 C.F.R. § 2510.3-2(d).
3. 29 C.F.R. § 2510.3-3(b).
4. 29 C.F.R. § 2510.3-2(f).
8. I.R.C. § 401(a)(13) provides that “(a) trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that benefits provided under the plan may not be assigned or alienated.”
12. Treas. Reg. § 1.401(a)-12(b)(2) provides that the ERISA anti-alienation provision shall not preclude the enforcement of (i) a federal tax levy pursuant to I.R.C. § 6331 or (ii) the collection by the United States on a judgment resulting from an unpaid tax assessment.
13. 29 U.S.C. § 1002 (ERISA § 3(2)).
15. See, e.g. Fitzadell v. Findall, 942 F.2d 419 (9th Cir. 1991); Reed v. Drummond, 1991 W.L. 258852 (9th Cir. 1991); In re LeFever, 906 F.2d 330 (7th Cir. 1990); In re Daniel, 771 F.2d 1352 (9th Cir. 1985); In re Lichahra, 750 F.2d 1488 (11th Cir. 1985); In re Graham, 726 F.2d 1268 (8th Cir. 1984); In re Goff, 706 F.2d 574 (5th Cir. 1983).
19. See Heitkemp v. Dyke, 493 F.2d 1435, (5th Cir., 1971) following Goff but concluding that the Texas state exemption scheme protected ERISA plan assets in addition to a homestead and Checkett v. Vickers No. 91-1067 (8th Cir. 1992) holding that ERISA did not pre-empt a Missouri state exemption for benefits reasonably necessary for the debtor’s support.
22. See PLR 8426124, 8829009, 8910065, 8951067, 9011037, and 9109051.
26. See In re Goff, 706 F.2d 574 (5th Cir. 1983); In re Kwaak, 42 B.R. 599 (Bankr. D.Me. 1984); McLean v. Central States Southeast & Southwest Areas Pension Fund, 762 F.2d 1204 (4th Cir. 1985); In re Dewees, supra note 17.
27. 907 F.2d 1476 (4th Cir. 1990).
28. Id. at 1477.
29. Id.
31. Id. 907 F.2d at 1478 (citing Morrison-Knudsen Const. Co. vs. Director, OWCP, 461 U.S. 624, 633 (1983)).
32. Id.
33. See Daniel, Lichahra, Graham, and Goff, supra note 15.
34. 907 F.2d at 1479.
35. Id. at 1480. See infra text accompanying notes 42-45 (extension of the ERISA anti-alienation protection to a participant debtor who controlled the corporate employer).
36. In re Moore, 907 F.2d at 1480.
37. Id.
38. Id. (citing In re Threewitt, 24 B.R. 927, 929 (Bankr. D. Kan. 1982)).
39. Id. (citing PPG Industries Pension Plan A v. Crews, 902 F.2d 1148 (4th Cir. 1990)).
40. Id.
41. Id. at 1481.
42. In re Lucas, supra note 17.
44. 943 F.2d 362 (4th Cir., 1991).
45. Id. at 364.
46. Id. at 364, 365.
47. Id. at 365, footnote 4.
49. 949 F.2d 78 (3d Cir. 1991).
50. 950 F.2d 669 (10th Cir. 1991).
51. In re Komet, supra note 18.
52. Supra note 5.
53. In re Komet, 104 B.R. at 806.
54. Id. at 807 (quoting Mackey, supra note 5).
55. Id.
56. Id.
57. Only New Hampshire, North Carolina and South Dakota have failed to adopt any form of shield statute. Delaware, Massachusetts, Nevada, New Jersey and Rhode Island have adopted statutes that protect only public plans.
63. Id. at 1446.
64. Id. at 1450.
65. Supra note 19.
66. Supra note 14.
SECTION VIII
PARTICIPANT LOANS FROM QUALIFIED RETIREMENT PLANS

A. In General.

In the past a highly compensated employee was able to take out large loans from qualified retirement plans in which he or she was a participant, repay them at the end of the repayment period and immediately take out another loan, resulting in substantial interest deductions for the employee, but frequently leaving plans with few assets other than the notes. Congress addressed this issue in Code §72(p), discussed below. The Treasury Department and Department of Labor, perceiving further abuses in the plan loan area, promulgated regulations severely restricting the scope of the plan loans. Final regulations were issued by the Department of Labor (DOL) on July 20, 1989 and are effective for all participant loans granted or renewed after October 18, 1989. 2

B. Limitations on Plan Loans.

1. Prohibited Transaction Rules.

Normally, a loan from a qualified plan to a disqualified person is a prohibited transaction, subjecting the parties to excise taxes. Code §4975(d)(1) provides that loans by a plan to participants or beneficiaries of a qualified plan will not be prohibited transactions if the loans:

1) are available to all participants, and beneficiaries on a reasonably equivalent basis; 2) are not made available to highly compensated employees in an amount greater than the amount made available to other employees; 3) bear a reasonable rate of interest; and 4) are adequately secured. The DOL regulations set forth the criteria for determining when a loan is made on a reasonably equivalent basis, providing that in addition to being available to all plan participants and beneficiaries regardless of race, color, religion, sex, age or national origin, consideration must be given only to those factors considered in a normal commercial setting by an entity in the business of making similar types of loans — factors such as the applicant’s creditworthiness and financial need.

The recent DOL regulations permit loans from a qualified plan to a participant or a fiduciary. However, those regulations reaffirm that plan fiduciaries are prohibited from receiving consideration for their personal account from any party dealing with a plan in connection with a transaction involving plan assets.

The DOL regulations have not relaxed the prohibition on loans made to owner-employees. The following persons and their family members are considered owner-employees and ineligible to receive exempt loans from qualified retirement plans: 1) an employee who owns the entire interest in an unincorporated trade or business; 2) in the case of a partnership, a partner owning more than 10 percent of either the capital interest or profits interest in the partnership; and 3) an owner of more than 5 percent of the outstanding stock of an S corporation.

The DOL regulations require that plan loans must be available to all participants, including participants who are no longer employees, although loans to participants and beneficiaries other than active employees may be offered on different terms and conditions if such terms and conditions are based solely on factors that are legally considered by commercial entities in the business of making similar loans. The DOL has recently retreated from this position in Advisory Opinion 89-30A, saying that the condition that loans be made available to all such participants and beneficiaries on a reasonably equivalent basis does not require the inclusion in participant loan programs of participants and beneficiaries who are not parties in interest to the plan. It would appear that permitting loans to former employees who are parties in interest but not to other former employees, while permissible under the DOL regulations, may violate the tax anti-discrimination rules.

