Chapter 10

RETIREMENT BENEFITS[1]

A very large portion of the wealth of many decedents who were gainfully employed (referred to herein collectively as "participants" rather than as employees, IRA owners, or otherwise) often consists of annuities and other employee benefits and deferred compensation held in various forms of retirement benefit accounts, such as:

- All manner of §401(a) qualified pension, profit sharing, or other retirement plans created by employers;
- §401(c) Keogh plans created by the self employed;
- §403(c) nonqualified retirement plans created by employers for a select group of senior employees;
- §408 individual retirement accounts (IRAs) and simplified employee pensions;
- Many other forms of deferred compensation and retirement arrangements (including Social Security, Railroad Retirement and other such federal or state benefits, stock option plans, death benefit only plans, and the like) that may have survivorship features or death benefits that survive the employee's demise. Most of these are not subject to inclusion in the decedent's gross estate for federal estate tax purposes[2] but they may constitute income in

1. One respected commentator on this area of the law has remarked that there are "several thousand rules—count them" that may be relevant. And they seem to be in constant flux. Much of the most useful explanatory material is in the form of continuing education outlines that are not generally commercially available, but a short bibliography of generally accessible resources that may be helpful in finding answers and staying current includes the most recent editions of Choate, LIFE AND DEATH PLANNING FOR RETIREMENT BENEFITS (5th ed. Rev. 2003); and Mezzullo, *Estate and Gift Tax Issues for Employee Benefit Plans*, 814 Tax Mgmt. (BNA) ESTATES, GIFTS & TRUSTS PORT. (1996).

2. There are dozens of such entitlements under various federal, state, and even foreign laws, and the traditional rationale for noninclusion is that these benefits are not payable pursuant to any contract or agreement by reason of employment, making §2039(a) inapplicable. For a sampling see Rev. Rul. 79-35 and Technical Advice Memorandum 8042006 (no inclusion of awards made to decedents whose families were entitled to annuity payments under German laws relating to injustices that occurred when the National Socialist Party took control of Germany); Rev. Rul. 76-102 (exclusion of payments under Federal Coal Mine Health and Safety Act of 1969); Rev. Rul. 76-501 (exclusion of veteran survivors' benefits); Rev. Rul. 77-274 and Rev. Rul. 66-234 (because amounts paid for funeral expenses under veterans' benefits or in a wrongful death action are not includible, no §2053(a)(1) deduction is allowable for those expenses); Rev. Rul. 81-182, Rev. Rul. 75-145, Rev. Rul. 67-277, and Rev. Rul. 55-87 (Social Security benefits payable to an employee's surviving spouse are not includible; the same is true for payments attributable to the tax on self-employment income); Rev. Rul. 56-637 (exclusion of worker compensation payment to dependents); Rev. Rul. 82-5 (survivors' loss benefits payable as an annuity under no fault automobile insurance was not includible); Rev. Rul. 75-127, Rev.

respect of the decedent for income tax purposes (meaning that the recipient will pay income tax on them, much as would the decedent had death not intervened). See Chapter 17 at pages 11-12.

These entitlements are designed principally for retirement purposes and typically only provide a death or survivorship benefit that is ancillary to the primary function of the plan. Although estate planners frequently focus on those elements that will be enjoyed by a decedent's survivors, the inter vivos enjoyment of these entitlements and the rules relevant to their taxation often drive the postmortem options and consequences of those benefits. So keeping one eye on the rules applicable to these assets during a client's life is critical to the estate planning endeavor.

In addition, it is wise to remember concepts that apply to all nonprobate assets and issues that can arise in a nontax context. One illustration concerns retirement benefits and insurance beneficiary designations following divorce. The question is whether a surviving former spouse, designated as the beneficiary prior to the divorce and not thereafter altered, is regarded as predeceased for purposes of any entitlement under that plan or policy. State laws routinely answer this question with respect to wills and probate property.[3] But most jurisdictions have no comparable statute dealing with nonprobate property, meaning the former spouse most likely will continue to benefit.

Finally, as introduction to this material, please be prepared for a very discouraging expedition. Estate planning is the tail on this dog, these benefits are not meant to be preserved, and the rules and options for postmortem enjoyment by those who survive the participant are not facile or very desirable. We do the best we can with this wealth, but it is frustrating and mostly it is not about the kinds of factors we consider elsewhere with other forms of a client's property. Please do not be surprised if you find yourself holding your head and bemoaning that this is a most dissatisfying journey. Sorry — that is just the way it is.

Gift Taxation

To illustrate the concept of retirement versus survivorship benefits, consider the fact that most employee benefit plans contemplate that the employee will live to enjoy various benefits and that there may be no residual death benefits whatsoever. Indeed, normally the lifetime

Rul. 75-126, Rev. Rul. 68-88, and Rev. Rul. 54-19 (all reflecting the exclusion of wrongful death recoveries except to the extent amounts received represent damages to which the decedent was entitled during life, such as for pain and suffering or medical expenses); Rev. Rul. 79-397 (public safety officer survivor benefits); Rev. Rul. 2002-39 (firefighter or police officers killed in the line of duty survivor death benefits; inclusion is required under §2033 for that portion of a postmortem payment representing a return of the decedent's own contributions to a pension fund but not for added benefits paid for which there was no entitlement, vested interest, or right to receive payments before death).

3. See the discussion of the analogous issue in life insurance planning in Chapter 9 at page 34.

enjoyment rights under such plans are nontransferable. More to the point, in a qualified plan this is a requisite of the anti-alienation rules found in §401(a)(13). As a consequence, most typical gift tax concerns are irrelevant to most retirement benefit plans.

If the plan permits assignment of benefits, however, and if the participant makes an assignment or an irrevocable beneficiary designation, the value the participant transfers by those acts may constitute a gift for federal gift tax purposes. It may have undesirable income tax consequences as well. See §72(e)(4)(C)(i), which provides that the lifetime transfer of an annuity contract for less than full and adequate consideration (a gift) causes income realization by the donor equal to the excess of the cash surrender value over the investment in the contract (which is the full accrued income element). Transfers between spouses that are excepted under §1041(a) avoid this income realization. §72(e)(4)(C)(ii). And transfers between a trust's grantor and the trust also should avoid income recognition.

Otherwise, gift tax issues abound. For example, it is not clear whether an irrevocable beneficiary designation qualifies for the gift tax annual exclusion, nor is the value of the gift easily determined. By adding §2503(f) in 1986, Congress addressed one such question by providing that a waiver by a participant's spouse before the participant's death of the spouse's federally guaranteed annuity entitlement is *not* a gift for gift tax purposes. See §§401(a)(11) and 417 (the participant may not defeat the spousal annuity and make an alternate beneficiary designation without the spouse's waiver and consent. §417(a)(2). See page 20.). One way to view the effect of §2503(f) is to consider it as tantamount to automatic marital deduction treatment with respect to any gift made by the participant's spouse to the participant of any benefits released by the spouse's waiver. That vision then leaves any gift occurring by the participant's beneficiary designation as coming wholly from the participant. This result protects the spouse but it does not speak to the gift tax consequence to a participant who makes an irrevocable beneficiary designation. Indeed, it may just confirm that a gift by the participant does occur.

Estate Taxation

As befits the gift tax confusion in this arena, the estate tax is only slightly more clear. Captioned "Annuities," the inclusion rule in §2039 is neither as limited nor as broad as its title might suggest. For example, some annuities are not taxable at all under the estate tax because they terminate with the decedent's death. The only wealth remaining to be included (under §2033) is whatever was paid to the annuitant during life and not exhausted by consumption or transfers before death.

In addition, some annuities that survive a decedent's death and continue to provide postmortem benefits to a survivor annuitant have been taxed under provisions other than §2039. This occurs most commonly under §2038 in the employment context in which a decedent was deemed to have made a transfer in exchange for the annuity and was regarded as retaining some degree of control over the transfer until death.[4] It also has occurred under §2033, as when a decedent owns a right to receive a stream of annuity payments for a term certain that exceeds the decedent's life.

More directly important to this discussion is that §2039 is not limited just to annuities. It also has been used to cause inclusion of the value of employee benefits paid postmortem in a lump sum. Indeed, notwithstanding its title, the primary thrust of §2039 is the estate taxation of all retirement benefits that survive a decedent's death.

