Lifetime Distribution Strategies for Your Client's Retirement Benefits

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Natalie B. Choate, Esq.
Nutter McClennen & Fish LLP/ Boston, Massachusetts
www.ataxplan.com

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Natalie B. Choate is an estate planning lawyer in Boston with the firm of Nutter, McClennen, & Fish, LLP. She is the author of two books, *Life and Death Planning for Retirement Benefits* and *The QPRT Manual*, both published by Ataxplan Publications (www.ataxplan.com). She is a former chair of both the Estate Planning and the Employee Benefits Committees of the Boston Bar Association; and a fellow, former Regent, and former chair of the Employee Benefits Committee, of the American College of Trust and Estate Counsel. Named "Estate Planner of the Year" by the Boston Estate Planning Council, she was awarded the "Distinguished Accredited Estate Planner" designation by the National Association of Estate Planners and Councils. She is listed in *The Best Lawyers in America*, and is an editorial advisor to *Trusts and Estates*, as well as a frequent lecturer and author on estate planning topics. She writes a monthly column for MorningstarAdvisor.com. Her comments on estate and retirement planning have been quoted in *The Wall Street Journal*, *Money*, the *New York Times*, and *Forbes*. A graduate of Radcliffe College and Harvard Law School, Natalie lives in Wellesley, Massachusetts.

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GETTING STARTED: HELPFUL INFO FOR UNDERSTANDING THIS OUTLINE

1. List of abbreviations and symbols used in this Report

§	The symbol "§" refers to a section of the Code unless otherwise indicated.
¶	The symbol "¶" refers to a section of the book *Life and Death Planning for Retirement Benefits* by Natalie B. Choate; see "Resources" below. Referenced sections may or may not be reproduced in this Outline.
AMT	Alternative minimum tax. § 55.
Code	Internal Revenue Code of 1986, as amended through June 2018.
COLA	Cost of living adjustment.
CRT	Charitable remainder trust.
CSV	Cash surrender value.
DOL	Department of Labor.
ERISA	The Employee Retirement Income Security Act of 1974 (P.L. 93-406).
FMV	Fair market value.
IRA	Individual retirement account or individual retirement trust under § 408.
IRD	Income in respect of a decedent. § 691.
HSA	Health Savings Account. § 223.
IRS	Internal Revenue Service.
LSD	Lump sum distribution. § 402(e).
NUA	Net unrealized appreciation. § 402(e)(4).
PT	Prohibited transaction. § 4975.
QDRO	Qualified domestic relations order. § 414(p).
QRP	Qualified retirement plan under § 401(a).
RBD	Required beginning date for RMDs. § 401(a)(9)(A).
Reg.	Treasury Regulation.
RMD	Required minimum distribution under § 401(a)(9).

2. Resources: Where to read more

Certain frequently cited resources are abbreviated in this Seminar Outline; here are the full citations:

Life and Death Planning for Retirement Benefits (7th ed. 2011) by Natalie B. Choate, Esq. Ataxplan Publications. Paperback bound version: 624 pages, $89.95 plus shipping; 800-247-6553 or www.ataxplan.com. For the electronic edition (by subscription $9/month) go to a different website: visit www.retirementbenefitsplanning.com.

The 203 Best & Worst Planning Ideas for Your Client's Retirement Benefits by Natalie B. Choate, 129-page seminar outline which may be purchased through the web site www.ataxplan.com.

Back issues of *Trusts & Estates* can be obtained through a law library. Individual articles can be purchased through the magazine's website, www.trustsandestates.com.

Top estate planning professionals rely on Steve Leimberg's *Employee Benefits and Retirement Planning Newsletter* (e-mail only). $30 per month gets you this and as many of the other

Leimberg Information Services, Inc., (LISI) e-newsletters as you wish (I recommend *Estate Planning*, *Charitable Planning*, and *Asset Protection*), plus access to the enormous database of past newsletters, supporting material and longer articles. Subscribe, or visit one time for free, at www.leimbergservices.com.

Another indispensable newsletter for keeping current on all aspects of retirement distribution planning is *Ed Slott's IRA Advisor*, published monthly; $125 per year; go to www.irahelp.com.

3. Introduction

This Seminar Outline offers information and suggestions regarding how to get money out of a retirement plan prior to death. It is mostly aimed at planners who are advising clients who are retired or approaching retirement or approaching (or past) age 70½, or terminating employment, but also covers issues for those younger than age 59½. This Seminar Outline does not discuss estate planning, financial planning, or investment aspects of retirement plans; rather, it focuses on the income tax consequences of distribution decisions.

This Seminar Outline is written for experienced estate planners, financial planners, investment advisers, trust officers, life insurance professionals, and others who advise individual clients regarding their retirement benefits. The Seminar Outline assumes that you are familiar with the income and estate tax rules applicable to retirement benefits.

4. What's the best financial plan for retirement?

Retirement means the end of compensation income. You are no longer supporting yourself through current work. You are supporting yourself, you hope, through pension and investment income representing the fruits of your prior work. The financial element of planning for retirement tends to focus on having a plan for generating a post-retirement stream of payments to yourself that will cover your expenses while still leaving enough for all your future years of life and your estate planning goals.

There always seems to be lurking just beyond the horizon the Grand Plan that will provide this stream of payments and eliminate all future worry and fussing about the subject.

One Grand Plan is to live on the "income" (interest and dividends) from your investment portfolio, preserving the "principal" to generate future income, protect against inflation, and leave to your heirs. But many people conclude they do not have sufficient capital to live on the income alone in the style to which they have become accustomed. So some way to tap the principal without exhausting it is required.

Another Grand Plan, the one most often recommended, is to have a diversified balanced investment portfolio, which you rebalance periodically, and withdraw 4.5% (or 3%, or some %) of the value of that portfolio the first year; then in each succeeding year you withdraw the same amount increased by a cost of living adjustment (COLA). And your financial planner's Monte Carlo projections show that you have a 90% chance of not outliving your money with this approach. The trouble with this Grand Plan is that it is too complicated and scary for most people. Waking up every day knowing that there is a 10% chance you will outlive your money does not make for a worry-free existence. Who can close his eyes to the stock market roller coaster, knowing that every downtick could mean you can't afford to live as long? What happens to the projections the year you need to take out a few extra dollars to replace the roof?

Another major flaw of this particular Grand Plan, in my opinion, is that it requires every retiree to reserve enough capital to cover living expenses for his longest possible lifespan, even though only a small percentage of retirees, say 10%, will actually live for that longest possible lifespan. Thus if everyone uses this plan either 90% of the retirees are preserving capital unnecessarily to cover an extreme old age they will never reach (capital they could have spent to improve their living standard now), or 10% of the retirees will run out of money in extreme old age.

A Grand Plan that I am secretly drawn to is called the four legs of the table:

Leg 1 is income: You arrange for an annuity or a collection of annuities (with a COLA) sufficient to cover your basic living expenses. Social Security plus your company pension plus a privately purchased annuity contract, and you now don't have to worry about paying the utility and food bills, no matter what the stock market does. Your expenses include the insurance premiums involved in Legs 2 and 3. Plus you now don't have to worry about living too long. If everyone bought this form of insurance against living too long, the risk of excess longevity would be pooled and assumed by insurance companies, and spread over the entire population, as it should be, and much of retirees' capital would be freed up for other purposes.

Leg 2 is medical care: Get the best health insurance you can afford, plus a Health Savings Account, plus Medicare, plus long-term care insurance. Also eat healthy, don't smoke, exercise regularly, and that's the best you can do to corral that monster.

Leg 3 is your estate plan: Buy life insurance to provide whatever you want to provide for your heirs in excess of the estate tax exemption amount, if anything (inside an irrevocable trust of course).

Leg 4 is the emergency fund/inflation backstop/estate plan core. That would be assets (house(s)s plus an investment fund). The total value of Leg 4 assets can be up to $11 million and still be within the federal estate tax exemption (as of 2018). These equity investments provide inflation protection, plus can be tapped when your expenses exceed your annuity income, plus provide an inheritance for your heirs. This money is available for fun (and should be spent for fun or given away if it grows to more than the federal estate tax exemption amount).

So what's wrong with the Four Legs of the Table Plan? The main sticking point is Leg 1, buying an annuity, which has two issues, only one of which is legitimate.

First, for some people, turning over cash to buy an annuity contract is too scary and unacceptable. You are parting with capital. One day you have $500,000 and the next day you just have a life income of $x. And if you die the day after that your heirs get nothing, so your $500,000 was "wasted."

I agree you shouldn't put ALL your capital into an annuity contract. But the idea that the annuity investment is "wasted" if you die early is false. This is liking saying that your homeowner's insurance premium is wasted if your house doesn't burn down. You are buying the annuity to insure against living too long. If you live too long it's a very good investment.

The most likely scenario is that you live to your life expectancy. If you don't buy an annuity, and you live to your life expectancy you will spend that $500,000 on your living expenses, and *your heirs won't get it anyway*. So we are NOT talking about the money you should be looking to leave to your heirs. This is the money you are going to SPEND. You have other money for your heirs.

What's really stupid is to buy an annuity (insurance against living too long) then reduce your annuity payments to provide a death payment to your heirs. The death benefit under an annuity

contract is subject to most unfavorable estate tax treatment. See Part I(3), ¶ 10.3.01. If you want to provide for your heirs buy a separate life insurance policy.

The second worry is that, viewed from one perspective, the annuity with a COLA is the ideal way to provide retirement income. From another perspective, it's nothing more than an i.o.u. from an insurance company. But insurance sellers assure us that, even when insurance companies have gone bankrupt, there have been no defaults on their annuity contracts, even if the insurance company's creditors and equity owners lost all or part of their investments.