2. Limits on Size of Loan.

Code §72(p) provides that a participant loan will be treated as a distribution (and thus taxable to the borrower-participant unless one of the exceptions of §72(t) applies, generally at his or her marginal rate plus 10 percent) unless, among other criteria, the loan does not exceed the lesser of 1) $50,000; or 2) the greater of one-half of the present value of the non-forfeitable accrued benefit of the participant under the plan or $10,000. For example, if the present value of a participant’s vested accrued benefit is $16,000, he or she could take out a loan for $10,000 but no more, even if he or she provided collateral other than his plan benefits. The $50,000 amount is reduced by the highest balance of outstanding loans from the plan during the one-year period ending on the day before the new loan is to be made. For this purpose, all plans of the employer and any related employers as defined in Code §414(b), (c) and (m) are treated as a single plan.

Since, as discussed below, a participant can pledge no more than 50 percent of his vested accrued benefit as collateral for a plan loan, loans of $10,000 that are not secured by the vested accrued benefit (i.e., that exceed 50 percent of the vested accrued benefit) are generally not available under most plans because most plans will not accept collateral other than a pledge of the vested accrued benefit. Plan administrators simply do not want to assume the role of a bank and be required to foreclose on a participant’s property. Furthermore, if a plan accepts outside collateral and the participant subsequently defaults, the plan administrator may not sell or dispose of the collateral to a party in interest, effectively precluding a foreclosure sale to the participant.

The final DOL regulations allow loan programs that provide for either a maximum dollar limita-
tion or a maximum percentage of a participant's vested account balance. They also provide a safe harbor for loan programs with a minimum loan threshold of $1,000.

3. Interest Rate Rules.

Section 4975(c) of the Code provides that loan programs with a minimum loan threshold of $1,000 shall bear a reasonable rate of interest. However, neither the Code nor subsequent Internal Revenue Service regulations define what constitutes a reasonable rate of interest. Treasury regulations applicable to ESOPs provide that the interest rate of a loan must not be in excess of a reasonable rate of interest. All relevant factors will be considered in determining a reasonable rate of interest, including the amount and duration of the loan, the security and guarantee (if any) involved, the credit standing of the ESOP and the guarantor (if any), and the interest rate prevailing for comparable loans. When these factors are considered, a variable interest rate may be reasonable.

The DOL final regulations provide guidance as to what is a reasonable rate of interest, but the guidance creates more questions than it answers. The regulations provide that a reasonable rate of interest is one which provides the plan with a return commensurate with the prevailing interest rate charged on similar commercial loans by persons in the business of lending money. The regulations offer three examples of plan loans that do not meet this criterion. In the first example, a plan made a participant loan at 8 percent when the prevailing interest rate ranged from 10 percent to 12 percent. In the second example, a plan provided that after two years the loan may be renewed, but did not adjust the interest rate to reflect current market rates at the end of the first two-year period. In the third example, a plan provided that interest rates may be no higher than the state usury law allowed, but the financial institutions in the community not subject to the usury law were charging interest higher than the usury limit. In this third example, the DOL noted that the loan did not bear a reasonable rate of interest charged by persons in the business of lending money under similar circumstances. It further noted that participant loans artificially limited to the then prevailing maximum usury ceiling call into question the status of such loans and §§ 403(c) and 404(a) of ERISA if higher yielding comparable investment opportunities are available to the plan. Apparently, the DOL would absolutely prohibit plan loans in states in which the maximum rate of interest the plan could lawfully charge was less than the market rate.

Despite these examples, questions remain concerning what is a "reasonable rate of interest." However, as the preamble to the final regulations points out, the DOL's position that a reasonable rate of interest is the prevailing market rate at the time of the loan was not followed in Brock v. Walton. In Brock, the Court of Appeals held that a rate 2% lower than the prevailing rate in the community was neither imprudent under § 401(b)(1) of ERISA nor unreasonable for purposes of § 408(b)(1). However, despite Brock, the DOL adheres to the objective prevailing rate standard under the theory that the law of trusts establishes an objective standard of fiduciary conduct that has been incorporated by Congress in ERISA and applied in numerous cases. There is some question whether this standard is appropriate in § 401(k) plans or plans where the participant can direct investment of his or her plan proceeds, since the choice of investment should be the participant's responsibility and not that of the plan's trustee. However, the DOL has refused to alter its position.

4. Term of Loan.

To avoid being deemed a plan distribution, a loan must be repaid within five years unless the loan is used to acquire any dwelling unit which within a reasonable time is to be used as the principal residence of the participant. In the case of plan loans made prior to 1987, the term "home loan" applied to any loan used to acquire, construct, reconstruct, or substantially rehabilitate a dwelling that was used, or was to be used, within a reasonable time as the principal residence of the participant or a member of his family. However, for loans after 1986 a loan is a "home loan" only if the proceeds are used for acquisition (not construction, reconstruction or rehabilitation) of a principal residence of the participant only (not members of the family). The determination of whether a dwelling is to be used as a principal residence is to be determined at the time the loan is made. Neither the statute nor subsequent regulations define what is deemed to be a reasonable time for repayment of a home loan. In addition, the loan must be amortized substantially equally over the term of the loan with payments not less frequently than quarterly.


A participant can pledge no more than 50 percent of his or her vested accrued benefit as collateral in a plan loan. If the participant borrows more than 50 percent of his or her vested accrued benefit, the excess over that amount will be treated as taxable income and frequently will be subject to the additional 10 percent tax on premature distributions, unless the total amount of the loan is $10,000 or less. Additional collateral outside the plan to supplement the 50 percent of the vested accrued benefit may be required. Failure adequately to secure a plan loan puts the plan at risk for disqualification, civil and criminal liability, and excise taxes under the prohibited transactions provisions of ERISA and the Code.


As a result of the Tax Reform Act of 1986, plan loans from plans subject to the joint and survivor annuity rules of Code § 401(a)(11) must provide that no portion of the accrued benefit of a participant may be used as security for any loan unless the participant's spouse (if any) consents to the loan. This requirement does not apply to participants whose total account balance subject to the security is less than $3,500. In order to have a valid consent the spouse of the participant must consent in writing to such use during the 90-day period ending on the date on which

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the loan is to be secured, and the spouse’s consent must acknowledge the effect of such election and be witnessed by a plan representative or a notary public. If it is established to the satisfaction of a plan representative that the consent of the spouse may not be obtained because there is no spouse, because the spouse cannot be located, or because of any additional reasons that may be prescribed in regulations by the Secretary of the Treasury, spousal consent may be waived. If use of a participant’s accrued benefit as security for a loan meets the above requirements, nothing in the survivor benefit requirements will prevent any distribution required by reason of a failure to comply with the terms of a loan. However, without the appropriate spousal consent prior to the making of a loan secured by the participant’s accrued benefit, the plan may not be able to execute on the security by reducing the participant’s accrued benefit without violating § 417(e) of the Code.