Given the confusion in the wealth transfer taxation of these assets, it also is fitting that these issues relate to wealth that is among the most difficult to address in most estate planning engagements today. As just one indication of the difficulty posed, consider the most challenging question in any planning situation in which these assets will be includible: the tax payment obligation. There is no federal right of reimbursement for estate taxes attributable to inclusion of these assets, which frequently have a huge value relative to the cash flow they make available through installment payments over the life of a designated beneficiary.

Worse, there is little reason to anticipate tax payment relief under any federal estate tax deferral provision. Deferral in the discretion of the Secretary might be available for a reasonable period (not to exceed 10 years) under the "reasonable cause" standard in §6161. This might be adequate in some cases to generate enough cash after income tax on these payments to satisfy the outstanding estate tax and any interest. But the §6163 deferral with respect to future interests is not allowable. See Rev. Rul. 73-311. Thus, the obligation to pay estate taxes attributable to §2039 inclusion could vastly exceed the immediately available wealth, which creates significant potential problems.

Prior to their repeal for estates of decedents dying after 1984, §§2039(c) and 2039(e) excluded certain employee death benefits and individual retirement accounts from a decedent's gross estate. Through a

4. See, e.g., Rev. Rul. 76-304 (a decedent-employee's contract with an employer called for an annual salary and a death benefit payable to the decedent's designated beneficiary if the decedent was still employed by that employer at death, which the government deemed includible under §2038(a)(1), not §2039(a), as an indirect transfer with a retained power of revocation); cf. Estate of Siegel v. Commissioner, 74 T.C. 613 (1980) (disability payments could cause §2038(a)(1) inclusion as a transfer by the deceased employee that was subject to modification); Looney v. United States, 569 F. Supp. 1569 (M.D. Ga. 1983) (a death benefit only plan generated inclusion because the court aggregated multiple benefits provided to the participant); Estate of Levin v. Commissioner, 90 T.C. 723 (1988) (death benefit only plans generated inclusion under §2038(a)(1) based on the decedent's control of the payor corporation); but see Estate of Tully v. United States, 528 F.2d 1401 (Ct. Cl. 1976) (death benefits payable directly to the decedent's surviving spouse under a contract with the decedent's 50% owned employer were not §2038(a)(1) includible, in part because the decedent's 50% ownership interest did not control the employer); Fidelity-Philadelphia Trust Co. v. Smith, 356 U.S. 274 (1958) (the government's unsuccessful effort to cause inclusion under §2036(a)(1)).

series of changes this favored status swung to the exact polar opposite[5] and, through adoption in 1986 of the §4980A surtax on certain qualified employee benefits, retirement benefits became the most heavily taxed assets in some decedents' estates. Since the repeal of §4980A in 1997, retirement benefits that survive a decedent's death now are taxed with neither preference nor prejudice, and with very few exceptions there is little controversy or uncertainty regarding the estate taxation of annuities or other survivorship benefits. Thus, in general, benefits that are payable postmortem if an individual dies before full premortem payment of an entitlement are includible in the individual's gross estate for federal estate tax purposes, regardless of the extent to which they were funded or nonforfeitable before death.

For §2039 purposes, an annuity is a periodic payment of money for the life of a designated individual or for a term of years. In general, if annuity payments do not terminate at a decedent's death, §2039(a) may require inclusion of the remaining value of that annuity to the extent it is payable to another beneficiary who is entitled to receive payments because of surviving the decedent. As with §2036(a)(1), under §2039(a) the annuity must have been payable (even if it was not yet being paid) to the decedent for life, for a period not ascertainable without reference to the decedent's death, or for a period that did not in fact end before the decedent's death. Under §2039(b), this inclusion is limited to that portion of the annuity attributable to contributions by the decedent (or by an employer on the decedent's behalf). Usually that is 100%.

In addition, the amount includible under §2039(a) reflects the expected duration of the annuity payments (for example, the discounted present value of payments for the life of the participant's surviving spouse). It also reflects a discount to present value if the payments will be deferred until some later starting payment date.

To be includible under §2039(a) the payments that survive the decedent must be made under "any form of contract or agreement" under which the decedent was entitled to payments. By its own terms, §2039(a) cannot cause inclusion of annuities payable under insurance policies on the decedent's life. Thus, the insurance inclusion rule in §2042 must be applied or inclusion is avoided, because the government cannot use §2039 as an alternate inclusion provision. For example, assume that a decedent assigned all rights under an employer funded group term life insurance policy more than three years before death and avoided both §§2035 and 2042 inclusion of the proceeds at death. The fact that the settlement option was an annuity for the

5. The history of amendments to §2039 and their application and effect on prior revenue rulings and procedures is detailed in Rev. Rul. 88-85. Transition date rules also are addressed in Rev. Rul. 92-22. In general, benefits may still be excludible if the participant separated from service before 1985. With respect to IRAs the key is being in pay status with an irrevocable beneficiary election before 1985. In either case no changes to the form of benefit should be made before careful analysis of the question.

beneficiary's life would not permit inclusion under §2039(a), even though payment of this employee benefit was in annuity form.

There are some unresolved estate tax inclusion questions under §2039. For example, of particular significance to community property estate planners (but relevant throughout the nation) is whether a spouse of a participant in an employee benefit plan owns any interest in the plan by virtue of the §401(a)(11) spousal annuity rules. If so, one question involves what happens if the nonparticipant spouse predeceases the participant. Is any part of the retirement benefit includible in the nonparticipant spouse's gross estate, and does that part qualify for the estate tax marital deduction?

An amendment to §2056(b)(7)(C) in 1997 specifies that any portion of a plan that is includible in the deceased nonparticipant spouse's gross estate under §2033 (meaning that it is the deceased spouse's community property) qualifies for automatic marital deduction treatment. In addition, it seems relatively clear that Congress does not believe a nonparticipant spouse in a noncommunity property state has any property rights that would generate estate tax consequences.[6]

Income Taxation

The wealth transfer taxation of annuities and other retirement benefits has been relatively stable compared to the amount of change to the income tax rules that affect planning for these assets. Change has been significant and frequent since Congress adopted the Employee Retirement Income Security Act of 1974 (ERISA). Two additional important wealth transfer tax issues are the "fallout" of income tax changes made under the

---

6. Although this notion almost certainly is correct in a noncommunity property jurisdiction, it is questionable in a community property state. See Hyde v. United States, 93-2 U.S. Tax Cas. (CCH) ¶50,605 (D. Ariz. 1993), aff'd in an unpublished opinion (9th Cir. 1994) (the nonparticipant spouse had a sufficient community property interest in the participant's qualified plan to be subject to a §6331 tax levy, which was honored notwithstanding the §401(a)(13) anti-alienation rule, due to the exception for taxes in Treas. Reg. §1.401(a)-13(b)(2)(i)); but see Boggs v. Boggs, 520 U.S. 833 (1997) (a 5-4 decision that a participant's predeceased spouse could not transfer any entitlement under a qualified plan because ERISA pre-empts any state property law community property interest; the participant had remarried and was survived by that new spouse, and the opinion speaks in terms of the ERISA protection for the surviving spouse of the participant); Ablamis v. Roper, 937 F.2d 1450 (9th Cir. 1991) (the nonparticipant spouse in a community property jurisdiction did not have a property right subject to disposition under the nonparticipant spouse's will prior to death of the participant); cf. Hisquierdo v. Hisquierdo, 439 U.S. 572 (1979) (ERISA pre-emption also prevents a nonparticipant spouse from having a community property interest on divorce in the participant's retirement benefits), and Bunney v. Commissioner, 114 T.C. 259 (2000) (notwithstanding that state law regarded an IRA as funded with community income, the Tax Court concluded that recognition of community property interests in an IRA for federal income tax purposes would conflict with several fundamental aspects of §408 and therefore regarded the participant as the owner and sole distributee for income tax purposes). Contra, Allard v. Frech, 754 S.W.2d 111 (Tex. 1988) (half of a participant's pension passed under the will of a predeceased nonparticipant spouse). The issue is not relevant with respect to IRAs and simplified employee pensions, which are not governed by ERISA.