5. Ba▪Si▪M▪A▪S▪U▪D: The key to retirement happiness

This Seminar Outline is about income tax planning for retirement plan distributions. The point of all the preceding discussions is to show there is no perfect Grand Plan for retirement. There similarly is no magic way to eliminate income taxes on retirement plan distributions, and there is no magic answer that is best for everyone regarding how to take retirement plan distributions. Thus, you will not read here "Always [or never] withdraw from your retirement plan to pay living expenses before you sell capital gain assets!" or "Convert everything [or nothing] to a Roth IRA!" or "Defer your retirement distributions as long as legally possible!" Instead, the philosophy of this Seminar Outline is just "do smart things and avoid stupid things." Or to put it in more concrete form regarding your retirement plan benefits, "Ba▪Si▪M▪A▪S▪U▪D":

- **Balance.** Don't bet everything on one horse. The happiest client is one who has some of her money in a Roth IRA, some in traditional retirement plans, and some outside of the plans.

- **Simplify.** Tax savings that are too complicated are generally not worth it. Remember the tax shelters of the early 1980s, where you invested, got some income tax deductions, then had to file a 100-page tax return on extension every year? Consolidate your retirement plans (don't have eight IRAs if two will do). Don't buy into complicated risky ideas for reducing taxes on the IRA. Don't invest your IRA in something that will require a prohibited transaction analysis or UBTI tax return. While all the tax planning ideas offered in this Seminar Outline are legitimate and "safe," some are a bit complicated, so avoid those ideas unless you have the time and appetite for complicated maneuvers.

- **Manage income levels.** Every finance publication tells us, at year end, to defer (or accelerate) income to minimize taxes. That advice is not realistic for people who work for a living. But retirees can actually do that by timing withdrawals from retirement plans. For example, the first year's required minimum distribution can be postponed to the following year; see the "Noah" and "Zeke" examples in Part IV(5). The retiree who owns a traditional IRA and a Roth IRA has hot and cold water faucets: If he needs more taxable income to soak up deductions, he can take it out of his traditional IRA. If he needs more income to live on, without increasing his taxable income, he can take it from his Roth IRA or HSA.

- **Avoid stupid mistakes.** As a planner, forget finding the ultimate plan that eliminates all taxes. You will be doing your client the greatest possible service if you help him avoid stupid mistakes and steer clear of penalties. The most common stupid mistakes are failing

to take required minimum distributions, naming no (or the wrong) beneficiary for death benefits, and botching rollovers and transfers.

- **Special deals in the Tax Code.** The Tax Code does contain a number of "special deals," tax bonanzas, or loopholes, whatever you want to call them. The planner's job is to be aware of the deals, know all their requirements, and be ready to recommend them when you meet a client who qualifies and can benefit. Deals such as: net unrealized appreciation of employer stock (NUA; see Part I(1)); Roth conversions by beneficiaries (Part III(1)); qualified charitable distributions (Part VI); and tax-free or tax-reduced Roth conversions of IRAs or plan accounts that contain after-tax money (Part IV(6)–(8)).

- **Unique circumstances.** Some clients present unique situations that again require you to know all the rules and know how to handle this client's benefits. For example, if the client has life insurance in his plan, see Part I(2). If the client's plan offers annuity payouts, read Part I(3). If the client is eligible for any "grandfather" benefits, see Part II. If the client has a plan loan outstanding, see Part I(4).

- **Don't forget the other stuff.** Federal income taxes are not the only thing you have to keep an eye on with retirement benefits. Don't overlook such things as: spousal rights; creditor protection of different types of retirement plans; and state income and estate tax treatment of retirement benefits.

I. APPROACHING RETIREMENT

The client is planning to retire within a few months or years. The client should consider these issues BEFORE retiring.

1. When should you take that LSD?

A participant whose retirement plan account holds appreciated stock of the employer that sponsors the plan, or who could acquire such stock in his account, can take advantage of a very special tax deal in the Code for "NUA" (net unrealized appreciation of employer stock). IF such stock is taken out of the plan as part of a lump sum distribution (LSD), then only the "plan's cost basis" in the stock is currently includible in the employee's gross income. The rest of the stock's value (the NUA) is not taxed until the stock is sold by the employee; and then it is taxed as long-term capital gain (regardless of how long either the employee or the plan held such stock).

If you have a client who *has such stock inside his employer-sponsored retirement plan* or who *may be able to acquire such stock inside his employer-sponsored retirement plan* then you need to thoroughly understand the benefits of, rules applicable to, and planning options available for this type of stock. ¶ 2.4 and ¶ 2.5 of *Life and Death Planning for Retirement Benefits* explain the legal requirements of a "lump sum distribution" and of NUA treatment. These sections are referenced in the following discussion.

Here are some planning pointers for employees eligible for this deal:

The first absolute cardinal rule for this employee is: If you take a distribution from the plan, make sure it is an LSD! A lump sum distribution (LSD) is the distribution of ALL of the employee's

benefits under ALL of his/her retirement plans of the same type within one taxable year following the most recent "triggering event." To learn which plans and plan balances must be aggregated and distributed within one calendar year, and other technical requirements of a "lump sum distribution," see ¶ 2.5 of *Life and Death Planning for Retirement Benefits*. The fatal mistake made all too often is to take distributions in more than one calendar year following retirement, which forfeits the ability to use the favorable NUA deal. So don't do that by mistake. That particular issue becomes critical when the employee reaches the age at which he must take RMDs.

But suppose the employee is merely retiring at age 60 or 65, and does not need to take any distributions right now. The plan allows him to leave all his money in the plan indefinitely (subject to RMD requirements). What strategies should the retiree consider and why?

Take the LSD sooner: There are several advantages to taking the LSD sooner rather than later. If the employee wants to diversify out of a heavy concentration of employer stock, he can take the LSD, and then sell all or part of the stock, pay the long-term capital gains tax, and reinvest in other investments. If he wants to do a partial rollover of the stock to eliminate current taxation altogether, and he is concerned the IRS might do away with that option (see ¶ 2.5.07(B)), he can get it over with before the IRS does so. By taking the stock now, and holding it until death, he gives his beneficiaries a shot at stepped-up basis; see ¶ 2.5.04. If the stock is still in the plan at his death, there is no chance of stepped-up basis. Finally, there's always the risk that Congress might eliminate the special deal for NUA stock, though presumably such repeal would have some type of delayed effective date or grandfather provision. The major *disadvantage* of taking the LSD sooner is that income taxes must be paid on the "plan's basis" portion sooner (unless the partial stock rollover strategy prevails).

Take the LSD later: The other approach is to leave the stock in the plan until forced to start taking RMDs at age 70½, then take an LSD at that time (combining the LSD with your first RMD; see Part IV(4), below). One advantage of delaying is deferral of income tax on the plan-basis portion of the distribution. Another advantage is that perhaps the availability of the partial stock rollover (see ¶ 2.5.07(B)) will be more clearly available (or not) at a later date. The disadvantage of the holding strategy is the continued concentration in employer stock (you'll be sorry if it goes down), and loss of any shot at stepped-up basis if you die while the stock is still in the plan.

Customers of financial institutions should check to see if their firm provides assistance in evaluating the choice between rollover (to continue tax deferral) versus cashout (to take advantage of the NUA deal).

Only distributions from § 401(a) "qualified plans" (pension, profit-sharing, or stock bonus) can qualify as LSDs. Both corporate plans and self-employed ("Keogh") plans can give rise to LSDs, but a distribution from an IRA, SEP-IRA, SIMPLE, or 403(b) plan can never qualify for LSD treatment. § 402(e)(4)(D)(i).

The distribution must be made following a triggering event. § 402(e)(4)(D)(i), I–IV. The triggering events are slightly different depending on whether the participant is a "common law employee" or is self-employed ("employee within the meaning of section 401(c)(1)").

If the participant is a common-law employee, the distribution must be made either:

- On account of the employee's death; or

- ‣ After the employee attains age 59½; or
- ‣ On account of the employee's "separation from service." § 402(e)(4)(D)(i), I–III.

If the participant is self-employed, the distribution must be made either:

- ♦ On account of the employee's death; or
- ♦ After the employee attains age 59½; or
- ♦ After the employee has become disabled within the meaning of § 72(m)(7). § 402(e)(4)(D)(i), I–II, IV.

A person is "disabled," according to § 72(m)(7), if he is "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration."

These LSD "triggering events" are of significance primarily for determining whether there has been a distribution of 100 percent of the balance to the credit of the employee (¶ 2.4.04). Distributions before the triggering event are irrelevant for this purpose; see, *e.g.*, PLR 8541089 (distributions before age 59½ did not adversely affect LSD status of distribution occurring after reaching age 59½).

For the distribution to qualify as an LSD, the employee's entire balance must be distributed to him in one calendar year. As the Code puts it, there must be a "distribution or payment within one taxable year of the recipient of the balance to the credit of…[the] employee..." from the plan. § 402(e)(4)(D)(i). The "balance to the credit" includes all the participant's accounts in that plan—employ*ee* contribution, employ*er* contribution, rollover, *and* designated Roth!

This hurdle is surrounded by land mines.

Clearly, if an employee takes out, say, one-third of his plan balance in Year 1 and leaves two-thirds in the plan, the distribution of the one-third portion in Year 1 does not qualify for LSD treatment because it is not a distribution of the entire balance. Now suppose the employee takes out the remaining two-thirds of his balance in Year 2. He has taken out 100 percent of his (remaining) plan balance in Year 2. Is the Year 2 distribution an LSD?