C. Default.

Three basic principles must be satisfied in regard to the issue of plan loan defaults: 1) all loans must be so secured that there will be no loss to the plan in the event of default; 2) a participant can pledge no more than 50 percent of the present value of his vested accrued benefit as security for the loan; and 3) all security must be such that it can be foreclosed upon, sold or otherwise disposed of upon default.

1. Effect on Plan.

Ideally, the participant borrowing from the plan will be borrowing an amount that is no more than 50 percent of the present value of his or her accrued benefit and repayment is by way of payroll deductions, reducing the likelihood of default. If the participant later retires, dies, or otherwise leaves the employ of the employer before paying off the loan, the plan can immediately foreclose on the loan, and his or her benefits will simply be reduced by the amount of the foreclosed loan.

However, repayment by way of payroll deduction is the exception rather than the rule. Problems arise when a participant defaults in his or her payments. A plan cannot foreclose immediately against the accrued benefit or account balance of the participant if the participant is still in the employ of the sponsoring employer because of the anti-assignment rule of § 401(a)(13). This may result in a loss to the plan because of the time value of money on the defaulted amount between the time of default and the time of foreclosure. However, the preamble to the DOL final regulations provides that although a plan cannot immediately foreclose against an employee not otherwise entitled to a distribution, the plan loan can still meet the “adequate security” requirement as long as the plan is protected against loss of principal or interest on the default. This can be accomplished in defined contribution plans if loan repayments are allocated to a segregated account on behalf of the participant, for then there is no danger that the assets of the plan will be reduced as a result of the default.

If, on the other hand, loan repayments are not or cannot be allocated to a separate account for the borrowing participants, such as in defined benefit plans, but are instead allocated among all participants, the plan may not be protected if the participant defaults, since the loss from the defaulted loan would be carried immediately by the plan, resulting in a loss to all plan accounts. This result can be avoided if the borrowing participant pledges additional amounts in excess of the principal and interest payment on the loan, making sure that throughout the life of the loan the present value of the security would equal or exceed the principal and interest payments due on the loan.

2. Effect on Participant.

A loan (unless the proceeds were used to acquire a principal residence within a reasonable time) not repaid within five years will be treated as a distribution from the plan. As a result, the participant may be subject to a 10-percent additional tax (unless an exception to Code 72 applies). Furthermore, even though the participant declares the distribution resulting from an unpaid loan as income, the plan must still seek to collect the unpaid amount of the promissory note owed to the plan by the participant. Again, foreclosure proceedings cannot take place with respect to the participant’s vested benefit until the happening of a distributable event.

3. Interest After Default.

There is a question whether the note accrues interest after default. Arguably, there is no need to accrue interest on a defaulted note because the participant will have reported income upon the deemed distribution in kind of the defaulted note.

A contrary argument is that since at default there is a taxable event and a reportable Form 1099-R must be filed, the note continues to accrue interest and the participant should receive a Form 1099-R each year on the interest accrued. Certainly, if the note were collected out of security other than the participant’s vested interest, post-default interest would be charged. This issue was not resolved by the final regulations.

D. Penalties.

If the loan does not meet the § 72(p) requirements, it will be deemed a plan distribution, possibly triggering § 72(t) of the Code. Section 72(t) provides for a 10-percent additional tax on early distributions from retirement plans. For purposes of § 72(t) any default in the repayment of a plan loan is deemed a distribution from the plan subject to the 10-percent additional tax unless one of the exceptions applies. Furthermore, even if a plan does not state the term of the loan, or provides for a term longer than five years and the participant repays the loan in full within five years, the loan is still deemed a plan distribution subject to the 10-percent additional tax.


The final DOL regulations set forth specific provisions that must be included in the plan document itself.
or in a written plan document forming part of the plan for loans granted or renewed on or after the 1st day of the first plan year beginning on or after January 1, 1989. Provisions that must be included are 1) the identity of the person or positions authorized to administer the participant loan program; 2) a procedure for applying for loans; 3) the basis on which loans will be approved or denied; 4) limitations (if any) on the types and amounts of loans offered; 5) the procedure under the program for determining a reasonable rate of interest; 6) the types of collateral that may secure a participant loan; and 7) the events constituting default and the steps that will be taken to preserve plan assets in case of such default.36

In addition, since the specific provisions describing the loan program, whether contained in the plan or in a written document forming part of the plan, do affect the rights and obligations of the participants and beneficiaries, they must be disclosed in the plan's summary plan description.37

F. Deductibility of Interest.

Interest on loans from qualified plans is subject to the normal limitations on deductibility.34 In addition, however, there is a special limitation applicable to key employees. If a key employee makes a loan from a qualified plan that is not treated as a distribution, then interest on that loan is not deductible at all, even if it meets the requirements under § 163.39 In addition, if deferrals under a 401(k) plan or 403(b) annuity contract secure a plan loan, interest on that loan is also non-deductible.40

It is not clear whether interest on a loan that is treated as a distribution is made non-deductible by § 72(p)(3). The Blue Book states that no interest deduction is allowed to key employees on any plan loan, but the statute goes into detail to limit non-deductibility to non-distribution loans.41 The issue may not matter, since excess loans create other problems, as discussed above.

G. Conclusion.

Plan loans are not as advantageous or as easily obtained as in the past. However, they can still serve as a vehicle for obtaining funds for plan participants as long as careful attention is paid both to the Internal Revenue Code and the recently promulgated DOL regulations.
NOTES

1. DOL Reg. § 2550.408b-1.

2. There is an exception to the effective date for Paragraph (d)(2) of the Regulations, which deals with specific plan loan provisions, that must be included in plan documents. The effective date for Paragraph (d)(2) is on or after the last day of the first plan year beginning on or after January 1, 1989. For calendar plans, the effective date would be January 1, 1990.

3. Code § 4975(e) defines a disqualified person as:
   (A) a fiduciary;
   (B) a person providing services to the plan;
   (C) an employer, any of whose employees are covered by the plan;
   (D) an employee organization, any of whose members are covered by such plan;
   (E) an owner, direct or indirect, of 50 percent or more of —
      (i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation,
      (ii) the capital interest or the profits interest of a partnership, or
      (iii) the beneficial interest of a trust or which is an employer or an employee organization described in subparagraph (C) or (D);
   (F) a member of the family (as defined in paragraph (6)) of any individual described in subparagraph (A), (B), (C), or (E);
   (G) a corporation, partnership, or trust or estate of which (or in which) 50 percent of more of —
      (i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,
      (ii) the capital interest or profits interest of such partnership, or
      (iii) the beneficial interest of such trust or estate, is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);
   (H) an officer, director (or an individual having powers or responsibilities similar to those officers or directors) or a 10-percent or more shareholder, directly or indirectly, of a person described in subparagraph (B), (C), (D), (E), or (G).
   (I) a 10-percent or more (in capital or profits) partner or joint venturer of any person described in subparagraph (C), (D), (E), or (G).