Retirement Equity Act of 1984 and the "spousal annuity" requirements that it added.

Before addressing those planning issues, however, a short digression is needed to study the income tax rules affecting retirement benefits, because these rules are integral to the estate planning that is available. Fortunately, these income tax issues are not likely to arise in the normal practice of estate planning professionals because frequently they relate to qualification of plans that have special income tax attributes. Indeed, the income tax issues described here are so complex that many seasoned estate planners conclude that the world of benefits planning is too specialized and simply delegate this work to benefits experts rather than attempting to acquire or retain the competence to create or maintain qualified plans. What follows is a brief general description of the key requirements of *qualified* plans. It is designed to establish the most basic understanding of the income and estate tax rules. These are of primary importance to estate planners who need to be conversant with clients who possess substantial retirement benefits that must be integrated into their estate plan.

Let's begin with a reality check. The amount of wealth controlled by private pension plans in America is staggering, and it grows exponentially annually. The principal reason for this investment of current earnings is the favorable income tax advantages granted to all parties involved with qualified plans. In exchange for these benefits, Congress imposes detailed qualification rules. For starters, a tax-favored "qualified" plan must satisfy all the qualification requirements of §401, the minimum participation standards of §410, the minimum vesting standards of §411, the minimum funding standards of §412, and the limitations on benefits and contributions of §415.

A qualified plan must exist for the exclusive benefit of employees and their beneficiaries and its sole objective must be to provide these individuals with a share of profits or an income after retirement. Death benefits can be only an "incidental" feature of a qualified plan. In addition, participation in, contributions to, and benefits provided under a qualified plan may not unduly discriminate in favor of officers, shareholders, or highly compensated employees. Because the definitions of what constitutes a discriminatory plan are among the elements that tend to vary from one Tax Reform Act or Congress to another, the most recent version of these rules should be the focus of study by those crafting a plan. Fortunately, these are rules about which the typical estate planner probably need not worry.

Another requirement is that the employer's contributions to the plan must "vest," meaning that contributions are not forfeited upon termination of employment. Again, the formulas or schedules for vesting have been subject to change and a number of alternatives are available. As a result, a given employer may maintain various plans with different rules, all explained in a summary plan description made available to the participant.

An estate planner normally would study this document only if the benefits involved are substantial enough to warrant this investment of time (and therefore fees).

A *contributory plan* either permits or requires employees to contribute after-tax dollars to the plan. These contributions will add to a participant's basis and complicate the tax consequences of distributions because these contributions are returned to the participant tax free. *Noncontributory plans* are funded only by pretax employer contributions and generally are easier to address for income tax purposes. This is deferred compensation and everything distributed is taxable as income. Noncontributory plans are the norm.

Defined contribution plans require specified contributions pursuant to a prescribed formula. These defined contributions build an identifiable (although not necessarily a separate or separable) fund on behalf of each participant, with no guarantees of investment performance or ultimate payout. There are two forms of defined contribution plan. *Money purchase plans* permit an annual contribution, not to exceed specified statutory limits. *Profit sharing plans* originally permitted contributions that were geared to actual profits of the employer; today contributions can be made even if there are no profits, again subject to maximum limits on contributions. So-called 401(k) *cash or deferred compensation plans* are a form of profit sharing, allowing the employee to either receive cash or defer compensation (up to a maximum amount) by contribution to the employer's profit sharing plan. The employer and employee contributions to a defined contribution plan may differ, but each must be made according to a specified formula.

Defined benefit plans establish a prescribed benefit, again by formula (such as [x%] times [years of service] times [the employee's average salary for a certain number of highest salary years before retirement]), subject to certain limits that prevent excess benefits. Contributions to a defined benefit plan are estimates of the amount that will be needed to provide the guaranteed benefit. Annual audits and actuarial determinations are required to ensure that the employer keeps the plan funded at a level deemed necessary to guarantee those benefits. Over time this form of plan has fallen into disfavor because employers do not want to be obligated for a guaranteed benefit and suffer the risk that investment performance may not correlate properly with contributions. Most plans today are of the defined contribution variety. As a result, investment performance is totally the participant's risk or reward.

Individual Retirement Accounts (IRAs) are available to individuals who are not otherwise covered by employer plans (and there are "spousal IRAs" with special limits for unemployed spouses, Roth IRAs,[7] and

7. Virtually no attention is devoted here to Roth IRAs because the §408A(c)(3) contribution and rollover restrictions are such that many potential users will be precluded from taking significant advantage of this opportunity. Roth IRAs may be desirable to

educational IRAs). Because of the §408(a)(1) contribution limitations for IRAs in general, the most important use of IRAs for most clients is as a "rollover" beneficiary of distributions from other qualified plans, with the ability to defer the income tax consequence of that distribution until the IRA is distributed in the future.[8] In addition, specialized plans, such as Employee Stock Ownership Plans (ESOPs), Incentive Stock Options (ISOs), Simplified Employee Pensions (SEPs), Supplemental Retirement Annuities (SRAs), and H.R.10 (Keogh) plans also exist but are less common and are not discussed separately here.

The income tax consequences to the employer-sponsor of a qualified plan are relatively straightforward. Under §404(a), the employer's contributions to the plan are deductible currently from its income as an immediate business expense. Nevertheless, under §402(a) the employer's contributions to the plan are not taxed currently as income to the employee-participant. Instead, taxation of this form of compensation is deferred until benefits are distributed or made available to the participant (or to designated beneficiaries). §83 does not alter this result. See §83(e)(2).

Deferring income to the participant has three tax advantages: First, it is anticipated that the participant will be in a lower income tax bracket in the years after retirement when distributions are received, so the benefits may incur a lower overall income tax liability. Second, if the participant is over the age of 65 when taxable distributions are received, an additional standard deduction will be available to offset this income (and additional deductions also may be available for the participant's spouse).

The third and perhaps the most important advantage of deferral is that income earned in the plan between the time of contribution and the time of distribution is exempt from income tax until distribution. This "tax free internal build up in value" applies to contributions by the employer and the participant alike in both qualified and nonqualified plans. The build up also allows a significant increase in the earning and growth potential of the invested wealth because dollars that otherwise would be paid in income tax instead are invested.[9]

---

individuals who will not need the wealth and do not want to be forced into taking minimum distributions (which are not required under §408A) or who want to designate a beneficiary, such as a generation-skipping trust, on which income tax liability should not be imposed.

8. Creditor protection may be lost on a rollover, the issue being state law protection of IRAs from creditor claims. With respect to creditor protection of qualified plans in general, see the anti-alienation rule in §401(a)(13) and Treas. Reg. §1.401(a)-13(b)(1); Patterson v. Shumate, 504 U.S. 753 (1992); *In re* Rueter, 11 F.3d 850 (9th Cir. 1993); *In re* Connor, 73 F.3d 258 (9th Cir. 1996). IRAs are exempt from bankruptcy claims but only "to the extent reasonably necessary for the support of the debtor and any dependent of the debtor. 11 U.S.C. §522(d)(10)(E)," quoted from *In re* Carmichael, 100 F.3d 375, 380 (5th Cir. 1996). Otherwise the issue for IRAs is a function of state law. Ice, What Are Creditors' Rights in Retirement Plan Benefits, 21 Est. Plan. 30 (1994).

9. Notwithstanding statements often made to the contrary, it is not a benefit that the income tax will be paid using "discounted" or "cheaper" dollars (considering their value in an inflationary economy), because the participant will receive the benefit distributions in the same devalued dollars.

Because income tax deferral normally is regarded as beneficial, seldom is the point made (but it is good to remember) that the Code establishes *minimum* distribution rules in most cases. If a qualified participant (who is not too young) wishes to receive benefits more quickly than is required, usually that is completely permissible under the law (although the plan may not be designed for premature distributions because of its investments and reserve estimates). The price to be paid by distributions in excess of the minimum distribution requirements is loss of deferral and potentially a higher rate of income tax if the amounts received push the recipient into a higher marginal income tax bracket.