It *would* be a distribution of 100 percent of the balance to his credit in one calendar year *if* the "balance to his credit" simply meant the balance as of the date of distribution—but that is not what it means. Rather, the rule means that the balance to the credit of the employee *as of the first distribution following the most recent triggering event* (¶ 2.4.03) must be distributed within one taxable year. See IRS Notice 89-25, 1989-1 C.B. 662, A-6; Prop. Reg. § 1.402(e)-2(d)(1)(ii); Rev. Rul. 69-495, 1969-2 C.B. 100.

Elaine Example: After Elaine retired from Acme in Year 1 at age 64, she withdrew $60,000 from her $800,000 Acme Profit-sharing Plan account in order to fulfill her dream of traveling around the world in a submarine. Returning to the U.S. in Year 2, she withdraws the rest of her account. This final distribution would not qualify for LSD treatment because the entire balance that existed on the date of the first distribution following the most recent triggering event (separation from service) was not distributed all in one calendar year. In contrast, suppose Elaine, upon returning from her cruise, died on her way to the Acme benefits office. Now there is a new triggering event, the employee's death. Her beneficiary can elect LSD treatment for her remaining plan balance even though Elaine, had she lived, could not have done so. Or suppose Elaine had withdrawn the $60,000 for her cruise

before she retired. Then her later separation from service would have been a new triggering event, and the final distribution would qualify for LSD treatment.

Failure to distribute the entire balance in one calendar year is a mistake you cannot fix. In PLR 2004-34022, a retiring employee intended to have all of the employer stock in his account in his employer's QRP distributed outright to him and to have all of the other assets in his account distributed directly to his IRA. Through some error of paperwork, the distribution of employer stock occurred in 2002, but the transfer of the other assets did not occur until 2003. He did not have an LSD. The IRS ruled that it could not allow him an extension of the all-in-one-year deadline.

2.5 Net Unrealized Appreciation of Employer Stock

This ¶ 2.5 describes the special favorable tax treatment available for "lump sum distributions" (and certain other distributions) of employer stock from a retirement plan.

*2.5.01 **NUA: Tax deferral and long-term capital gain***

The Code gives special favorable treatment to distributions of employer securities (referred to here as "employer stock," though the "securities" could be stocks or bonds; § 402(e)(4)(E)) from a qualified plan.

Under certain circumstances, the "net unrealized appreciation" (NUA) inherent in the stock is excluded from the employee's gross income at the time the securities are distributed to the employee. § 402(e)(4)(A), (B). NUA is the excess of the stock's fair market value at the time of distribution over the plan's basis in the stock. Reg. § 1.402(a)-1(b)(2). When the stock is later sold, the NUA is taxed as long-term capital gain, regardless of how long the recipient (or the plan) actually held the stock. Reg. § 1.402(a)-1(b)(1)(i); Notice 98-24, 1998-1 C.B. 929; PLR 2004-10023.

Joe Example: Joe, age 61, retires from Baby Bell Corp. in 2012 and receives an LSD of his 401(k) plan, consisting entirely of 10,000 shares of Baby Bell stock. The plan's basis for that stock is $10 per share; the stock is worth $100 a share at the time of the distribution. Joe will receive a 1099-R from Baby Bell for 2012, indicating a "Gross distribution" of $1 million (in Box 1), a "Taxable amount" of $100,000 (in Box 2a), and "Net unrealized appreciation" of $900,000 (in Box 6). In Box 2b, "Total distribution" will be checked.

How Joe reports this distribution: Joe does not have to file any special tax form to report his receipt of NUA stock. He does *not* have to file Form 4972, which is used only by those claiming the special tax treatments for those born before 1936 (see ¶ 2.4.06 in Part II(3), below). He simply reports the "Gross distribution" amount (from Box 1 of Form 1099-R) on line 16a of his 2012 Form 1040, and the "Taxable amount" (from Box 2a of Form 1099-R) on line 16b, as a retirement plan distribution.

What happens when Joe sells the stock: If Joe sells the stock immediately for $1 million, he will have long-term capital gain of $900,000. If he waits two months and sells the stock for $125 a share, he has a short-term capital gain of $250,000 ($25 appreciation between date of distribution and date of sale, times 10,000 shares) in addition to his long-term capital gain of $900,000. If he

holds the stock for 12 months after receiving the distribution, all gain on any subsequent sale will be long-term capital gain.

The tax deferral/capital gain treatment is not available for all distributions of employer securities. It applies in only two situations:

1. If the securities are distributed as part of a "lump sum distribution" (see ¶ 2.4.02–¶ 2.4.05 above for definition) *all* the NUA is nontaxable at the time of the distribution. § 402(e)(4)(B).

2. If the distribution is *not* an LSD, then only the NUA attributable to the *employee's* contributions is excludible. § 402(e)(4)(A).

NUA: Expert Tips

When first advising an employee who holds NUA stock in his retirement plan, consider consulting with a more experienced practitioner. Advisors who counsel numerous NUA stock-holding retirees often know more about the subject than the plan's own counsel and/or an auditing IRS agent. Here are some tips and war stories from three advisors who have counseled numerous employees regarding the best disposition of their NUA stock:

Mark Cortazzo, **CFP,** of Parsippany, NJ, reports that each employer has its own method of calculating the plan's "cost basis" in the NUA stock; the employee may be able to take advantage of his particular employer's variation to increase his NUA benefit prior to retiring. Mark also has found shocking mistakes by employers, such as reporting periodic distributions as being entitled to NUA treatment even though they clearly don't qualify.

Frank Duke, CPA, of Cincinnati, OH, recommends that the employee consider rolling over stock equal in value to the plan's "cost basis," and not rolling stock equal in value to the NUA. Using the basis allocation method endorsed by the IRS in two PLRs (see ¶ 2.5.07(B), below), such a partial rollover potentially maximizes the tax benefits to the employee, who can realize long-term capital gain on the NUA portion whenever he decides to sell the nonrolled stock, while deferring income tax on the ordinary income portion that is rolled over until he later takes a distribution from the IRA.

Bob Keebler, CPA, of Green Bay, WI, and his firm, do extensive work with NUA-holding employees and retirees. PLR 2002-15032, involving gifting NUA stock to a charitable remainder trust, is an example of their creative planning. Much of Bob's work involves computer modeling and hedging strategies to help clients maintain their employer stock (and favorable NUA treatment) while managing the risk of a one-stock portfolio. Bob shares his NUA expertise in seminars.

2.5.06 ***Should employee keep the LSD or roll it over?***

For most retiring employees, rolling over, to an IRA, a lump sum distribution received from an employer plan is the best tax-saving and financial planning strategy. The opportunity for continued tax-deferred growth of retirement assets inside an IRA offers the greatest financial value for *most* retirees.

An LSD that includes appreciated employer securities often provides an exception to this rule of thumb. Since the NUA is not taxed currently anyway, rolling it over does not defer tax on

the NUA. Furthermore, rolling over NUA will convert this unrealized long-term capital gain into ordinary income, since IRA distributions cannot qualify for NUA treatment. Reg. § 1.402(c)-2, A-13(a), last two sentences. So which is best, taking employer stock as part of the LSD (to take advantage of the NUA deal) or rolling over that stock to an IRA? The answer depends on multiple factors (as well as guesswork), and there is no one decision that is right for everyone.

Factors to consider include:

A. **How old is the employee?** If he is under 59½, the currently-taxable part of the distribution will be subject to the 10 percent penalty (§ 72(t)) unless it qualifies for an exception or unless the tax can be eliminated by a partial rollover (¶ 2.5.07(B)). Also, the younger the employee is, the more attractive continued tax deferral through a total rollover becomes because he has many more years to go until he starts required minimum distributions. If he is near or past age 70½, on the other hand, RMDs are starting or have started already, so an immediate distribution at a low tax rate becomes more attractive relative to the limited possibilities for continued deferral.

B. **What other plans does the participant have?** If the employee has substantial other assets in other retirement plans, the chance to cash out some of his benefits at a relatively low tax rate can be appealing. See Part VI. But if this is the employee's only retirement nest egg, rolling it to an IRA could be more attractive.

C. **How much of the distribution is NUA?** If the NUA is a substantial portion of the stock's value, taking the NUA deal becomes more attractive, even irresistible. If the NUA is a small portion, however, rolling over becomes more attractive.

Thus, the advice to a 45-year-old executive who is switching jobs, whose employer stock is only 10 percent NUA, and who needs to save for retirement, may be to roll over the entire distribution (and forfeit the NUA deal), while the advice to a 71-year-old whose stock is 90 percent NUA and who has other retirement plans that are funded beyond his likely needs would be the opposite.

2.5.07 ***NUA and partial rollovers***

Although it is a requirement, when claiming "special averaging" (see Part II(3), below), that no portion of the LSD be rolled over, and indeed that no other qualifying distribution received in the same year be rolled over, no such requirement applies to obtaining the exclusion from income of the NUA portion of an LSD.

For the effect of combining an NUA distribution and a partial rollover for a year in which a minimum distribution is required, see Elizabeth Example at see Part IV(4), below

A. **Rolling over everything except the NUA stock.** If the employee receives a distribution that (i) meets the LSD requirements (¶ 2.4.02–¶ 2.4.05) and (ii) includes employer securities, the employee can exclude from his income the NUA inherent in the securities, while rolling over to an IRA the *rest* of the distribution, *i.e.*, the assets other than the employer securities, which otherwise would be included in gross income. See PLRs 2004-10023, 2001-38030,

2001-38031, 2000-38052, 2000-38057, 9721036. This can even be done by direct rollover of the nonstock assets to another plan; see PLR 2000-03058.