4. Section 4975(c) of the Internal Revenue Code of 1986 defines a prohibited transaction as any direct or indirect 1) sale or exchange, or leasing, of any property between a plan and a disqualified person; 2) lending of money or other extension of credit between a plan and a disqualified person; 3) furnishing of goods, services, or facilities between a plan and a disqualified person; 4) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan; 5) act by a disqualified person who is a fiduciary whereby he or she deals with the income or assets of a plan in his or her own interest or for his or her own personal account; or 6) receipt of any consideration for his or her own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

5. Code § 4975(a) provides an excise tax on each prohibited transaction amount to 5 percent of the amount involved with respect to the prohibited transaction for each year (or part thereof). The tax must be paid by any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such). In addition, § 4975(b) of the Code provides an additional tax equal to 100 percent of the amount involved if the violation triggering the 5-percent excise tax is not corrected within the taxable period, also to be paid by the disqualified person.

6. DOL Reg. § 2550.408b-1(b).

7. Code § 4975.

8. Code §§ 401(c)(3), 1379, 4975(d)(flush language); ERISA § 408(d).


10. See Section B 5, infra for restrictions on the type and amount of collateral allowed as security for plan loans.


12. See Section B 5 infra.

13. Code § 4975(c).


15. DOL Reg. § 2550.408b-1(e).

16. 794 F.2d 586 (11th Cir. 1986).


20. DOL Reg. § 2550.408b-1(f).
22. DOL Reg. § 2550.408b-1(f).
23. ERISA §§ 406, 408; Code § 4975; see also ERISA § 3003.
24. In general, profit-sharing plans and 401(k) plans will not be subject to the Code § 401(a)(11) requirements.
25. Section 417(a)(4) of the Code.
26. Treas. Reg. § 1.401(a)-20, Q&A 24(a)-(b).
27. Section 417(a)(2) and (4) of the Code.
29. DOL Reg. § 2550.408b-1(f).
30. Section 401(a)(13) of the Code reads as follows:

(13) ASSIGNMENT AND ALIENATION —
(A) IN GENERAL. — A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that benefits provided under the plan may not be assigned or alienated. For purposes of the preceding sentence, there shall not be taken into account any voluntary and revocable assignment of not to exceed 10 percent of any benefit payment made by any participant who is receiving benefits under the plan unless the assignment or alienation is made for purposes of defraying plan administration costs. For purposes of this paragraph a loan made to a participant or beneficiary shall not be treated as an assignment or alienation if such loan is secured by the participant’s or beneficiary’s non-forfeitable benefit and is exempt from the tax imposed by Section 4975 (relating to tax on prohibited transaction) by reason of Section 4975(d)(1). This paragraph shall apply to assignments which were irrevocable on September 2, 1974.

(B) SPECIAL RULES FOR DOMESTIC RELATIONS ORDERS. — Subparagraph (A) shall apply to the creation, assignment, or recognition of a right to any benefit payable with respect to a participant pursuant to a domestic relations order, except that subparagraph (A) shall not apply if the order is determined to be a qualified domestic relations order.

33. Section 72(p)(1)(A) reads:

(A) Loans. — If during any taxable year a participant or beneficiary receives (directly or indirectly) any amounts as a loan from a qualified employee plan, such amount shall be treated as having been received by such individual as a distribution under such plan.
34. There are exceptions to the 10-percent additional tax under Code § 72(t)(2), notably if the reason for default was due to the death of the employee. In that case, a distribution made to a beneficiary or to a deceased employee’s estate is not subject to the 10-percent additional tax.
36. DOL Reg. § 2550.408b-1(d).
37. DOL Reg. § 2550-405b-1(d).
38. The deductibility of interest is allowable, limited or barred, depending on the purpose of the loan. A full discussion of the deductibility of interest is beyond the scope of this section of the Study. However, following is an overview of some limits and bars on the deductibility of interest that would most likely arise in connection with employees repaying plan loans. Interest for which a deduction is barred includes personal interest Code §§ 163(h). The deduction for personal interest is phased out over a five-year period starting in 1987. Code § 163(h). Personal interest is any interest otherwise deductible by an individual, other than (a) interest properly allocable to a trade or business (other than the trade or business of being an employee), (b) investment interest, (c) interest taken into account in computing passive activity income or loss under § 469, (d) qualified residence interest, and (e) certain interest on unpaid estate taxes.

39. Code Sec. 72(p)(3)(A), (B)(i)
SECTION IX
COMMUNITY PROPERTY

A. Introduction.
In a community property state the non-participant spouse is generally deemed under state law to own a share of the participant spouse's interest in a qualified retirement plan or IRA. This section will analyze the rights of the respective spouses (and their estates) while the community is intact and after it is dissolved. Particularly vexing questions arise when the community is dissolved by the death of the non-participant spouse. Neither under the Code nor under state law are the rights of the non-participant spouse (and her estate) clearly defined at this time. Special steps may have to be taken to assure the best tax results.

This section is relevant not only for those married persons who now live in a community property state but also for any couples who in the past accrued benefits under a qualified retirement plan or IRA while living in a community property state.

The rules for qualified retirement plans are significantly different from the rules for IRAs; therefore most of the following sub-sections discuss qualified retirement plans and IRAs separately. To avoid confusion it will be assumed that the husband is the participant spouse and IRA account holder.

B. State Law.
1. Qualified Retirement Plans.
Although the community property states are not uniform as to what they characterize as community or separate, nevertheless all community property states apparently recognize that interests in qualified retirement plans can be acquired as community property. When the community share of the benefit is distributed from the plan to the participant, it is received by him as community property.

The statutory and case law of the community property states is not well-developed or uniform concerning the rights of the non-participant spouse upon divorce, or the rights of the successors of the non-participant spouse who dies before the benefit has been distributed from the plan. Nevertheless, the trend among all the community property states is to extend community property principles to both situations, so that the divorced non-participant spouse and the successors to a deceased non-participant spouse continue to have a half interest in the plan assets attributable to the community. Of course, if the couple was not married and living in a community property state during the entire time that the benefit was earned, only part of the benefit may be characterized as community property.