Nonqualified Plans

The income tax difference between qualified and nonqualified plans is *not* to the participants. There still is deferral until distribution or availability of the funds. Instead, the primary consequence of being nonqualified is that the employer may not deduct its contributions until the year the participant includes the amount in income, meaning that there is no mismatch of the employer's deduction and the participant's inclusion as there is with a qualified plan (instead, both are deferred until distributions are made). The participant's inclusion, however, normally is not affected. See §§402(b), 403(c), 83(a)(1), and 83(c)(1). The fact that nonqualified plans typically are not funded or vested normally precludes current §83 taxation to the employee.

Even though nonqualified deferred compensation may be an attractive negotiated benefit, the participant incurs certain risks that are meant to be minimized under the federal requirements for qualified plans. Still, nonqualified plans are relatively popular for a number of reasons, notwithstanding deferral of the employer's deduction. For example, nonqualified plans need not meet the rigid funding, minimum participation, minimum vesting, nondiscrimination, and other technical rules that apply to qualified plans. Thus, an employer may target benefits to certain favored officers and employees and the plan need not be funded currently, so the employer may defer payment of the dollars to satisfy its obligations under the plan. In addition, certain incidental administrative costs of maintaining qualified plans may be reduced or avoided entirely. Further, the §401(a)(9) required beginning date and minimum distribution rules discussed next do not apply, nor do the penalties under §§4974 and 72(t) for early or late receipt of benefits apply, meaning that there is more flexibility in determining when to receive the benefit.

Rules Governing Distributions

The income tax treatment of retirement benefit distributions is a source of significant complication for estate planners. The distribution options are not elections about which the typical estate planner needs to be intimately aware, because the participant is entitled to receive guidance from the qualified plan's administrator on whether to take an annuity, a lump sum, or to roll over into an IRA or another plan. Instead, the importance of these income tax rules is two-fold.

First, elections made by the participant and the designated beneficiary will affect income tax planning and the flexibility available for distributions after their respective deaths, particularly with respect to providing liquidity for estate tax payment purposes.

Second, there are spousal annuity entitlements and waiver issues that must be considered and factored into the planning equation. The decision regarding a waiver of the spousal annuity will be affected by the income tax consequences of actions taken during the participant's life, by elections that are available to the spouse, and by the estate and gift tax issues considered beginning at page 20.

Fortunately, the income tax rules that apply during the participant's life need not be a principal concern, because most estate planners will not be involved in the client's decisions about pre-death enjoyment of retirement benefits. However, taxation during life must be studied to fully appreciate and understand the options available for postmortem distribution, especially if payout began during the participant's life.

In a nutshell, the income taxation of benefits during life can be described as following a "not too early, not too late" pattern. Congress seeks to ensure that participants and their beneficiaries receive benefits in a way that provides a retirement income during the full duration of their "retirement years," rather than receiving the amounts too early or too late in life. Indeed, Congress especially wants to ensure that, in normal cases, the benefits are paid to the participant rather than left to accumulate tax free for disposition to future generations (or left to increase through tax free investment of a fund that is unreduced by income taxes on investment gains).

The "required distribution" rules in §§401(a)(9), 408(a)(6), 408(b)(13), and Treas. Reg. §§1.401(a)(9)-1 and 1.408-8 A-1 impose conditions for qualified plan status that require distributions to begin by a certain time and to be made within certain periods. This "not too late" aspect is enforced by means of a §4974(a) penalty tax of 50% on the amount of any deficiency in meeting these minimum distribution standards. This penalty makes it too expensive for the participant or beneficiary who should receive distributions to leave amounts in a plan and avoid taking them into income as required.

Distributions must begin no later than April 1 of the calendar year in which the participant reaches 71½ years of age or retires, whichever is later.[10] Let's ignore a late retirement for now: most folks will be retired by

10. §401(a)(9)(C); Treas. Reg. §1.401(a)(9)-2 A-2. Technically, the rule as written is that distributions must begin no later than April 1 of the calendar year following the year in which the participant reached 70½ years of age. The "later of" retirement aspect of the rule

the age of 70 if they work for someone else. Because a payment is required for the year the participant reached the age of 70½ and another is required for the year the participant reaches the age of 71½, waiting to make the first distribution until April 1 of that latter year will result in a bunching of two installments in one year. Treas. Reg. §1.401(a)(9)-5 A-1(b). Delay also leaves a larger amount in the plan as of the end of the first year, with the result that a larger amount must be distributed for the second year than if the first year distribution was made in the first year, before calculating the second year required distribution. Thus, many individuals will elect to start receiving distributions in the calendar year in which they reach 70½ years of age.

For many participants payments will begin years before that, due to the §401(a)(14) default distribution rules that apply unless the participant affirmatively elects to defer distributions. There is no exception to the first payment date and no penalty tax as the price for missing it: it *must* be met. There are no options. The first payment date is coupled with a 10% penalty that applies if distributions begin before age 59½ (the §72(t) "not too soon" aspect, which applies unless distribution is on account of death, disability, separation from service, other hardships, or as a life annuity). Thus, the "window" of time during which distributions must begin is approximately 12 years (unless the participant is still working after age 71½).

These rules are important to estate planners because, once payments begin, the benefit must be paid in certain minimum annual amounts. The longer the delay in beginning distribution, the larger the amounts must be to avoid the minimum distribution penalty. This will have a carryover effect on distributions received after death, as noted below.

Benefits paid during a participant's life must be paid over one of the following periods: (1) the life of the participant, (2) a term certain that does not exceed the actuarial life expectancy of the participant, (3) the joint lives of the participant and a designated beneficiary, or (4) a term certain that does not exceed the actuarial life expectancy of the participant and a designated beneficiary. §401(a)(9)(A)(ii); Treas. Reg. §§1.401(a)(9)-2 A-1 and 1.401(a)(9)-5 A-4.

The life expectancy of the participant is redetermined on an annual basis. The same is true of the participant's spouse, but only if the spouse is more than 10 years younger than the participant (a "young spouse").[11]

---

does not apply if the participant is a 5% owner of the employer. In addition, the plan may not reflect the "later of" aspect to permit deferral beyond age 70½. Nor does the "later of" rule apply to IRA owners. See Treas. Reg. §1.408-8 A-3. As a result, a participant who is not a 5% owner might have different required beginning dates for IRA distributions and various qualified plans.

11. Treas. Reg. §1.401(a)(9)-5 A-4(b), using joint life tables in Treas. Reg. §1.72-9 Table VI. In this case the joint life expectancy of the participant and the young spouse is used to determine the inter vivos minimum required distribution. This is not elective (notwithstanding that the preamble to the proposed regulations described it as an option),

Otherwise, during the participant's life the life expectancy of any other designated beneficiary is irrelevant in establishing the minimum distribution amount payable during the participant's life: the minimum distribution table applicable during the participant's life is constructed using the life expectancy of the participant and a hypothetical beneficiary always deemed to be 10 years younger than the participant.[12]

Because life expectancy increases as an individual grows older (for example, your chances of reaching 100 are a lot better if you're already 99), automatic redetermination of the participant's life expectancy (and any applicable young spouse redetermination) minimizes the amount of each year's distribution and defers the payout as long as possible, thereby minimizing exposure to the regular income tax. In an age of reduced income tax brackets, this recalculation and deferral does not generate much income tax saving, and making most of these rules automatic eliminates the need to constantly recalculate and consider the benefits of redetermination.

Under these rules, the designated beneficiary alternatives if §401(a)(9)(A)(ii) present the opportunity to select a long-term payout, but typically only if the designated beneficiary is a child or a more remote descendant. This option may allow for significant reductions in the overall income tax cost of the distributions. To prevent an excessive amount of such deferral, however, distributions to a designated beneficiary must be "incidental" to payments to the participant, meaning that the present value of the benefit payable to the participant (and the participant's spouse) must be worth at least 50% of the participant's interest in the plan.[13]

The real significance of the income tax distribution rules for estate planning purposes lies in §401(a)(9)(B), which applies if the participant

---

but the minimum distribution rules always permit taking more than the minimum required amount if the participant wants a larger payout as if the otherwise standard rule applied. This one exception to the otherwise normal rule that the designated beneficiary's life expectancy does not matter is applied annually. Thus, the participant is thrown back into the default rule if the young spouse dies (or there is a divorce), and a participant who marries a young spouse during the year can change the next year's required minimum distribution.