If the LSD includes other assets besides the NUA stock it is usually desirable to roll over the nonstock assets, because there is no special tax advantage to not rolling them over. The only exception would be, if the LSD also qualifies for special averaging treatment (see Part II(3), below), the employee should evaluate whether special-averaging gives him a low enough tax rate on the LSD to make it worthwhile *not* to roll over any part of the distribution, then pay tax on the taxable portion using the special averaging method.

B. Rolling over part of the NUA stock. If the employee rolls over some but not all of the employer stock, the NUA and plan's "cost basis" must be allocated, somehow, between the rolled and the nonrolled stock.

Grace Example: Grace, age 52, receives an LSD of $1 million, consisting entirely of employer stock, of which $300,000 is the plan's cost basis and $700,000 is NUA. She rolls over 30 percent of the stock to an IRA within 60 days. How are the NUA and plan-basis allocated as between the rolled and nonrolled stock? Grace would *like* to allocate all of the $700,000 of NUA to the stock that is *not* rolled over, and allocate all of the $300,000 of plan-basis to the stock that *is* rolled over to the IRA. The advantages of that allocation are: She pays no current income tax and no 10 percent "premature distributions" penalty, because the "taxable income" part of the distribution ($300,000) was entirely rolled over; she pays no current income tax on the $700,000 NUA portion (because it's NUA); and when she eventually sells the NUA stock she will have long-term capital gain on the first $700,000 of gain. Would Grace's proposed allocation of all of the plan-basis to the rolled over stock be correct?

Grace's preferred method of allocation appears to be correct. § 402(c)(2) provides that, in the case of a distribution which is partially rolled over to an IRA, the rolled portion "shall be treated as consisting first of the portion of such distribution that is includible in gross income…." This interpretation was endorsed by the IRS in the well-reasoned PLR 8538062, and again more recently though indirectly in PLR 2011-44040, the only IRS pronouncements discussing this subject.

Although there is no other authority directly on point, this approach is consistent with other regulations on similar subjects. See Reg. § 1.402A-1, A-5(b), dealing with a partial rollover of a nonqualified distribution from a designated Roth account (taxable portion is deemed rolled over first); and Reg. § 1.402(c)-2, A-8 (if a partially taxable distribution is received in the same year as a distribution is required under § 401(a)(9), the nontaxable portion is allocated first to the RMD, which cannot be rolled over, and the taxable portion is therefore treated as an eligible rollover distribution to the maximum extent possible).

Another approach would be to allocate NUA and ordinary income proportionately to the rolled and nonrolled stock; this approach appears possibly to have been used in PLR 2000-38050. Other PLRs do not discuss how basis and NUA are allocated between the rolled and nonrolled shares received in an LSD of employer stock; see, *e.g.*, PLRs 2002-43052, 2002-15032.

2.5.08 ***If the employee wants to sell the stock***

If the employee wants to sell the employer stock he is receiving, more complex calculations become necessary in evaluating the rollover-or-not choice. He can take his distribution of employer stock, not roll it over, and sell it; he will then pay tax at long-term capital gain rates, to the extent the sale proceeds consist of NUA.

Or, the employee can roll the stock over to an IRA and sell it inside the IRA and pay *no* current tax. This approach could be attractive if the taxation can be deferred, via the IRA, for a very long period of time. Even if the employee's ordinary income tax bracket at the time of ultimate future distribution will be higher than the capital gain tax he would have to pay today if he sells the stock outside the plan, the advantages of deferral may overcome the bracket differential.

[END OF DISCUSSION OF NUA/EMPLOYER STOCK]

2. Life insurance: The "rollout" at retirement

A qualified retirement plan (QRP) may hold life insurance on the life of an employee inside that employee's account in the plan, subject to various limits. Once the employee reaches retirement, decisions must be made regarding that insurance. During employment, a certain portion of the premiums paid by the employer is included in the insured employee's income each year. The includible portion is called the "Current Insurance Cost" in this Seminar Outline.

This section gives an overview of the choices an employee faces upon retirement regarding life insurance on his life that is owned by his account in an employer-sponsored qualified retirement plan. For full detail on the rules mentioned here, see Chapters 10 and 11 of the "online" (ebook) version of Natalie Choate's book *Life and Death Planning for Retirement Benefits*, also available as a downloadable *Special Report: When Insurance Products Meet Retirement Plans* (at www.ataxplan.com).

Current Insurance Cost: Basis, RMDs, 10% penalty

Generally, the amount included in the employee's gross income over the years on account of the Current Insurance Cost is considered his "investment in the contract" and in effect becomes his income tax "basis" in the policy. One exception to this rule is that an owner-employee does not get to treat even the Current Insurance Cost as an investment in the contract. Reg. § 1.72-16(b)(4). An owner-employee is a self-employed person who owns 10 percent or more of the profits or capital of the business. § 402(c)(3).

Difference between "basis" and "investment in the contract"

Retirement plan distributions are taxable under § 72; see ¶ 2.1. Taxation under § 72 has two implications. First, the income will be "ordinary income," not capital gain. Second, distributions will not be taxable to the extent they constitute a return of the individual's "investment in the contract." § 72(b). A different set of rules applies to the profit from the sale of a capital asset. That type of income may be taxed as capital gain (§ 1001), and sale proceeds are not taxable to the extent they

constitute a return of the individual's "basis" (§ 1011). In Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, the IRS ruled that an individual's "investment in the contract" in an insurance policy (to determine the amount of his income under § 72 if he surrenders the policy to the insurer for its cash value) is not necessarily the same as his "basis" in the contract (used to determine gain when a policy is sold to an unrelated third party investor). Investment in the contract (which is normally the sum of all the premiums the insured policy holder has paid) includes the annual cost for insurance protection prior to the disposition. This cost is NOT included in the seller's basis if the contract is sold to a third party.

The employee is entitled to recover his "investment in the contract" income tax-free, but only if the policy itself is distributed to him. If the policy lapses, or is surrendered for its cash value *at the plan level*, the investment in the contract disappears and cannot be offset against other plan distributions. If the plan sells the policy to the employee, the investment in the contract may or may not be applied to reduce the price the employee has to pay to the plan, depending on how the bargain sale and prohibited transaction rules apply to the purchase. Thus, the payment of income taxes (or a share of premiums) over the years generates an "investment in the contract" that may or may not be recouped later. On the other hand, since the Current Insurance Cost is supposed to represent the annual cost of pure insurance protection, it is surprising the Code allows it to be used as basis at all; it is really an expense, as the IRS formally recognized in Rev. Rul. 2009-13 (applicable only to policy sales to third parties).

The Current Insurance Cost that the employee must include in his gross income each year is not treated as a distribution to him for purposes of either the 10 percent penalty on premature distributions (see IRS instructions for Form 1099-R (2013), p. 2) or the minimum distribution rules (Reg. § 1.401(a)(9)-5, A-9(b)(6)).

Options for the policy when the participant retires

If the participant does not die while still employed, he must make some choices regarding the life insurance policy when he retires. The IRS generally requires that plan-owned life insurance policies be either converted to cash or distributed to the participant at retirement. This is one of the constellation of plan qualification requirements known as the "incidental death benefits rule," the gist of which is that a retirement plan is supposed to provide retirement benefits, and may provide death benefits only to the extent they are "incidental." See Rev. Rul. 54-51, 1954-1 C.B. 147, as modified by Rev. Ruls. 57-213, 1957-1 C.B. 157, and 60-84, 1960-1 C.B. 159.

Disposing of the plan-owned policy at or before retirement is popularly referred to as the "rollout" of the policy (not to be confused with a "rollover!"). There are three ways the plan can dispose of the policy: distribute it to the participant; surrender it to the insurance company; or sell it to the participant or beneficiary.

If the life insurance policy is <u>distributed</u> to the participant, the policy's fair market value, less the amount of his investment in the contract, becomes gross income to him. He can not roll over the policy to an IRA; an IRA cannot own life insurance. § 408(a)(3).

If the policy is <u>surrendered</u> to the insurance company, the plan receives the cash value from the insurance company. The participant could then leave those proceeds in the plan, or roll them over to an IRA, thus continuing tax deferral on the policy's value. However, he would lose the

insurance protection provided by the policy. His "investment in the contract" disappears under this scenario; he cannot apply it to subsequent cash distributions from the plan.

Selling the policy to the participant or to the beneficiaries requires the parties to navigate the "transfer for value" and "prohibited transaction" rules.

In contrast, if the employee buys his life insurance *outside* of the plan to begin with, these issues at retirement simply do not arise.

How to determine policy's FMV: Rev. Proc. 2005-25

When a QRP distributes a life insurance policy to the insured participant, the value of the policy (minus the participant's investment in the contract) is includible in the participant's income. Reg. § 1.402(a)-1(a)(iii). Prior to February 13, 2004, the "value" of a life insurance policy for this purpose was either the policy's cash surrender value (CSV) or in certain cases the policy reserves. See Reg. § 1.402(a)-1(a)(2) (pre-amendment), Notice 89-25, 1989-1 C.B. 662, A-10. For policy distributions after February 12, 2004, the amount includible is the policy's fair market value (FMV). The "policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed) are included" in determining FMV. Reg. § 1.402(a)-1(a)(1)(iii), as amended 8/29/2005.

Rev. Proc. 2005-25, 2205-17 I.R.B. 962, provides a safe harbor formula for valuing a life insurance policy distributed by a QRP for purposes of Reg. § 1.402(a)-1(a)(1)(iii). There is one version of the formula for nonvariable contracts and one for variable contracts (as defined in § 817(d)). For both types of policies, the safe harbor value is "the greater of A or B."