2. IRAs.
Although there is considerably less authority on IRAs than qualified retirement plans, one would expect interests in IRAs to be subject to community property laws at least to the same extent as interests in qualified retirement plans.

The Code, however, adds a wrinkle for IRAs that does not apply to qualified retirement plans. Code § 408(g) states that "this section [setting out the requirements for IRAs] shall be applied without regard to any community property laws." Does this mean that IRAs cannot be held as community property? It seems most unlikely that Congress intended community property rights to be recognized in qualified retirement plans but not in IRAs. Probably Code § 408(g) was designed only to make it clear that 100 percent of what a participant earns must be taken into account for purposes of determining what he or she can contribute to an IRA, so that the fact that under state law one-half of the earnings are considered to belong to the spouse is ignored. The IRS itself has taken this position. 2 Louisiana courts have taken contradictory positions on this question, 3 but a recent California decision assumed without discussion that IRAs are subject to community property principles. 4

3. Form of Disposition at Death
Under state law the participant has the contractual right to dispose of at death 100 percent of the community interest in the qualified retirement plan or IRA by designation of a beneficiary or a form provided by the Plan Administrator or IRA sponsor, subject possibly to a claim by the non-participant spouse for his or her community share. 5 The participant's will has no bearing unless, in the absence of any other beneficiary, the benefit falls into the participant's probate estate. Federal law, of course, substantially limits the participant's freedom of disposition as to interests in qualified retirement plans. 6

The non-participant spouse, on the other hand, apparently can at death dispose of her community interest in the qualified retirement plan or IRA only by will (or the laws of intestacy). 7 Federal law, again, may interfere with the enforceability of the will with respect to qualified retirement plans. 8

4. Restrictions on Freedom of Disposition
The State of Louisiana now requires that the participant spouse inherit a usufruct of certain interests in pension plans when the non-participant spouse dies first. 9 The intent apparently is to prevent a testamentary disposition from inadvertently taking away from the participant spouse a portion of the retirement benefit he earned.

C. Asserting the Non-Participant Spouse's Community Interest Against the Plan.
1. Qualified Retirement Plans.
Under the Code and ERISA the participant spouse is generally the only person during his life who has a right to receive benefits accrued in his name. 10 Under Code § 401(a)(13) the participant cannot assign his or her rights nor can a creditor seize them. And of course the provisions of ERISA "supersede any and all
state laws insofar as they . . . relate to any participant benefit plan . . ."11 Thus it appears that in order for the non-participant spouse’s interest to be recognized against the plan, such recognition must be permitted by ERISA and the Code, or must be allowed under a state law that is not pre-empted by ERISA.

Prior to 1984, neither ERISA nor the Code expressly addressed community property rights in qualified retirement plans. During those years, in cases involving divorced spouses, several courts held that community property rights were not pre-empted; thus a court order on behalf of the divorced spouse could be enforced against the qualified retirement plan.12

Moreover, several IRS rulings specifically authorized payments to divorced spouses as not being in violation of the Code, provided the benefit was in pay status,13 The claim was allowed because it was based on ownership and not a creditor’s claim.

In 1984, Congress adopted the Retirement Equity Act (“REA”), which amended both ERISA and the Code, to describe circumstances in which a non-participant spouse can assert her community property rights against the qualified retirement plan. The spouse must obtain a qualified domestic relations order (“QDRO”). As defined in Code § 414(p), a “domestic relations order means any judgment, decree or order (including approval of a property settlement agreement) which . . . is made pursuant to a State domestic relations law (including a community property law).14 The requirements for a QDRO are further described in Section V.B.

Having now addressed community property rights, Congress may have pre-empted the field. If a court order does not meet the technical requirements for a QDRO, the order may be ineffective against the qualified retirement plan.

a. The Consequences of QDROs.

Payments made to an alternate payee who is the spouse or former spouse are taxed to the alternate payee.15 Payments to other alternate payees are apparently taxed to the participant, probably because Congress assumed that such payments would always be in satisfaction of the participant’s support obligation.16

There are numerous special tax benefits enjoyed by the non-participant spouse who receives benefits pursuant to a QDRO:

- Lump sum payments can be rolled over to the spouse’s own IRA.17
- If the participant could elect income averaging as to his benefit, if paid to him in a lump sum, the spouse or former spouse can elect income averaging as to her share if received in a lump sum.18
- Payments made to a spouse as an alternate payee pursuant to a QDRO are not included in the participant’s excess distributions that are subject to the 15-percent excise tax (although they will be included in determining whether the spouse has excess distributions).19
- Likewise, the amount exempt from the 15-percent estate tax on excess accumulations can be doubled if a QDRO is obtained.20 This is better than the deferral that is available if the surviving spouse is the recipient,21 because the deferral still allows only one exemption to be used.

- Payments made pursuant to a QDRO are not subject to the 10-percent tax on premature distributions.22

b. QDROs in Connection with Divorce.

Through REA, Congress clearly intended to allow community property rights to be recognized against a qualified retirement plan in a divorce context.

The form of benefit required by the QDRO must be permitted under the plan, and the QDRO cannot require the benefit to be paid prior to a time when the plan would permit.23 A special rule allows requiring immediate distribution if the participant is over 50 and the plan would permit an immediate distribution if he terminated employment.24

Thus, QDROs generally contemplate that the non-participant spouse will receive her share only when the participant receives his. This is not, however, a necessary result. The Code allows a qualified retirement plan to permit immediate distribution of the non-participant spouse’s share pursuant to a QDRO, even if by law or the terms of the plan the participant himself cannot receive any benefit at that time.25

If the participant spouse controls the plan, the divorce settlement might include an agreement by the participant spouse to amend the plan to allow a QDRO to direct an immediate distribution of the amount due the non-employed spouse. In this way the non-participant spouse’s claim can be promptly resolved.

Taking an immediate distribution also avoids possible loss of rights if the non-participant spouse dies before receiving the benefits. The provisions of REA that describe QDROs do not expressly provide for inheritance26 and do not elevate the spouse named as the alternate payee under the QDRO to the full status of a participant. Thus, it is by no means certain that QDRO rights are inheritable.

Indeed some features of the statutory scheme imply an intent that a QDRO not be inheritable. For example, as mentioned, Code § 402(a)(9) appears to tax to the participant spouse any payment made under a QDRO to anyone other than the non-participant spouse or former spouse. If courts should find that QDRO payments to an alternate payee’s heirs or legatees were indeed contemplated, in order to prevent a grossly unfair tax result the courts would also somehow have to find that Congress in § 402(a)(9) did not mean to tax such payments to the participant.