12. See the Uniform Lifetime Table in Treas. Reg. §§1.401(a)(9)-5 A-4 and 1.401(a)(9)-9 A-2, which do not articulate this notion, but the latter reveals it upon careful inspection and comparison to traditional one life tables. Treas. Reg. §1.72-9 Table VI shows the source of the two life expectancy, in each case assuming the 10 year differential in ages as the source of the Uniform Lifetime Table. This rule explains why designating a beneficiary before the participant dies is not necessary, and the designated beneficiary may change up until the end of September of the first year following the year of the participant's death. Thus, for example, a postmortem beneficiary need not be designated by the required beginning date. Moreover, assuming the plan permits, the participant may change the designated beneficiary after the required beginning date, without altering the required minimum distribution. Indeed, the designated beneficiary might be subject to change postmortem (for example, by distribution—such as to pay out a charitable benefit that might alter the designated beneficiary minimum distribution calculation—or by disclaimer) until the end of September of the first year after the year of the participant's death. Treas. Reg. §1.401(a)(9)-4 A-4(a).

13. Rev. Rul. 74-359, Rev. Rul. 74-325, and Rev. Rul. 72-241.

dies before the entire interest is distributed.[14] If distributions had begun before death, then the stated rule is that the entire benefit must be distributed after death at least as rapidly as under the distribution program that was begun during life. §401(a)(9)(B)(i). The logic for this requirement is found in the annuity income tax rules of §72(s)(1)(A), which imposes the same requirement for any garden-variety annuity when the owner dies.

If distributions had *not* begun before the participant's death, then by statute the entire interest must be distributed before the sixth New Year after the participant's death. §401(a)(9)(B)(ii).

The first exception applies if payments begin within one year after the participant's death. In this case the participant may elect a benefit payable over the life expectancy of a designated beneficiary or a term certain that does not exceed the actuarial life expectancy of the designated beneficiary. §401(a)(9)(B)(iii). See the analogous annuity income tax rule in §72(s)(2). "Designated beneficiary" means any individual, so distribution to the participant's estate would preclude application of this exception. §401(a)(9)(E); Treas. Reg. §1.401(a)(9)-4 A-3. No definitive authority appears to exist, but knowledgeable commentators have represented privately that a trust making the §645 election to be treated as part of the decedent's estate will *not* be regarded as an estate for purposes of this rule.

In that regard, a trust may be a designated beneficiary if:

- The trust is valid under state law (or would be but for the fact that it does not yet own any corpus, including a testamentary trust notwithstanding the technicality that it too cannot exist until the testator's will is probated postmortem).
- All trust beneficiaries who can conceivably enjoy plan benefits are individuals (that is, none are charities or estates, including indirect enjoyment by payment of estate debts, expenses, or taxes).
- Those beneficiaries are identifiable from the terms of the trust instrument, which is irrevocable and unamendable at the participant's death.[15]

14. See also §408(a)(6), which provides that IRA distributions must follow the same rules as those imposed by §401(a)(9) for qualified plans. In that regard, in some cases it will prove desirable that Private Letter Ruling 9416037, referencing Notice 88-38, held that one IRA may make total annual distributions based on the minimum distributions required of all the taxpayer's IRAs and satisfy this requirement. Treas. Reg. §1.408-8 A-9 limits this opportunity by precluding aggregation of multiple IRAs created by different grantors, but multiple IRAs created by the same person (the recipient personally or the same third party for the recipient) may benefit from aggregation and then selective distribution.

15. It is unknown whether the ability to add beneficiaries by adoption or exercise of a power of appointment will defeat designated beneficiary status. It ought to be adequate to proscribe addition of any beneficiary who would alter the identity of the oldest beneficiary because it is the shortest life expectancy among all beneficiaries that is used to compute the distributions. Uncertainty exists because Prop. Treas. Reg. §1.401(a)(9)-5 A-7(d) seemingly permitted a beneficiary to possess a testamentary power over the balance of a beneficiary's entitlement, and that example was deleted without explanation when the final regulations were adopted.

- A copy of the trust, or a list of the trust beneficiaries (and a copy of the trust instrument itself, if requested), is put on file with the plan administrator before the end of October of the first year following the participant's death.

Treas. Reg. §§1.401(a)(9)-4 A-5(b) and 1.401(a)(9)-4 A-6(b). The trust beneficiaries will be treated as the designated beneficiaries if these requirements are met and the beneficiary with the shortest life expectancy is used to determine the payout period. Treas. Reg. §1.401(a)(9)-5 A-7(a).

Applying these rules under the §401(a)(9) regulations produces the following principles that govern postmortem distributions (to the extent not otherwise precluded by the terms of the plan itself):

- If there is a designated beneficiary, payments postmortem must be made over that designated beneficiary's life expectancy, regardless of whether the participant died before or after the required beginning date (subject to special rules if the beneficiary is a spouse, an entity, or multiple individuals). The life expectancy of a designated beneficiary other than the participant's surviving spouse is determined in the year following the year of the participant's death and thereafter is reduced by one for each subsequent year (notwithstanding that true life expectancy does not decline by a full year for each added year of life). Treas. Reg. §1.401(a)(9)-5 A-5. On the other hand, if the participant's spouse is the sole beneficiary, the life expectancy of the participant's surviving spouse actually is determined annually, meaning that the benefits cannot pay out sooner than the spouse's actual death. Treas. Reg. §1.401(a)(9)-5 A-5(c)(2).
- If there are multiple individual beneficiaries after the participant's death, the life expectancy used is that of the oldest of them (creating the shortest payout period). As a result, postmortem severance into separate accounts or shares may be desirable, so that each beneficiary's share is distributed on the basis of just that one beneficiary's life expectancy (or to create opportunities that otherwise might not exist, as for example if one of several beneficiaries is the participant's surviving spouse). Treas. Reg. §§1.401(a)(9)-5 A-7(a) and 1.401(a)(9)-8 A-2(a)(2). Special care is required to consider the operation of "contingent" and "successor" beneficiary rules, including the effect of permissible appointees under powers of appointment, under the circumstances of each trust beneficiary.
- If the participant dies *after* the required beginning date and there is no designated beneficiary for postmortem distribution, then distributions will continue over the participant's remaining life expectancy, determined immediately before the participant's death. Treas. Reg. §§1.401(a)(9)-2 A-5 and 1.401(a)(9)-5 A-5(a)(2).

- The five year payout rule of §401(a)(9)(B)(ii) applies postmortem only if the participant dies *before* the required beginning date *and* there is *no* designated beneficiary before the second New Year after the participant's death. Treas. Reg. §1.401(a)(9)-3 A-1(a).
- If any beneficiary is not an individual (such as a charity or a fiduciary entity), the account is deemed to have *no* designated beneficiary and these rules apply according to whether the participant died before or after the required beginning date. Treas. Reg. §§1.401(a)(9)-3 A-4(a)(2), 1.401(a)(9)-4 A-3, and 1.401(a)(9)-8 A-11.
- Trust beneficiaries may be considered when determining the minimum required distribution, provided that documentation on the trust is provided by the end of October of the first year following the year of the participant's death. Testamentary trusts qualify the same as inter vivos trusts. Treas. Reg. §1.401(a)(9)-4 A-5.

The facts of Rev. Rul. 2000-2 may be useful in regard to all of these requirements. They state that the decedent was not yet in pay status under an IRA, making §401(a)(9)(B)(ii) and the exception to it in §401(a)(9)(B)(iii) relevant. The beneficiary designation under the IRA was the decedent's testamentary QTIP trust. The Ruling states that a copy of the trust and a list of the trust beneficiaries were delivered to the IRA Administrator within nine months after the decedent's death, and those facts alone apparently support the Ruling's conclusion that the surviving spouse (as the oldest trust beneficiary) was the designated beneficiary whose life expectancy would be used as the payment period under the IRA for minimum annual distribution purposes. Any undistributed IRA balance would be distributed to the QTIP trust after the surviving spouse's death, according to the Ruling, "over the remaining distribution period." Based on these facts, the Ruling concluded that the testamentary trust qualified the surviving spouse as a designated beneficiary under §401(a)(9)(B)(iii)(I), which is significant in its own right.