"A" is the same for both types of contracts: It is the sum of the interpolated terminal reserve (a number which must be obtained from the insurance company) and any unearned premiums, plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience. "B" differs depending on the type of policy; it is a formula which can be summarized as "PERC" (Premiums + Earnings - Reasonable Charges) times a certain permitted factor for surrender charges. The formulas basically disallow excessive, waivable, or "disappearing" surrender charges as an offset against value.

The "greater of A or B" formula determines the FMV of the policy. Two other items must then be added to the value so determined, to arrive at the full amount includible in the participant's gross income if the policy is distributed to him:

- ❏ "Dividends held on deposit with respect to an insurance contract," though not included in the FMV of the contract, "are taxable income to the employee…at the time the rights to those dividends are transferred to that individual." Rev. Proc. 2005-25, § 4.01.

- ❏ If any loan made to the employee "in connection with the performance of services…is terminated upon distribution or transfer of the collateral, the terminated loan or debt amount constitutes an additional distribution to the employee…." Rev. Proc. 2005-25, § 4.02.

Valuation game-playing by some insurance companies necessitated the change in the rules reflected in the 2005 amendment of Reg. § 1.402(a)-1(a)(1)(iii). The IRS is determined to end such game-playing. Accordingly, the formulas in Rev. Proc. 2005-25 "must be interpreted in a reasonable manner, consistent with the purpose of identifying the fair market value of a contract."

"Furthermore, at no time are these rules to be interpreted in a manner that allows the use of these formulas to understate the fair market value…For example, if the insurance contract has not been in force *for some time*, the value of the contract is best established through the sale of the particular insurance contract by the insurance company (i.e., as the premiums paid for that contract)." Rev. Proc. 2005-25, § 3.05 (emphasis added). How long is "some time?" It is not defined. In other words, the sum of premiums paid since date of issue is the only REALLY safe harbor. This IRS "fudge factor" makes these formulas just "semi-safe harbors."

Rev. Proc. 2005-25 supersedes Rev. Proc. 2004-16, 2004-10 I.R.B. 559; however, the safe harbor valuation method in Rev. Proc. 2004-16 could still be used to value contracts distributed between February 13, 2004, and May 1, 2005. The Rev. Proc. 2005-25 safe harbor may also be used for policy distributions before May 1, 2005.

On the bright side, the IRS does not require that the participant's actual health be taken into account in valuing the policy.

Taxpayers are not required to use the valuation formula of Rev. Proc. 2005-25; that formula is just a safe harbor. Another approach, not discussed by the IRS, would be to get an appraisal of the policy from an independent company that is in the business of evaluating insurance policies, if such a company can be found.

Tax code effects of sale below market value

The final version of Reg. § 1.402(a)-1(a)(1)(iii) provides that, for transfers on or after August 29, 2005, where a QRP "transfers property to a plan participant or beneficiary in exchange for consideration and where the fair market value of the property transferred exceeds the value of the consideration" the excess value "is treated as a *distribution to the distributee* under the plan for all purposes under the Internal Revenue Code." Emphasis added.

Although the excess policy value distributed through a bargain sale is treated as a distribution for all purposes of the Code, the regulation does *not* say that the plan-owned policy must be valued at FMV "for all purposes of the Code." Thus, for gift tax purposes, Reg. § 25.2512-6(a), which provides that life insurance policies are generally valued at "interpolated terminal reserve, plus unearned premium," is still controlling.

Plan sells the policy to the participant

If the policy is distributed to the participant, then all opportunity to defer income taxes on the amount represented by the policy value is lost. For this reason, the participant may decide to purchase the policy from the plan. Although this requires the participant to come up with some cash, it does allow him to continue deferring income tax on the amount represented by the policy value. Following the purchase, the participant will own the policy, which he can transfer to an irrevocable trust if he wants to remove the proceeds from his gross estate; and the plan will own cash, which can then be distributed to the participant and rolled over to an IRA for maximum continued deferral.

Sale of the policy to the participant creates a prohibited transaction issue.

Sale of the policy to the participant is considered to be partly a "distribution" to him if the consideration he pays to the plan is less than fair market value. Such a deemed distribution has two Code consequences. First, the excess value is gross income to the participant. However, if the

participant has "investment in the contract" equal to the amount of the "bargain element," there will be no gross income generated by the transaction.

Second, the bargain sale could be a plan qualification issue if the plan is prohibited from making a distribution to the participant at the applicable time. For example, a 401(k) plan is not allowed to distribute elective deferral amounts to the employee prior to severance from employment or certain other events. § 401(k)(2)(B)(i). Pension plans have similar restrictions on pre-retirement distributions. Reg. § 1.401-1(b)(1)(i). Thus, if the plan is not allowed to make a distribution to the participant at the applicable time, the participant will have to pay the plan the full fair market value of the policy, and not reduce the purchase price by the amount of his investment in the contract, to avoid a plan-disqualifying distribution.

Sale to participant: Prohibited transaction issue

Buying the policy from the plan may create a prohibited transaction (PT) problem. ERISA § 406(a), 29 U.S.C.§ 1106(a), prohibits the sale of plan assets to a "party in interest." The definition of "parties in interest" includes categories one would expect, such as plan fiduciaries, the employer, and officers, directors, and 10 percent owners of the employer. It also includes, surprisingly, any *employee* of the employer. ERISA § 3(14), 29 U.S.C. § 1002(14). Thus, as an initial proposition, the sale of a life insurance policy from the plan to the insured employee is a PT.

IRC § 4975 has its own set of PT rules, prohibiting sales between a plan and a "disqualified person" (DQP). An employee of the employer is not *per se* a DQP under § 4975; however, if the insured participant has more relationships with the employer than merely being an employee (for example, if the participant *is* "the employer," or directly or indirectly owns more than 50 percent of the employer, or is an officer of the employer), then the plan's sale to him of an insurance contract would be a PT under IRC § 4975 as well as under ERISA § 406.

The Department of Labor (DOL) has issued a class Prohibited Transaction Exemption (PTE) which exempts such sales if certain requirements are met. PTE 1992-6, 2/12/92, 57 FR 5190; amended 9/3/02, 67 FR 56,313. The PTE exempts the transaction from both IRC § 4975 and ERISA § 406. Thus, if the desired approach is to have the participant buy the policy from the plan, the transaction must comply with PTE 1992-6 if the participant is a party-in-interest.

To comply with PTE 1992-6 when the *insured participant* is buying the policy from the plan, the following two requirements must be met. If the purchaser is someone *other than* the participant-insured, there are additional requirements.

1. The contract would, but for the sale, be surrendered by the plan. PTE 92-6, II(c). This requirement is not a problem, if the participant is retiring, for the type of QRP that is *required* to sell or surrender the policy at that point.

2. The price must be "at least equal to the amount necessary to put the plan in the same cash position as it would have been [sic] had it retained the contract, surrendered it, and made any distribution owing to the participant on [sic] his vested interest under the plan." PTE 92-6, II(e). This requirement does not permit any price reduction for the participant's investment in the contract.

Prior to the 2005 IRS policy-valuation rule changes, it was most common for these sales to take place at CSV. The participant can still pay just the CSV as far as the DOL is concerned. However, if the price he pays is less than the FMV, he will have to deal with the tax Code consequences described above.

Plan sells policy to the beneficiary(ies)

Sometimes, instead of selling the policy to the participant, the rollout is accomplished by having the plan sell the policy to the beneficiaries. This is usually done for estate tax-planning reasons, to avoid the "three-year rule." As with the sale of the policy to the participant, this raises both tax and PT issues.

For tax purposes, if the policy is sold to the beneficiary at its FMV there is no income tax consequence; note, however, that the FMV standard allows no reduction of the purchase price to reflect the participant's investment in the contract.

If the price paid by the beneficiary is less than the FMV, Reg. § 1.402(a)-1(a)(1)(iii) provides that the bargain element will be includible in the gross income *of the beneficiary who buys the policy*. This treatment seems questionable. The plan account belongs to the participant, who is the only person entitled to receive distributions during his lifetime. See *Bunney*, 114 T.C. 259 (2000). A bargain sale from his account to his beneficiary can only occur with his consent. Thus, such a bargain sale would more properly be treated as a distribution of the bargain element *to the participant*, followed by a gift of the bargain element to the beneficiary.

A more serious problem with a QRP's distributing part of the participant's benefits, while the participant is still alive, to *someone other than the participant* is disqualification of the plan, since this would be a violation of the terms of the plan.

Because of the risks associated with sale of an insurance policy to the participant's beneficiaries caused by the final version of Reg. § 1.402(a)-1(a)(1)(iii), it may be better to avoid this approach. Instead, have the plan sell or distribute the policy to the participant. Once the participant has the policy (either because he bought it from the plan or because he took it as a distribution from the plan), the participant can sell it to the beneficiary to avoid estate tax inclusion (but beware of the "transfer for value" rule). Reg. § 1.402(a)-1(a)(1)(iii) would not apply to a sale by the insured to the beneficiary; it applies only to sales by a QRP. There would be no income tax consequences from undervaluing the contract; valuation concerns would be solely for gift and estate tax purposes.

Sale to beneficiary: Prohibited transaction aspects

The DOL's class exemption PTE 1992-6 exempts the sale of a life insurance policy by the plan from various PT rules if certain requirements are met. The requirements that must be met if the purchaser of the policy is the participant-insured himself are described above. If the sale is to someone *other than* the participant, and would be a PT if not exempted, the following three *additional* requirements must be met:

1. The buyer is a "relative" of the insured participant, or a "trust established by or for the benefit of" the insured participant or a relative. PTE 92-6, I(a), I(b).