In many circumstances an immediate distribution pursuant to a QDRO will not be allowed by the plan. In these cases it may be in the best interests of both spouses if the non-participant spouse surrenders her interest in the qualified retirement plan in exchange for a greater share of other community assets. If it should be necessary to divide plan assets through a QDRO without an immediate distribution, the QDRO should specify what will happen if the non-participant

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spouse dies before receiving all of her share, just in case her rights are inheritable or she is deemed to have the power to name a beneficiary.

c. QDROs During Marriage.

As explained, QDROs not only assist in the division of the community in divorce but also offer significant tax benefits. Is it possible to obtain a QDRO during a marriage (and in the absence of a domestic relations problem) in order to get some of those tax benefits? Under REA, QDROs are available to spouses as well as former spouses and can be rendered pursuant to a "domestic relations law (including community property law)." 27 Nevertheless, as discussed in the very next section, the Department of Labor has taken the position that only a court order in a domestic relations context can be recognized as a QDRO28, and it is likely that this position will hold up.

d. QDROs for the Estate of the Non-Participant Spouse Who Dies First.

In those cases where the non-participant spouse dies first, REA seems to overlook and disrupt community property rights. The QDRO procedure shows a concern for the divorced spouse. It shows no concern whatever for the heirs or legatees of the non-participant spouse, divorced or not. We have already noted that it is not clear that a QDRO is inheritable. There is even more cause to doubt that a judgment recognizing the rights of the deceased non-participant spouse's successors can serve as a QDRO.

REA says a QDRO can be obtained by a spouse or former spouse, but does not say that a QDRO can be obtained by her successors at death.29 REA says a QDRO can be granted under a state's community property law, but it does not say that it can be obtained under a state's laws of inheritance.30

The Department of Labor was asked whether a Washington State probate court order was a QDRO, which required the trustee of a qualified retirement plan to pay the non-participant spouse's community half interest to her estate. The DOL firmly denied that such a court order could be a QDRO. The reason being that "Congress intended that the QDRO provisions of ERISA would have application in those court proceedings conducted primarily to resolve domestic relations issues."31

The DOL position was echoed by the 9th Circuit Court of Appeals in Ablamis v. Roper.32 When the estate of a non-participant spouse in California obtained a court order requiring the plan to pay the non-participant spouse's community half interest to her estate, the plan trustee applied for a declaratory judgment in federal court. The Court of Appeals affirmed the District Court judgment that the estate could not obtain the benefit from the plan. The court held that rights derived from state community property law can be claimed against a qualified retirement plan only in the context of a QDRO; in other words, through REA, Congress preempted any conflicting state law of community property bearing on payments from qualified retirement plans. The court further held that since

the definition of a QDRO does not refer to probate orders or payments to a deceased spouse's successors, the probate order could not be recognized as a QDRO. The court viewed the result to be good policy because it preserved the security of retirees. This decision may not be the last word: one judge vehemently dissented, and an en banc rehearing has been applied for. At this stage, however, our only authority — the two DOL opinion letters and the Ablamis decision — establish (1) that a QDRO can be rendered only in a domestic relations context, and (2) that without a QDRO no one can receive benefits from a qualified retirement plan other than the participant himself or his death beneficiary.

e. When the Participant Spouse Dies First.

As explained at Section V.A., if the participant spouse is married at his death, the surviving spouse must by law be the beneficiary of up to 100 percent of the death benefit, unless the surviving spouse consented in writing in the presence of a representative of the plan or a Notary Public to a different designation. This right to be the beneficiary has no footing in community property principles and exists regardless of the nature of the spouses' property rights in the plan, but assures that in almost every case the non-participant spouse will receive (if she wants it) a benefit at least equal in value to the value of her community interest.

If a former spouse has obtained a QDRO to protect her community property, the surviving spouse's death benefit claim is subordinated to the former spouse's rights under the QDRO.33

2. IRAs.

IRAs are not "plans" that are subject to ERISA.34 Thus ERISA's pre-emption of state law does not apply. And, as discussed in the preceding sub-section, it is believed that the statement at Code § 408(g) that § 408 is "to be applied without regard to any community property laws" is not intended to preclude community property ownership under state law.

Furthermore, the Code contains no prohibition against paying IRAs to third parties. The QDRO rules do not apply to IRAs. Thus payments out of IRAs can be made to third parties more freely than can payments out of qualified retirement plans. As pointed out in the following paragraphs, however, there can be tax drawbacks to such a payout.

a. Divorce.

A QDRO is not needed to partition an IRA upon divorce. Any transfer of an IRA interest to the non-participant spouse in connection with a divorce suffices to make that IRA interest hers, and it can be rolled over to her own IRA, deferring the income tax.35

b. During the Marriage.

A participant is free to transfer IRA funds to his spouse during the marriage. The IRA, however, cannot be put in the non-participant spouse's name. Thus the only way to deliver title to the funds to him or her is to deliver them free of the IRA, in which case there will be immediate recognition of taxable income,
plus possibly the 10-percent excise tax on premature distributions.36

c. Death of the Non-Participant Spouse.
No federal law prevents the heirs or legatees of the non-participant spouse from claiming their share from the participant’s IRA.37 In order for them to effectively obtain possession, however, the community portion actually has to be distributed from the IRA, giving rise to immediate income tax and perhaps a 10-percent excise tax.

d. Death of the Participant Spouse.
The participant is free to name anyone as beneficiary without getting the spouse’s consent. REA does not apply to IRAs. If the participant spouse designates as beneficiary someone other than the non-participant spouse, state law may allow the non-participant spouse to make a claim for his or her share.

D. Asserting the Non-Participant Spouse’s Community Interest Outside the Plan.

ERISA’s modification by REA may well, as a procedural matter, prevent the estate of a non-participant spouse from obtaining against a qualified retirement plan a distribution of that spouse’s community share of the participant spouse’s interest in the plan. The question then arises whether the estate of a non-participant spouse may be able to obtain satisfaction of its community property rights through a claim that state law allows to be made outside the plan. State law, for example, might permit the estate to obtain an accounting or reimbursement from the participant spouse or his or her death beneficiary for the non-participant spouse’s community share.39 Such a claim may be more troublesome for the heirs or legatees to make than a claim against the stakeholder plan, but nevertheless such a claim may provide a remedy not otherwise available.

Is such an indirect claim pre-empted by ERISA because it defeats the purposes of REA? The structure of REA and the logic of the pre-REA cases suggest that Congress did not intend to pre-empt all claims under state community property laws when it provided the QDRO procedure, but only to put a limit on occasions when such claims can be made directly against qualified retirement plans.39 The excerpt from the Senate Finance Committee report on the 1986 Tax Reform Act, quoted at E.2 below, states that a marital deduction is available only if a non-participant spouse actually transfers his or her interest in the qualified retirement plan to the participant. That statement only makes sense if a transfer to a person other than the employed spouse is enforceable.