A second entirely separate exception applies if the designated beneficiary is the participant's surviving spouse. In that case payments may be deferred to begin no later than when the participant (not the spouse) would have reached 70½ years of age, and may extend for the life expectancy of the spouse or a term certain that does not exceed the life expectancy of the spouse. §401(a)(9)(B)(iv); Treas. Reg. §1.401(a)(9)-3 A-3(b)(2). See the annuity income tax analogue in §72(s)(3). Further, if the surviving spouse also dies before distributions begin, then the benefits must be paid following the spouse's death according to the foregoing rules, as if the spouse were the participant. Treas. Reg. §1.401(a)(9)-3 A-5.

As a planning matter, instead of electing such deferral, some advisors recommend that the surviving spouse accelerate distributions before death to incur any remaining income tax liability during life, thereby reducing the surviving spouse's estate for estate tax purposes. See Treas. Reg.

§20.2053-6(f) (no estate tax deduction is allowable for any built-in income tax liability that was not incurred before death and is not paid during administration of the decedent's estate).

A final alternative, often producing a better result, is for the surviving spouse to receive a lump sum (if this is available under the plan) and roll it over to an IRA of the spouse's creation. See page 18. Given the complexity of the minimum distribution and the minimum distribution incidental benefit rules with respect to trusts as beneficiaries, designation of the participant's spouse as the direct beneficiary who may take a lump sum and roll over the distribution or elect to receive the benefits in installments often is the option of choice if the participant is not intent on denying control to the spouse.

Income Tax Consequence of Distributions

The assumed or default income tax treatment of distributions to participants and their beneficiaries is as an annuity, with income tax imposed under §72. See §§402(a) and 408(d)(1). In a nutshell, §72 provides that annuities held by a natural person (or by an entity acting as agent for a natural person, or by an estate that acquired the annuities by reason of a natural person's death) qualify for deferral treatment. Annuity treatment would be unavailable by virtue of §72(u)(1) without an "agent for a natural person" status.

Without annuity taxation, income under an annuity contract is subject to annual inclusion (as ordinary income) as income accrues on the contract, not as deferred payments are made. §72(u)(1)(B). With annuity treatment income taxation is deferred until each payment is made. Every distribution is taxable as ordinary income, subject to exclusion of a portion that represents the participant's after-tax investment in the plan (including employer contributions that were taxable to the employee when made). Usually there is no excluded amount, but if there is it is recovered as a pro rata portion of each annuity payment. Under §72(b) this exclusion from income is limited to any unrecovered investment in the contract, so all payments are entirely taxable as ordinary income once the participant's total investment has been recovered in the form of these excluded pro rata portions of each annual payment.[16]

The fundamental alternative to annuity treatment is lump sum distribution of the participant's entire remaining interest in the plan, with

16. A deduction is available on the participant's final income tax return for any unrecovered investment if payments cease with the participant's death before recovery of the participant's entire investment. §72(b)(3). Curiously, §72(b)(3)(A) authorizes this deduction only if the participant dies after the annuity starting date, which appears to mean that death before then would not provide a deduction for any basis in the plan. That result seems counterintuitive unless there is a death benefit that pays that investment in the contract and therefore there is no loss to be deducted. See St. Laurent, *Estate Planning with Tax-Deferred Annuities—Special Problems Under Section* 72, 21 EST., GIFTS & TRUSTS J. 234, 236 (1996).

payment being made within a single taxable year of the participant or designated beneficiary. §402(d)(4)(A). Not all plans permit a lump sum distribution, and not all participants (or their designated beneficiaries) will qualify. The most important requirements are a length of service threshold of at least five years for distributions to a living participant and distributions that must be triggered by certain qualifying events (the participant's attainment of age 59½, death, separation from service, or disability). §§402(d)(4)(A) and (F). In addition, lump sum treatment must be elected with respect to all distributions in the same taxable year and is a once in a lifetime opportunity after the participant reaches the age of 59½. §402(d)(4)(B). Did you get all that? This is a tad complicated!

Spousal Rollover

The lump sum election is available as an alternative to annuity tax treatment for either the participant or the designated beneficiary. In addition, rollover elections are available to the participant during life, and to the participant's surviving spouse (but no one else) as a designated beneficiary after the participant's death. §§402(c)(1), (c)(5), and (c)(9). The rollover election permits the recipient (participant or spouse) to place a portion or all of a distribution in another eligible tax deferred plan, with the advantage of deferral of all income tax on the benefit itself and on any internal build up in the receptacle plan until distribution. Technical rules deal with partial rollover elections, the time within which rollovers must be made, the amount (both maximum and minimum) that may be rolled over, and the types of benefits that may be rolled over. See §§402(c) and 408(d)(3).

With respect to a participant's IRA, a surviving spouse may effect a rollover of that IRA merely by redesignating the IRA in the spouse's name as *owner* instead of as beneficiary. Treas. Reg. §1.408-8 A-5. Ostensibly, an IRA rollover by a surviving spouse is permitted only if the spouse is the sole beneficiary of the IRA and has an unlimited right to withdraw funds from the IRA. This requirement is not met if the spouse is the beneficiary of a *trust* that is the beneficiary of the IRA, even if the spouse is the *only* beneficiary of that trust. Treas. Reg. §1.408-8 A-5. See Choate, LIFE AND DEATH PLANNING FOR RETIREMENT BENEFITS ¶3.2.09 (5th ed. 2003), and Choate, *When a "Trust For The Spouse" Is Treated The Same As "The Spouse,"* 140 TRUSTS & ESTATES 36 (Sept. 2001). These seemingly clear rules are not crystal if the beneficiary is a marital deduction trust for the benefit of the participant's spouse. The issue turns on the meaning of "designated beneficiary" under §401(a)(9)(E), and developments regarding spousal rollover elections provide only helpful clues to the proper resolution of these rules.

A study of various ruling results leads to the conclusion that the important designated beneficiary factor is whether the spouse can unilaterally cause or control distribution of the qualified plan or IRA.

There have been dozens of such rulings; the following discussion is meant to be illustrative, not exhaustive. For example, Private Letter Ruling 9509028 allowed a §402 spousal rollover of qualified plan proceeds to a §402(c)(9) spousal rollover IRA, because the qualified plan distribution was to a marital deduction trust over which the spouse had a full withdrawal power. And Private Letter Ruling 9451059 allowed §§402(c)(9) qualified plan and 408(d)(3) IRA rollovers by the surviving spouse because both forms of benefits were payable to a §2056(b)(5) marital deduction trust over which the surviving spouse had an inter vivos power of withdrawal.[17]

A convoluted pathway to the surviving spouse was involved in Private Letter Ruling 9450041. The surviving spouse made a nonqualified disclaimer of qualified plan proceeds from a trust that was the designated beneficiary, causing the proceeds to become payable to a second trust. The beneficiaries of that second trust then made a qualified disclaimer of the proceeds (a new nine-month disclaimer period began to run when the spouse made the nonqualified disclaimer), which caused the proceeds to become payable to the decedent's estate, from which they passed by intestacy to the surviving spouse outright.

Because the second disclaimer was qualified and therefore did not attract gift taxation, the government determined that the net result was that the proceeds passed from the decedent's plan to the surviving spouse. This distribution qualified for the estate tax marital deduction and also made possible a §402(c)(9) rollover election by the surviving spouse, all as if the intermediate disclaimer steps had not been necessary. Therefore, the passage of the distribution was regarded as direct, not as if the property had passed into one trust, then another, then to the decedent's estate, and finally to the surviving spouse. Private Letter Ruling 9450042 reached the same result with respect to the decedent's IRA that went directly to the decedent's estate and then to the surviving spouse. In this case the government held a §408(d)(3) rollover was permissible by virtue of its contingent beneficiary provision.