2. The buyer is the beneficiary of the policy. PTE 92-6, II(b).

3. The participant is "first informed of the proposed sale and is given the opportunity to purchase such contract from the plan, and delivers a written document to the plan stating that he or she elects not to purchase the policy and consents to the sale by the plan of such policy to such" relative or trust. PTE 92-6, II(d).

"Relative" for purposes of the exemption means either a relative as defined in § 3(15) of ERISA, 29 U.S.C. § 1002(15), and IRC § 4975(e)(6) (spouse, ancestor, lineal descendant, or spouse of a lineal descendant), *or* a sibling or a spouse of a sibling. PTE 92-6, II(b).

Note that the PTE's definition of permitted buyers does not mention partnerships. If the strategy is for the plan to sell the policy to a partnership, the plan's ERISA counsel must determine whether the transaction is a PT and, if it is, seek a DOL exemption.

Avoiding estate tax inclusion and "transfer for value"

As discussed above, the normal course is for the retirement plan to sell or distribute the policy to the participant at retirement. The participant may wish at that point to transfer the policy to his intended beneficiaries (or to an irrevocable trust for their benefit) to get the proceeds out of his estate for estate tax purposes. Since giving away the policy would not remove the proceeds from the participant's estate until three years after the gift (§ 2035(a)), practitioners look for an alternative way to get the policy into the hands of the beneficiary(ies) without the three-year waiting period. The obstacles to success in this endeavor are discussed in this ¶ 8.4.02; for further discussion of ways to deal with what its authors call this "vastly over-exaggerated problem," see the article by Ratner, C.L., and Leimberg, S.R., "Planning Under the New Split-Dollar Life Insurance Prop. Regs., Part 2," 29 *Estate Planning* 12 (Dec. 2002), p. 603, at 606.

Since the plan cannot distribute benefits to anyone other than the participant during the participant's lifetime, the only ways the policy can be moved from the plan to the intended beneficiaries without triggering the three-year rule are for the plan (1) to sell the policy directly to the beneficiaries, or (2) distribute or sell the policy to the participant who then sells it to the beneficiaries. *The second method is safer, due to the IRS rule changes discussed above.*

Another problem with selling the policy to the beneficiary (regardless of who is the seller) is the transfer-for-value rule of § 101(a)(2). Life insurance proceeds (net of consideration paid for the policy) are taxable income to a recipient who acquired the policy in a transfer for value unless an exception applies. The beneficiaries' purchase of the policy from the participant, or from the plan, would be a transfer for value, causing the eventual death benefit to be taxable income instead of tax-exempt income.

Techniques practitioners use to avoid the transfer-for-value problem include selling the policy to a partnership in which the insured is a partner (see § 101(a)(2)(B), PLR 2001-20007), or to a "grantor trust" (see § 671–§ 677, Rev. Rul. 85-13, 1985-C.B. 184, and PLRs 2005-14001, 2005-14002, 2002-47006). This subject is beyond the scope of this Seminar Outline.

3. Defined benefit plan decisions

Defined benefit plans offer annuities. The question is whether you should take one of the annuities offered by your retirement plan, or, instead, take a lump sum distribution of your benefits from the plan, roll it over to an IRA, and buy the annuity inside the IRA…or roll over the plan

benefits to an IRA and NOT buy an annuity in the IRA. For someone who does not have a DB plan, the question is whether to use all or part of his IRA or other defined contribution plan balance to buy the desired annuity inside the IRA or plan.

Where to read more: See ¶ 10.2.10 of the Natalie B. Choate *Special Report: When Insurance Products Meet Retirement Plans* (downloadable at www.ataxplan.com) regarding the RMD rules for an IRA or other defined contribution (individual account) plan that is annuitized. The following is adapted from that Special Report:

10.1.04 ***Defined Benefit plan***

A Defined Benefit (DB) plan is a type of QRP. Under a DB plan, also called a "defined benefit pension plan," the employer promises to pay the employee a specific pension, starting at retirement, and continuing for the employee's life. Social Security is similar to a DB plan.

A. **"Classic" DB plan.** Under the classic type of DB plan, the amount of the pension is based on a formula, such as "a monthly pension for life, beginning at age 65, equal to 1/12th of 1 percent of final average compensation times years of service, reduced by 10 percent for each year of service less than 10 if the employee has less than 10 years of service, and up to an annual maximum of 40 percent of career average compensation."

The formula may award a lower percentage for compensation below the Social Security tax wage base than for compensation in excess of such base. This is called the "permitted disparity." The formula will contain adjustments for early or late retirement.

The employer hires an actuary to tell it, each year, the minimum amount it *must* contribute to the plan (and how much extra it *may* contribute) (both limits being set by the tax Code) in order to amortize the employer's future obligations to retiring employees under the plan.

Classic DB plans generally are of greater value to older employees (older than approximately age 50) than to young employees, just because of the time value of money. Even if their eventual projected pensions are the same amount, say $36,000 per year starting at age 65, the value is greater to the employee who will be receiving that sooner. $36,000 a year starting in 10 years (how the pension looks to the 55 year-old employee) is a more significant asset than $36,000 a year starting in 30 years (how the pension looks to a 35 year-old employee). The older employee's pension looks more valuable to the employer too, who has to contribute more for the older employee than for the younger.

Classic DB plans were once the normal form of retirement plan for American businesses. Their popularity has declined (especially among small businesses) due to the increasingly complex tax and administrative rules applicable to these plans and due to the lower cost of Defined Contribution (DC) plans. However, classic DB plans remain attractive to the one-person business as a way of maximizing tax-deductible retirement contributions. If the business owner/sole employee is over age 50, approximately, a classic DB plan will give him a much larger annual tax-deductible contribution than is permissible under a DC plan.

B. **Cash balance DB plans.** There is another type of DB plan, called a **cash balance plan**, which uses a different type of formula. "A cash balance plan is a defined benefit plan that

defines benefits for each employee by reference to the employee's hypothetical account. An employee's hypothetical account is determined by reference to hypothetical allocations and interest adjustments that are analogous to actual allocations of contributions and earnings to an employee's account under a defined contribution plan." Reg. § 1.401(a)(4)-8(c)(3)(i). Under a cash balance plan, contributions are more uniform across age groups, making cash plans more attractive than classic DB plans for younger employees (and less generous for older employees).

C. Estate planning features. From an *estate planning perspective*, the DB plan has the following distinctive features.

First, the participant does not have an "account" in a DB plan the way he does in a DC plan. Even under a cash balance DB plan, though the plan's funding formula is determined by reference to a hypothetical "account" for each employee, the participant does not have an actual account in the plan.

The benefit statement for a classic DB plan will typically say the employee's "accrued benefit" under the plan is (*e.g.*) "$1,450 a month," of which (say) "80 percent is vested." What this means is that the employer has already obligated itself to provide for this employee (if the employee *keeps on working* until retirement age) a pension of $1,450 per month for life starting at the employee's "normal retirement age" under the plan (usually, 65); and if the employee *quits right now*, he's vested in 80 percent of that, meaning that at normal retirement age he would receive 80 percent of $1,450 per month.

The benefit statement may or may not contain more details such as: how much of a pension the employee would receive if he retired early; and (of great significance in estate planning), whether the employee will be permitted upon retirement to withdraw the lump sum equivalent of the accrued pension, or what death benefit, if any, would be available for the employee's beneficiaries. This brings us to the second significant factor in planning for DB pension benefits: Many DB plans do not offer the option of taking a lump sum equivalent in cash (or the client may have already chosen an annuity option and foreclosed his ability to take a lump sum equivalent). Thus under some DB plans there is no ability to "roll over" the benefits to an IRA.

Also, a DB plan may provide no benefits at all after the death of the employee other than the statutorily required annuity for the surviving spouse. If the participant dies prematurely, the money that was set aside to fund his pension goes back into the general fund to finance the benefits of other employees, rather than passing to the deceased employee's heirs.

D. Investment and longevity risks. Under a DC plan, the participant owns identifiable assets held in an account with his name on it. The value of the account fluctuates depending on investment results, but no party to the proceedings has any money staked on the question of how long the participant will live. With a DC plan, the risk that the participant will outlive his money falls on the participant.

With a DB plan, the plan (or insurance company issuing the annuity contract used to fund the benefits) takes the excess-longevity risk.

Theoretically, under a DB plan, the plan also takes all the investment risk. If the plan's investments go down in value, the employee's promised benefit remains the same; the employer

must contribute more money to the plan to fund that benefit. There are two exceptions to this statement. First, under one type of annuity, the variable annuity, the participant also has investment risk. Second, the employee has the risk that the employer will default on its obligation to fund the plan. If the plan becomes insolvent and/or the employer goes bankrupt, the employee may find his benefits limited to the amount insured by the government's pension insurer, the Pension Benefit Guarantee Corporation. The employee will not receive the full benefits promised by the plan.

Which form of benefit should the participant choose? That extremely important decision should be made with the advice of a professional such as a financial planner or actuary. The answer depends on a variety of factors including the participant's health, other assets, income, and estate planning objectives, the circumstances of the beneficiary(ies), the financial health of the pension plan, and the degree (if any) to which the plan subsidizes one option or the other.

10.3.01 ***Problem with nonspouse survivor annuities***

Retirees choose a life annuity to provide for their own living expenses in retirement and to protect against the risk of living too long, but are often loathe to accept the idea of the insurance company's (or plan's) gaining a "windfall profit" if the retiree dies prematurely. To avoid that result, a retiree may choose an annuity that provides benefits for a minimum guaranteed term. Or the participant may choose an annuity that provides a survivor annuity to his beneficiary, because he wants to provide an inheritance.