Nevertheless, it is possible that a reimbursement claim is pre-empted. ERISA pre-emption has been broadly applied by the court to cover any state law that “has a connection with or reference to” an ERISA plan.40

The only case under REA that has come to our attention is the recent Louisiana Court of Appeals decision, Succession of Netterville.41 When a participant spouse died, and his surviving spouse was his death beneficiary under some qualified retirement plans, his former spouse (who had not obtained a QDRO) was allowed to collect her community interest in the plans from the surviving spouse. Although the case involved the participant spouse’s death, the pre-emption issue is equally important. The court held that REA does not pre-empt accounting claims that state community property law allows to be made against the person who receives the benefits from the plan.

With respect to benefits paid under U.S. Government pension plans, where the obligation is created under federal law, there is a stronger case for federal pre-emption, and a reimbursement claim is likely to fail.42

E. Gift and Estate Taxes

1. Upon the Death of the Participant Spouse

First.

Upon the death of one of the owners of an item of community property, normally only half of the item is includable in that spouse’s gross estate for federal estate tax purposes. There is no reason to believe this general rule does not apply to interests in qualified retirement plans and IRAs, despite their special features.

There are two consequences of this rule, when the participant spouse dies first: 1) the participant spouse’s gross estate does not include the non-participant spouse’s community share of the plan or IRA; and 2) the non-participant spouse may be deemed to have made a taxable gift of his or her community share of the plan or IRA, depending on how that share passes at the participant spouse’s death. Code § 2517(c), which used to exempt the non-participant spouse’s community interest in qualified retirement plans from gift tax, was repealed in 1986.

If the non-participant spouse having a community property interest is also the sole death beneficiary, normally no transfer tax will be due on the participant spouse’s share (thanks to the marital deduction under Code § 2506), or on the non-participant spouse’s share (because he or she has not lost any ownership rights).

If the two spouses are still married at the participant’s death and the death beneficiary is someone other than the non-participant spouse, there will be no marital deduction as to the participant spouse’s share, and the non-participant spouse will be deemed to have made a gift of his or her community share of the plan. In the case of a qualified retirement plan this could only happen if the non-participant spouse has waived the right to be the death beneficiary. Code § 2503(f) [as explained at Section IV(A)] exempts gift tax the waiver by the non-participant spouse of the statutory right to be the death beneficiary under a qualified retirement plan. But § 2503(f) does not exempt from gift tax the value of an ownership interest passing to another.

In the case of a qualified retirement plan, after a divorce the participant spouse is able to dispose of the non-participant spouse’s community interest without his or her consent unless he or she has obtained a QDRO or can obtain reimbursement. If the non-partici-
pant spouse is unable to obtain any of his or her community interest in the plan, he or she is not only impoverished but also may be deemed to have made a taxable gift of his or her interest.

2. Upon the Death of the Non-Participant Spouse First.

Section 2039(c) formerly excluded the non-participant spouse’s community interest in qualified retirement plans and IRAs from his or her taxable estate. That exclusion was repealed in 1986.

In the case of IRAs, the non-participant spouse’s interest is transferable to his or her heirs or legatees and should be subject to withdrawal at will by the heirs or legatees. The marital deduction, therefore, should be available for any testamentary disposition that would ordinarily qualify for the marital deduction.

The treatment of interests in qualified retirement plans, however, is among the most difficult of issues for estate planners at this time. Thanks to the repeal of § 2039(c), there is no question that the non-participant spouse’s community interest must be included in his or her gross estate. However, it is not yet known to what extent the non-participant spouse’s will has any bearing on whether his or her interest passes in a way that qualifies for the marital deduction.

If it is true that state laws of inheritance have been completely pre-empted by ERISA and accordingly that the participant spouse is deemed under federal law to succeed to the non-participant spouse’s interest in a qualified retirement plan automatically, free of any accounting or reimbursement claim under state law, a marital deduction should be available regardless of the terms of the non-participant spouse’s will. Such was the conclusion of the IRS with respect to a Louisiana estate. In TAM 8943066 the IRS allowed a marital deduction, even though the non-participant spouse’s will left her share of the community property to her children and not to her husband. Under this holding the non-participant spouse’s interest in the qualified retirement plan could never be used to fund a credit-shelter disposition.

It does not appear, however, that Congress intended a mandatory marital deduction. The repeal of § 2039(c) seemed to contemplate a possible estate tax at the non-participant spouse’s death. Additional evidence of Congressional intent appears in the following strange statement on page 1014 of the Senate Finance Committee Report to TRA 86:

Under the bill, the special community property rules applicable to qualified retirement plans for purposes of the estate and gift tax provisions are repealed. However, the bill clarifies that, if a transfer is made to a participant spouse by a non-participant in a community property state, the amount transferred is eligible for the unlimited marital deduction. (emphasis added)

Although the Act actually contained no such clarification, the statement in the Committee Report certainly implies that a marital deduction will be available only if the non-participant spouse actually transfers her interest in the qualified retirement plan to the participant. Therefore, if the non-participant spouse fails to make a transfer of his or her interest to the participant spouse, it may be subject to estate tax. A careful will draftsman should therefore routinely include such a bequest in the will of the non-participant spouse.

If the marital deduction is not available upon the non-participant spouse’s death, the consequences could be unduly harsh. Estate tax may have to be paid by his or her successors on a property interest they may never receive. Even if the successors of the non-participant spouse can expect to receive the benefit, through a QDRO or a reimbursement or accounting claim, if the benefit is not in pay status, an estate tax might have to be paid at a time when the asset giving rise to the tax is not available to fund the payment of the tax. None of the deferrals under Code §§ 6161 through 6166 appear to be of any significant help. Furthermore, the calculation of the tax would be most difficult, especially in the case of a defined benefit plan that is not yet in pay status and under the terms of which the participant’s benefit is forfeitable at his or her death.

Assuming there is no automatic qualification for the marital deduction, any disposition other than an outright ownership to the participant spouse may trigger an estate tax. If the benefit is not in pay status, the disposition may not qualify for the QTIP marital deduction or the power of appointment marital deduction because it may be impossible for the participant spouse to receive the income annually.

F. Estate Planning.

Pending the resolution of a number of issues, including the ability of the non-participant spouse’s heirs or legatees to obtain a QDRO or at least an accounting, and the question of whether the marital deduction is available if the non-participant spouse’s interest in a qualified retirement plan is not left by will outright to the participant spouse, it is highly desirable to plan in such a way as to assure that the marital deduction is available upon the death of either spouse. It is also desirable to allow the participant spouse not to take a marital deduction for the interest (e.g., in order to make full use of the non-participant spouse’s $600,000 exemption), if it is ultimately determined that the non-participant spouse’s interest does not automatically pass by law to the participant spouse.