17. In this case the Ruling noted that the spouse was a cotrustee of the trust, had a power to remove the other cotrustee, and was the controlling cotrustee in the case of a tie vote. Other Rulings also indicate that control as trustee may be essential. See, e.g., Private Letter Rulings 199925033 and 9820020, in which payment was to the decedent's inter vivos trust, as to which the spouse was trustee with the authority to allocate the proceeds to a community property survivor's subtrust or to a marital deduction subtrust over which the spouse had a power of withdrawal, 9633043 and 9426049, in which the spouse could remove the trustee and become the sole or the controlling trustee, 200011062, in which an IRA was payable to a trust as to which the spouse had a full withdrawal power *and* was trustee, 200208030 (same), which involved discretion in funding a fractional marital bequest to the trust and the balance of the qualified plan went to a bypass trust and was deemed to have a valid designated beneficiary with payout over the life of the spouse as the oldest beneficiary of that trust, and 9813018, in which payment to a trust and distribution to the spouse qualified for rollover because the spouse was the trustee. In Private Letter Ruling 9303031 the spouse was not in control and the rollover was denied. In each of these cases the inter vivos power of withdrawal appears to be the key.

Two other Rulings also permitted a tax free rollover. In Private Letter Ruling 9524020 the surviving spouse elected against the decedent's will in favor of a statutory share of the decedent's estate. Exercising a state law right to select the assets in the decedent's estate that would satisfy that elective share, the surviving spouse obtained a portion of qualified plan proceeds, which were payable to the decedent's estate as the designated beneficiary. In Private Letter Ruling 9626049 the surviving spouse and all descendants of the decedent disclaimed a fraction of the decedent's estate, causing an intestacy that the spouse was entitled to receive, and the decedent's personal representative funded that fractional entitlement with the decedent's IRAs. In both of these cases, the government ruled that these payments constituted distributions directly to the spouse and not to the estate and then to the spouse, thus permitting a tax free §402(c)(9) rollover to an IRA created by the spouse.

In Private Letter Ruling 9445029, however, the decedent's estate was the designated beneficiary of an IRA. The estate poured over to a marital deduction trust, over which the trustee proposed to exercise discretion to distribute the IRA to the decedent's surviving spouse, who then would roll the distribution over to an IRA of the spouse's creation. The government held that the rollover would not qualify under §408(d)(3) as a rollover distribution that would avoid income taxation. The Ruling gave three reasons for stating that "we do not believe it is appropriate to treat [the spouse] as the distributee of [the decedent's IRA] for purposes of section 408[(d)(3)(C)(ii)(II)]." First, the spouse was not the personal representative of the decedent's estate; second, the spouse was not treated as the owner of the marital deduction trust under §678 for income tax purposes; and third, the marital deduction trustee had unlimited discretion whether to distribute the distribution amount to the surviving spouse.

Spousal Annuity Rules

For estate planners, probably the single most significant development in the retirement benefits arena was adoption by the Retirement Equity Act of 1984 of the spousal annuity requirements of §401(a)(11). These requirements apply to all qualified defined benefit and defined contribution plans (but not to IRAs) if the participant was married for at least one year prior to the earlier of the annuity starting date or the participant's death. The plan must pay an annuity (which is taxable under §72) that is either a "qualified joint and survivor" annuity if the participant dies after the annuity starting date or a "qualified preretirement survivor" annuity if the participant dies before the annuity starting date.

A qualified joint and survivor annuity must be payable for the life of the participant and thereafter for the life of the participant's surviving spouse. §417(b). The survivorship annuity must be worth no less than 50% of the value of the joint annuity that was payable during the joint lives of the participant and the spouse (and no more than 100% of the value of that joint life annuity). Further, the combined joint and survivor annuities must be worth the actuarial equivalent of a single life annuity for the participant alone under the terms of the qualified plan.

A qualified preretirement survivor annuity is payable for the life of the participant's surviving spouse. §417(c). In a defined contribution plan, it must be worth at least 50% of the participant's account balance at death. In a defined benefit plan, the annuity must be the actuarial equivalent of the survivor annuity that would be payable under a qualified joint and survivor annuity if the participant had retired immediately before death or, if not then entitled to retire, on the earliest possible date when the participant could have retired. See §417(c)(1)(A).

It is notable that the qualified preretirement survivor annuity is not the actuarial equivalent of the benefit that would be available if the participant had survived to the annuity starting date and a qualified joint and survivor annuity had become payable. An unanswered question is whether the difference between the participant's account balance and the value of this qualified preretirement survivor annuity is forfeited, or whether it is subject to disposition by the participant in some other manner.

Knowledgeable pension specialists indicate that this issue is not resolved in most plans, although some major plans specify that the excess is forfeited (meaning the plan, rather than the participant's beneficiaries, picks up the excess). In any plan the normal rule is that, absent an effective beneficiary designation, the provisions of the plan will govern disposition of this amount rather than this amount passing under state intestacy laws. See MacLean v. Ford Motor Co., 831 F.2d 723 (7th Cir. 1987). So the participant's beneficiary designation should attempt to dispose of this excess, if possible.

A plan is exempt from the spousal annuity requirements if (1) the plan is not a defined benefit plan, a defined contribution plan, or a direct transferee of either (for example, the plan is an IRA,[18] a simplified employee pension, a §403(b) salary reduction agreement, an ESOP, a Keogh plan, or a profit-sharing plan during the participant's life), or (2) the participant's nonforfeitable accrued benefit is payable in full to the surviving spouse on the participant's death and the participant did not elect payments in a life annuity format. §401(a)(11)(B)(iii).

A plan also is exempt from the spousal annuity requirements if the participant's spouse waives the right to the annuity by consenting to the participant's designation of some other beneficiary. Temp. Treas. Reg. §1.401(a)-11(c) establishes how the consent must be documented, and §417(a)(6) establishes the timing requirements for an effective waiver and consent. For example, the consent may (but need not) be irrevocable (even though the plan cannot deny the right to revoke a consent). It also is

18. As a consequence, spousal consent is required before a participant may roll over to an IRA. Temp. Treas. Reg. §1.401(a)(31)-1 Q&A 14.

permissible for the participant to revoke a spousal consent. But under Treas. Reg. §1.401(a)-20 Q&A 28 the Internal Revenue Service will not recognize prenuptial agreements as a valid spousal consent, and there is little doubt that this is a permissible position.[19]

In addition, waiver of the qualified joint and survivor annuity must occur within 90 days before the required beginning date. §§417(a)(1)(A); 417(a)(6)(A). The spouse must be informed about the participant's beneficiary designation, and that designation cannot be altered without the further consent of the spouse unless the original spousal consent expressly gave the participant the right to make changes in the future without the spouse's consent. §417(a)(2)(A)(ii). Except with respect to a spouse's community property interest (due to gift tax complications), it probably is wise to obtain a consent that allows alterations by the participant without renewed consent from the spouse. See generally Treas. Reg. §1.401(a)-20 Q&A 30 et seq. with respect to the waiver and consent requirements.

Finally, a spousal consent does not mean that the spouse cannot be a designated beneficiary under the plan. Indeed, it is likely that many spousal consents will be made to permit elections other than annuities, with the spouse or a marital deduction trust as a lump sum beneficiary of the plan.

Planning Issues Relating to Designating Beneficiaries

Planning for retirement benefits may require the estate planner to become involved before the participant retires, at the time of retirement, or after the participant's death. Without question the latter is most common, although decisions made inter vivos in designating the beneficiary and in selecting a retirement payout will affect the income tax and other consequences after death. Whenever the planner gets involved, the first order of business should be to consult the plan documents to determine what options are available.

Invariably, retirement benefits are income in respect of a decedent, meaning that §1014(c) denies a basis adjustment and, in most cases, the basis of the benefit payout is zero. Thus, income tax must be paid on the amounts as they are received. An anticipated application of §1022 carryover basis (if the estate tax is repealed) will not alter this. Until repeal of the estate tax the question will remain whether the benefits should be

19. Notwithstanding Uniform Premarital Agreement Act §3, 9C U.L.A. 43 (2001), which authorizes the beneficiary of a retirement plan to relinquish any interest through a prenuptial agreement, according to Treas. Reg. §1.401(a)-20 Q&A 28 the spousal waiver and consent cannot be given until the participant is married; a prenuptial agreement is not effective to make the waiver. See Hurwitz v. Sher, 789 F. Supp. 134 (S.D. N.Y. 1992), aff'd, 982 F.2d 778 (2d Cir. 1992); Callahan v. Hutsell, Callahan & Buchino Revised Profit Sharing Plan, 1992 U.S. Dist. LEXIS 20773 and 813 F. Supp. 541 (W.D. Ky. 1992) (separate opinions); Zinn v. Donaldson Co. Salaried Employees Retirement Savings Plan, 799 F. Supp. 69 (D. Minn. 1992).

paid to a marital deduction trust or to a nonmarital trust. Relevant to this inquiry is whether it would be desirable to waste the marital fund with the income tax that will be payable on the benefits as received. Another option may be to use this wealth to fund a charitable gift, because the income tax imposed on that recipient is a better result than imposing it on any other beneficiary of the participant. Further, control issues and the availability of other assets to allocate to the nonmarital trust should inform these decisions.