Providing a survivor benefit (through either a survivor annuity or a guaranteed term) to a beneficiary who is not a charity and who is not the participant's spouse has gift and estate tax consequences: The value of the survivor benefit is included in the participant's estate with no offsetting marital or charitable deduction. The estate tax rules for valuing annuity benefits are considered unfavorable; see "The Booby Prize," by Noel C. Ice and Robert W. Goff, in *Trusts & Estates* (May 2006), p. 36. For this reason, a survivor annuity is not the best vehicle for wealth transfer for clients with taxable estates. There may also be a taxable gift involved, if the participant irrevocably elects a joint and survivor annuity with a nonspouse beneficiary.

The participant might better choose an annuity that provides the right level of income for himself (and his spouse, if any). If his plan benefits would provide a larger income than they need, the participant could take the excess as a lump sum distribution, roll that to an IRA, and leave *the IRA* to chosen beneficiaries as an inheritance, rather than leaving them an inheritance in the form of a survivor annuity, or a minimum guaranteed term, under the participant's annuity. This approach treats the annuity as something for the participant and spouse to consume during retirement, and as longevity insurance, and uses other assets for wealth transfer.

10.3.02 ***Illustrations: Different choices***

How do people choose among different forms of plan benefits? The best approach is to get professional advice; see factors discussed at ¶ 10.3.03. Here are examples of some of the approaches people consider.

Hugh, Stu, Lou, and Sue Example: Hugh, Stu, Lou, and Sue are all retiring from Acme Widget. The Acme DB Plan offers every type of annuity or term certain payout permitted by the RMD regulation (minimum term payout ten years), but does not offer the lump sum distribution option.

Hugh views his pension as an asset to be consumed during his life, with his other assets to be used for estate planning objectives. Since he plans to consume the pension, he doesn't mind if his premature death leaves his beneficiaries with no value from the plan; he doesn't intend them to have this particular asset in any case. Hugh chooses a single life annuity, which provides the largest payments to him.

Stu's main concern is to provide for his wife. He chooses a joint and 100 percent survivor life annuity with her as his sole beneficiary.

Lou is primarily interested in providing an inheritance for her children. She decides that the best way to do that is to take a life annuity (thus providing the largest possible payments to herself), and use those annuity payments to buy a life insurance policy (through an irrevocable trust, to keep the proceeds free of estate taxes) that will provide for her children in case of her death. Premature death would cause an economic loss under the annuity, but a gain under the insurance policy. With the combination of a life annuity and a life insurance policy, she has hedged away all risk of both premature death and living too long.

Unlike Hugh, Stu, Stu's wife, and Lou, Sue is not in good health. She would "lose" by choosing a life annuity payout, because she is likely to live less long than the "average" person her age. She is also uninsurable, so she can't use the life insurance technique Lou uses. She will choose a period-certain payout, the shortest one the plan offers so as to move the money out of the plan as quickly as possible. That way it is maximally available for her needs, or for estate planning moves such as lifetime gifts, and the guaranteed term means there will be no economic loss caused by her premature death.

*10.3.03 **Expert tip: Subsidized plan benefits***

Often the retiree's decision is made complicated not merely by a variety of annuity offerings, but by the additional option of taking a lump sum distribution and rolling it over to an IRA instead of taking any annuity offered by the plan; and also by the issue of subsidized benefits.

A retirement plan may subsidize certain options. Typically, for example, a plan may subsidize the joint and survivor spousal annuity option:

Parker Example: Parker is retiring. His plan offers him three options: a life annuity of $1,000 per month; a lump sum cash distribution of $X (which is the actuarial equivalent of a life annuity of $1,000 per month for a person Parker's age); or a joint and survivor annuity with his wife. In order for the joint and survivor annuity to be actuarially equivalent to the straight one-life annuity, the payment to Parker should be reduced to something less than $1,000, to reflect the addition of the survivor annuity. However, this particular plan (like the plan discussed in PLR 2005-50039) provides that a 60 percent survivor annuity can be provided for the participant's spouse without any reduction of the participant's benefit if the spouse is not more than five years younger than the participant. In effect the plan is offering Parker a "free" 60% survivor annuity for his wife.

An early retirement pension is another type of benefit a plan might subsidize. For example, if Parker is 60 years old, and is entitled to a pension of $1,000 a month for life starting at age 65, the

plan might offer him the choice of $1,000 a month for life beginning at age 60 (subsidized early retirement benefit) or a lump sum of $Y (the actuarial equivalent of the $1,000-a-month pension starting at age 65). If he takes the lump sum, he is giving up $60,000 (five years' worth of $1,000-a-month payments) and getting nothing in return.

Does this mean the participant should always choose the subsidized benefit, to avoid wasting money? No. If the participant is in poor health, or if the pension plan is in poor financial shape, any life annuity would be a "bad bet," even if it is subsidized. The point is not that one should always take the subsidized benefit; the point is that one should be aware which benefit forms, if any, are subsidized by the plan, in order to properly evaluate the choices. This point can be missed when (for example) a financial advisor who wants to manage the participant's money focuses only on the possibility of rolling over a lump sum distribution to an IRA, without evaluating the plan's annuity options.

10.3.04 ***More expert tips: How to evaluate choices***

How can the retiree tell the relative values of different benefit options? Fred Lindgren, Vice President and senior actuary with Fidelity Investments, points out that (since 2006) pension plans are required to tell retirees the relative values of the different options the plan is offering them. See Reg. § 1.417(a)(3)-1(c). (This regulation, though it appears to deal with qualified annuity options that must be offered to married participants, also applies to unmarried employees.)

Unfortunately, Fred says, the plan's use of different interest and mortality assumptions to calculate benefits and/or display the "relative values" of benefits (all as permitted by the IRS regulations) may create additional confusion. Accordingly, the participant should still seek outside help. A professional advisor acting on the retiree's behalf can evaluate the options using "apples to apples" comparisons, and can also consider the individual's own health and financial needs, and the financial health of the plan, factors the plan does not take into account in its "relative value" analysis.

Fred also warns:

- ❑ **If you delay the start of your pension** (for example, because you are still working), will you get an increased pension when you eventually start taking payments, or are you giving up current monthly payments and getting nothing in return? In this situation, a "cash balance" plan would typically be more favorable than a "classic" DB plan.

- ❑ **If you want an annuity benefit:** Will the plan buy your annuity from an insurance company, or fund it directly from plan assets? If the latter, and your benefit exceeds the amount insured by the federal pension guaranty program, are you willing to take the risk of the plan's insolvency? Are you better off rolling over a lump sum to an IRA and buying the annuity in the IRA?

If the amount of benefits is not large enough to justify the fee for consulting a professional actuary, a "quick and dirty" method of evaluating the plan's annuity offerings is to compare the prices you would have to pay to purchase each option from an annuity company, *outside* the plan. You can obtain such annuity quotes (free) from the website www.annuityquotes.com.

4. Plan loans: What to do upon terminating employment

QRPs are permitted to make loans to employees from their accounts in the plan provided various requirements are met regarding the amount of the loan and the repayment terms. § 72(p)(2). There are two ways a loan from a QRP to a participant can result in an income-taxable distribution.

- **Deemed distribution caused by "flunking" § 72(p)**. First, if the loan does not meet the requirements of § 72(p) (either from the beginning, or because the employee later fails to meet the repayment terms) the loan (or, if the problem is that the loan exceeded the permitted amount, the excess part of the loan) is treated as a "deemed distribution" to the employee. A deemed distribution under § 72(p) is not an eligible rollover distribution. Reg. § 1.402(c)-2, A-4(d).

If, after the loan was treated as a deemed distribution, the employee does in fact repay the loan, then such repayments are treated as employee after-tax contributions to the plan for purposes of computing the employee's basis (investment in the contract). Reg. § 1.72(p)-1, A-4, A-10, A-11, A-21; see IRS Instructions for Forms 1099-R and 5498 (2016), p. 8, "Loans Treated as Distributions." *This circumstance gives a few individuals an unusually high basis in their plan accounts; see Part IV(6)–(8) for what to do with this "unique circumstance."*

- **Plan loan offset distributions.** If the loan complies with § 72(p), we get away from the nonrollable deemed distribution that occurs when § 72(p) is violated. We then encounter another type of deemed distribution, the "plan loan offset distribution." This occurs when the employee terminates his employment. Typically the plan requires the loan to be repaid at that point, and typically the plan just reimburses itself out of the employee's account and gives the employee a check for the net amount of his plan benefits minus the loan amount. The plan's repayment of itself is called a loan offset, and it is considered an actual distribution to the participant.

A plan loan offset IS an eligible rollover distribution; the participant can roll it over using substituted funds. Reg. § 1.402(c)-2, A-9; PLR 2006-17037; IRS Instructions for Forms 1099-R and 5498 (2016), p. 4. See *Tilley v. Comm'r*, T.C. Summary 2008-86, in which an employee failed to pay back a plan loan. The Tax Court ruled that, for purposes of computing the 60-day rollover deadline (¶ 2.6.06), the offset distribution was deemed to have occurred upon expiration of the loan's 90-day cure period.

An outstanding plan loan means extra planning work when the participant retires or changes jobs: Where will he get the money to either pay off the loan, roll over the "offset" distribution, or (if he can't do either of those things) pay the taxes on the phantom income resulting from the offset distribution?

5. Case study: Ralph's decisions at retirement

Ralph comes to see you a few months before his retirement from Kramden Bus Co., where he has worked since 1970. He has three retirement plans with Kramden, a defined benefit plan, a money purchase pension plan (worth $400,000) and a profit sharing plan worth $1 million. The $1

million in the profit sharing plan includes $100,000 cash value of a $500,000 life insurance policy that the plan owns on Ralph's life.