Thus, the non-participant spouse’s will should normally leave her interests in qualified retirement plans and IRAs outright to the participant spouse. If the non-participant spouse anticipates that a full marital deduction for these interests may prevent full use of the unified credit in his or her estate, the non-participant spouse’s will should provide for disclaimer by the participant spouse: the will could provide that to the extent of an effective disclaimer by the participant spouse, the participant will receive only an income.
interest in the non-participant spouse’s share of the qualified retirement plan. If timely made, such a disclaimer should be a “qualified disclaimer” under IRC § 2518(b)(4)(A). See, for example, PLR 9016026. What kind of income interest should the participant receive? If possible, a life estate, or usufruct in Louisiana, should be used; if a trust is used, the trustee may be unable to obtain possession of the benefit.

In planning for the death of the participant spouse first, it is usually desirable to name the surviving spouse as primary beneficiary outright. In addition to the benefits of such a designation described at Section VI, the designation avoids the non-participant spouse making a taxable gift and avoids difficulties that could arise if the non-participant spouse would make an accounting claim. The designation should include a contingent disposition, to apply if the non-participant spouse dies first or disclaims the outright designation. The contingent disposition might provide that the non-participant spouse’s interest would pass outright to her, but that the participant spouse’s interest would pass to a credit shelter trust in which the surviving spouse could receive an income interest. This plan takes advantage of the participant’s unified credit without causing the non-participant spouse to make a taxable gift as to his or her half.

G. Conclusion.

A final word of caution is important. As discussed elsewhere, directing IRAs or qualified retirement plan benefits to trusts or using such benefits to fund marital deduction dispositions or credit shelter trusts are not without risks. Funding a pecuniary deduction formula clause with retirement benefits and IRAs can trigger the acceleration of income. Allocating such assets to various trusts can forfeit rollover and deferred payout benefits as well as cause a loss of the estate tax marital deduction. The risks attendant to estate planning for retirement benefits that have a community property element are even greater, and each half of the community property interest must be planned for with extreme care.


3. *Compare Stewart v. Estate of Stewart*, No. 352-660, 1st J.D.C. Caddo Parish, La. (decided February 24, 1988) (no community property ownership of IRA with Succession of Egan, 543 So. 2d 940 (La. App. 5th Cir. 1989) (community property principles do apply to IRAs), and with Succession of McVay, 476 So. 2d 1070 (La. App. 3rd Cir. 1985) (the IRA was separate but an accounting was due for the community investment).


6. IRC §§ 401(a)(11), 417, discussed at Section V.A.1 and 4, above.

7. See *Estate of Margery M. Mac Donald v. Robert F. Mac Donald*, supra note 4.

8. See Section V.B., above, and Subsection C, below.


11. ERISA § 514(a).


13. See, e.g., PLR 8125097, PLR 8027041, and PLR 7952045 September 25, 1979. See also, Rev. Rul. 80-27, PLR 8304089.


25. Code § 414(p)(10). See, for example, PLR 8837013 and PLR 8744023.


31. DOL Opinion Letter No. 90-46A.

32. No. 89-15352, Daily Journal DAR 8011 (9th Cir. 1991).

33. Code § 414(p)(5).

34. DOL Reg. § 2510.3-2(d).

35. Code § 408(d)(6).

36. Code § 72(t).

37. See, for example, PLR 8040101. See also *Estate of Mac Donald*, supra, Section B, note 4.


41. 579 So.2d 1046 (La. App. 4th Cir. 1991).

42. See, e.g., *Succession of Sims*, 464 So.2d 991 (La. App. 1st Cir.), writ denied, 467 So.2d 532 (La. 1985).
A. Trends.

As is the case with any area that involves federal income taxation, planning for qualified retirement plan benefits and IRAs is difficult because the law remains in a state of flux. Over the last seven years a number of tax acts have dealt in part with distributions from qualified retirement plans and IRAs. The trend of this legislation probably will continue.

Future legislation no doubt will impose additional restrictions on the amounts that can be accumulated in qualified retirement plans and IRAs. This trend will be fueled by Congress’s desires to raise additional revenue to offset the federal deficit and to force employers to provide greater benefits to the rank and file employees. For example, Congress has restricted the amount of compensation that can be taken into account for purposes of determining the annual benefit that can be provided to a participant under a defined benefit plan or the annual addition that can be allocated to a participant’s account under a defined contribution plan. This cap on compensation forces the employer to contribute a higher percentage to all participants in order to achieve the maximum contribution for the highly compensated participants.

To illustrate, the maximum dollar amount that can be allocated to a participant’s account in a defined contribution plan is $30,000, and the maximum amount of annual compensation that can be taken into account currently is $200,000 (as indexed). Consequently, a contribution of 15 percent of compensation must be made on behalf of all participants in order to achieve a $30,000 contribution on behalf of a highly compensated participant with compensation in excess of $200,000. If the cap on the annual compensation were reduced to $150,000, the required percentage to achieve a $30,000 contribution on behalf of such a participant would be increased to 20 percent.

There also may be greater protection for spousal rights. It may be more difficult for a participant in defined contribution plans that are not required to provide qualified preretirement survivor annuities and qualified joint and survivor annuities to exclude the non-participant spouse from any benefits while the participant is alive. Under current law the participant in such a plan may elect lump sum treatment without the consent of the non-participant spouse.

More protection and increased benefits may be provided for the rank and file participants in the plan. This protection may take the form of qualification requirements, such as more liberal vesting and more rapid accrual of benefits. In addition, participants may be protected with respect to distributions by requiring certain assumptions (such as interest rates) that benefit the participant when determining the actuarial eva-

lency of the normal form of benefit. For example, a lower assumed interest rate results in a higher lump sum payment. The Pension Protection Act of 1987, which was part of the Revenue Act of 1987, established a number of new requirements designed to protect the accrued benefit of the participant.

Even though the wealthier participant may not be able to accumulate as much wealth in a qualified retirement plan in the future as in the past, a larger portion of the average participant’s estate probably will consist of qualified retirement plan benefits and IRAs. It is hoped that Congress will work to simplify the rules concerning distributions from qualified retirement plans and IRAs so that the rank and file participant does not have to pay advisors a substantial fee to assist the participant in planning for the receipt of such benefits. Estate planners, financial advisors, and other consultants will have to continue to keep up to date in this area in order to advise their clients properly.

B. Sources for More Information.