Also relevant is the frequently unanswered question whether retirement benefits are allocable to income or principal for state fiduciary accounting purposes.[20] This issue in particular is too often overlooked; state law and the terms of the document must be considered before concluding that the appropriate treatment is clear.

Another serious issue is how wealth transfer taxes attributable to the benefits will be paid. In most situations liquidity is a serious issue with respect to retirement benefits, to the extent they are includible in an estate and do not qualify for the marital deduction. This concern is magnified if the benefits are not paid in a lump sum. In this case that means payable in one taxable year of the recipient on account of the participant's death. See §402(d)(4)(A). This may be a double-edged issue if community property ownership rights of the participant's spouse are involved. In addition, payment in a lump sum may generate an immediate income tax that otherwise could be deferred. This is the price to be paid for liquidity.

The most important question, however, is who should be the designated beneficiary and how should the designated beneficiary receive the distribution: in annuity form, as a lump sum distribution, or (if the participant's surviving spouse is beneficiary) as a rollover distribution. Factors to be considered in determining the form of distribution include:

- Expected income and estate tax rates;
- Expected return on the dollars received and whether a tax free build up in a rollover receptacle or in an annuity is desirable;

20. For example, Revised Uniform Principal and Income Act (1962 Act) §11, 7B U.L.A. 228 (2000), provides that principal consists of the "rights to receive payments on a contract for deferred compensation" and also provides that receipts not in excess of 5% of inventory value are income and the balance is principal. But §4 of the Act, applicable only to estates, also provides that periodic payments, including annuities, are allocable to principal to the extent accrued before death, with the portion accrued postmortem allocable to income. Further, §13(a)(6) charges income taxes on such receipts to income, although §13(c)(4) provides that income taxes incurred under §691 as income in respect of a decedent are a charge to principal to the extent the payments are allocable to principal. Analogous provisions in the Uniform Principal and Income Act (1997 Act), 7B U.L.A. 170, 184, 187 (2000), include §§409(c) (required periodic distributions such as under the minimum distribution rules are allocable 10% to income, the balance to principal; lump sum and other payments are allocable entirely to principal), 409(d) (allocating additional amounts to income as required for marital deduction qualification purposes), 502(a)(6) (charging transfer taxes to principal), and 505 (charging income taxes proportionately as the receipts are allocated).

- Life expectancy of a designated life annuitant as beneficiary or the term certain over which the benefit would be received as an annuity;
- *Liquidity*: will the funds be needed to pay taxes or otherwise, making a lump sum distribution essential (assuming it is allowable under the terms of the plan);
- The desired degree of control and investment flexibility (an annuity gives little, a rollover gives more, but a lump sum payment gives the most);
- Whether a rollover distribution is more important than restrictions on control over the property;
- Whether control exercised to make inter vivos gifts will produce more wealth for the objects of the participant's bounty than income tax deferral will produce (often the gift alternative is preferable notwithstanding the income tax cost of withdrawals to provide the necessary funds); and
- Whether a spousal consent to any beneficiary designation will be problematic.

Given the amount of uncertainty that can surround the selection of a beneficiary and payout option, many planners recommend that the beneficiary designation be structured so that disclaimers can be made to move the property through a succession of intended beneficiaries. For example, the beneficiary designation might be structured to pay an annuity or a lump sum first outright to the participant's surviving spouse (who, among other factors to recommend this approach, is the only beneficiary who can roll over to an IRA to further defer income tax), second to the participant's marital deduction trust (if any),[21] third to a nonmarital trust, then outright to the participant's surviving descendants and, finally, if all else fails, to the participant's estate, all by default or disclaimers at each higher beneficiary designation level. Moreover, added thought by the estate planner will be required to coordinate income tax elections and liquidity concerns if multiple beneficiaries may be selected.[22]

In any trust, a provision should specify that amounts received that are exempt from federal wealth transfer tax (either because the benefits are

---

21. Alternatively to a bypass trust that is capable of being elected as qualified terminable interest property. It is notable that wasting some unified credit may be a preferable result if it permits the surviving spouse to make an IRA rollover election to defer income taxes, especially if coupled with a gifting program conducted by the surviving spouse postmortem.

22. See Private Letter Ruling 9630034 for a road map of a cascading disclaimer beneficiary designation, and Keydel & Wallace, *The Revocable Trust—Disclaimer Method for Integrating Qualified Plan & IRA Benefits into an Estate Plan*, 13 PROB. NOTES 158 (1987), recommending a slightly different order of priorities and containing sample forms. By Private Letter Rulings 9319029, 9303027, and 9037048, the government deems §2518 qualification as a disclaimer for wealth transfer tax purposes as adequate for income tax purposes as well, to preclude the disclaimant from having to report income under §§691, 402(a), and 408(d)(1), respectively, and instead for the person taking by virtue of the disclaimer to be regarded as the proper income taxpayer.

chronologically exempt from repeal of the former estate tax exclusions for retirement benefits or because the unified credit is adequate to shelter this property) are to be allocated to the nonmarital trust to preserve the benefit of that exclusion. Another provision should specify how items of income in respect of a decedent should be allocated between marital and nonmarital trusts to prevent an acceleration of the income tax liability under §691(a)(2). And the trustees of each potential recipient should have the express authority to make disclaimers to permit the benefits to pass down the line of beneficiaries.

Marital deduction qualification of benefits payable in installments (to any trust other than an estate trust) requires that the surviving spouse be entitled to all income generated by the plan or account annually. §§2056(b)(5) and (b)(7)(B)(i)(II). If this income amount exceeds the minimum distribution amount for the year, the government requires either that the spouse have a power to demand, or that the trust itself requires, that the trustee make a withdrawal from the account or plan equal to that excess of the annual income generated by the plan or account over the minimum distribution amount. Treas. Reg. §20.2056(b)-7(h) Example 10 and Rev. Rul. 2000-2. It is too early to know whether the §643(b) income definition rules and their 3% to 5% unitrust safe harbor income equivalence rule might affect any of this. See Chapter 7 at page 72.

Alternatively, as discussed in Chapter 7 at page 88, the trustee could simply distribute corpus of the marital deduction trust equal to the amount of that income in the plan or account, which may permit a longer deferral of distributions from the plan (but also may be inconsistent with the decedent's desire to deny control over the trust to the surviving spouse). Unfortunately, marital deduction qualification requires no less. Congress granted §2056(b)(7)(C) automatic QTIP qualification to a spousal annuity payable *outright* to the participant's surviving spouse, which is just one of several reasons why outright distribution is a preferable approach.

If it is not essential that the full value of the participant's account balance qualify for the marital deduction, a partial QTIP election might be permissible for only the amount of corpus deemed necessary to produce the annuity payments guaranteed to the marital deduction trust or directly to the surviving spouse annually. Treas. Reg. §20.2056(b)-7(e)(2). See Technical Advice Memorandum 8446006. Based on the applicable valuation tables, this amount may not be as great as the amount includible in the decedent's gross estate under §2039 (but conceivably it could exceed that amount, in which case the marital deduction would be limited to the amount includible in the participant's gross estate).

As a practical matter, however, outright distribution to the participant's surviving spouse is the easiest approach and raises the fewest qualification issues. It allows the surviving spouse to select whether to receive an annuity, or a lump sum distribution, or to roll the distribution over for maximum income tax deferral. It allows annual redetermination of life expectancy, it avoids fiduciary liability relating to selecting among payout options or making disclaimers or other tax elections, and the income tax liability inherent in the distributions will reduce the amount taxable in the surviving spouse's estate at death. Most importantly, the spousal annuity consent that is needed to deviate from the annuity approach is not likely to raise objections from the surviving spouse. Considering all these factors, any other beneficiary designation should be made only after the most careful deliberation.