Under the defined benefit and money purchase plans, Ralph can take a life annuity that provides a 50 percent survivor annuity to his spouse Alice; or (if Alice consents) he can instead take a single life annuity for himself alone or a lump sum distribution in cash. Regarding the profit sharing plan, the only option is a lump sum, but he can either take the life insurance policy with him or direct the plan to convert the policy to cash. He wants advice in evaluating the various payout options, and in deciding whether to cash out the plans, roll them to an IRA, or consider other alternatives.

To make sure we consider all factors that go into this decision, we need some more information about Ralph, such as:

What is the state of his and his wife's health? If their health is robust and they are from long-lived families, the plans' annuity options may become relatively attractive, and the life insurance policy may seem less attractive. An actuary should be engaged to advise whether the pension plans' annuity options are financially favorable and to analyze the terms of the life insurance policy to determine if it is worth keeping.

Often the retiree's decision is made complicated not merely by a variety of annuity offerings, but by the additional option of taking a lump sum distribution and rolling it over to an IRA instead of taking any annuity offered by the plan; and also by the issue of subsidized benefits. See the "Expert tips" below.

What other assets do the spouses own—both inside and outside retirement plans? Suppose Alice has a $2 million 403(b) plan, and the spouses also own $1 million worth of personal residences, $1 million of life insurance and a $2 million investment portfolio. If Ralph takes all his benefits in lump sum form and rolls them all to an IRA, the couple will then have close to $4 million in retirement plans—and be facing huge distributions in a few years when Ralph reaches age 70½. With those facts, we would look for favorable ways to get money out of the retirement plans. For example, *if* Ralph could take a "lump sum distribution" (LSD) of the money purchase plan, it could qualify for 10 year averaging (if he was born before 1936...this particular "grandfather rule" is rarely if ever applicable now, since those qualifying are over 82 and presumably already have retired) and for the 20 percent maximum tax on pre-1974 benefits (if Ralph has participated in the plan since before 1974). If these two "grandfather rules" applied, they would produce a fairly low tax rate (under 25%) if applied *only* to the $400,000 money purchase plan.

It is probably not possible, however, to get a LSD of the money purchase pension plan because "all pension plans are considered as one plan" for purposes of determining whether he has taken a distribution of his entire interest in the plan in one taxable year; thus the defined benefit plan would be combined with the money purchase plan and the combined total would be large enough that the 10-year averaging would cease to be attractive. (The 10-year averaging tax rate is graduated.)

Nevertheless it would be worth investigating whether there is any way to split the plans for this purpose; for example, if Ralph took a distribution of his entire interest in the defined benefit plan by taking distribution of an annuity contract, prior to his retirement, then retired (separated from service), the money purchase plan perhaps could be considered on its own. This depends on whether Ralph wants to take an annuity from the DB plan and whether the DB plan would permit such a distribution prior to Ralph's separation from service (he has reached normal retirement age under the plan, though he is still working).

Ralph decides he wants to keep the life insurance policy in force; he also wants to roll over his profit-sharing plan to an IRA, maximize deferral of income taxes, and keep the life insurance out of his taxable estate. He cannot roll the insurance policy over to an IRA, since an IRA cannot hold life insurance. The plan could simply distribute the policy to him, and then he could give the policy to an irrevocable life insurance trust (ILIT). One drawback of this approach is that he loses future potential income tax deferral on the value of the policy, because he would have to pay income tax, when the policy is distributed to him, on the policy value (minus any portion of the premiums he paid income tax on over the years).

This current income tax can be avoided by having Ralph *buy* the policy from the profit sharing plan, before anything is distributed. Such a purchase can be done by complying with a detailed Department of Labor class exemption granted to these transactions (which otherwise might be "prohibited transactions"). The policy would be valued at "fair market value" for income tax purposes, so Ralph would have to pay the plan that amount to avoid income tax on the distribution of the policy. Determining fair market value may require an appraisal of the policy, unless the "safe harbor" valuation method in Rev. Proc. 2005-25, 2205-17 I.R.B. 962 (April 2005) is used.

The other drawback of giving the policy to an ILIT is that the gift triggers the three-year waiting period under § 2035 before the policy is removed from his estate; it may be possible to avoid the waiting period by distributing the policy to Ralph, then having a family partnership in which Ralph is a partner buy the policy from Ralph. Ralph must be a member of the buying partnership to avoid the adverse income tax consequences of a transfer for value under § 101(a)(2). If he sells the policy, it may be possible for him to roll over the sale proceeds tax-free to an IRA. Another possible route is to have the plan sell the policy to a trust that is beneficiary of the policy and that is a 100% "grantor trust" as to Ralph; other DOL guidelines apply in this case.

II. TAKING CARE OF "GRANDFATHER"

The retirement benefits landscape is littered with "grandfather rules." While these provide no benefit to most clients, a particular grandfather rule may provide a considerable benefit to the rare client who qualifies for such rule. It is typically at retirement that the lucky "grandfathered" client faces the choice of preserving, cashing in, or destroying his special grandfather benefits.

1. Pre-1987 403(b) balances

A 403(b) participant whose plan holds separately-identified pre-1986 funds gets some special privileges that may or may not be worth bothering with. The following is excerpted from ¶ 1.4.06 in Chapter 1 of *Life and Death Planning for Retirement Benefits*.

The RBD for all 403(b) plans is April 1 of the calendar year following the later of the year the participant reaches age 70½ or the year the participant retires. There is no possibility of a different rule for 5-percent owners because all 403(b) plans are maintained by tax-exempt charitable organizations that have no "owners." Reg. § 1.403(b)-3, A-1(c)(1). In contrast to the rule for qualified plans, there is no apparent permission for the plan to establish an RBD earlier than that in the statute.

A "grandfather rule" applies to certain pre-1987 balances in 403(b) plans if separately identified. See Reg. § 1.403(b)-3, A-2, A-3. The Tax Reform Act of 1986 made the minimum distribution rules applicable, for the first time, to all 403(b) plans, but made this rule prospective

only by exempting any pre-1987 403(b) plan balance from the new regime, provided such balance is accounted for separately. The pre-1987 account balance, while not subject to the full panoply of today's minimum distribution rules, is still subject to the more primitive predecessor of today's rules, the **incidental death benefits rule** of Reg. § 1.401-1(b)(1).

Here are the three advantages of qualifying for this grandfather rule: First, the age for starting lifetime required distributions from the pre-1987 balance is actual retirement or, if later, age 75 (not age 70½). See PLR 9345044. Second, required distributions from the grandfathered balance are computed under the **incidental death benefits rule**, meaning that any mode of distribution to the participant qualifies provided that it is projected to distribute the benefits over the lifetimes of the participant and his spouse, or to distribute at least 50 percent of the benefits during the participant's life. Reg. § 1.403(b)-3, A-3; Rev. Rul. 72-240, 1972-1 C.B. 108; Rev. Rul. 72-241, 1972-1 C.B. 108, ninth paragraph. Third, there were no specific requirements for how rapidly death benefits would have to be distributed if the participant died before commencing distributions.

The significance of this grandfather rule has diminished over the years. The pre-1987 grandfather amount is a frozen, fixed-dollar amount; investment earnings and gains do not increase the grandfathered balance. Reg. § 1.403(b)-3, A-2(a), (c). With the passage of time, additional contributions to the plan and investment growth make the pre-1987 balance an ever-smaller percentage of the overall plan balance, so in most cases it is not a significant planning factor.

To preserve these advantages for the grandfathered balance, the participant should not take any distributions from the 403(b) plan other than RMDs with respect to the post-1986 balance, because any distributions in excess of such RMDs are deemed to come first out of the pre-1987 balance.

2. TEFRA 242(b) elections

Did the client participate in his qualified retirement plan (QRP) prior to 1984? If so he may have signed a TEFRA 242(b) election. The following is excerpted from ¶ 1.4.10 of Chapter 1 of *Life and Death Planning for Retirement Benefits*:

TEFRA (1982) significantly expanded the minimum distribution rules. For years after 1983, § 401(a)(9) would apply to *all* QRPs (previously it had applied only to Keogh plans). Under the pre-TEFRA rules, no distributions were required prior to retirement; TEFRA (and the Tax Reform Act of 1984, "TRA '84," which "cleaned up" the TEFRA changes via many retroactive amendments) added a requirement that 5-percent owners would have to start distributions at age 70½ even if still employed. TEFRA also added requirements for post-death distributions (there had been none previously).

TEFRA contained a grandfather rule, § 242(b)(2), which provided that a plan will not be disqualified "by reason of distributions under a designation (before January 1, 1984) by any employee of a method of distribution...(A) which does not meet the requirements of [§ 401(a)(9)], but (B) which would not have disqualified such [plan] under [§ 401(a)(9)] as in effect before the amendment" made by TEFRA. TRA '84 continued the TEFRA grandfather rule: The TRA '84 changes would not apply to "distributions under a designation (before January 1, 1984) by any employee in accordance with a designation described in section 242(b)(2) of [TEFRA] (as in effect before the amendments made by this Act)." TRA '84, § 521(d)(2)-5. The minimum distribution regulations provide special RMD rules for those with TEFRA 242(b) elections. Reg. § 1.401(a)(9)-8, A-13–A-16.

As a result of the many changes brought by TEFRA, there was a flurry of activity among sophisticated plan participants trying to make a "designation" by December 31, 1983 that would enable them to continue to use the older, more liberal rules. Theoretically, participants with TEFRA 242(b) elections in effect can postpone the start of RMDs past age 70½, until retirement (even if they own more than 5 percent of the employer), and their death benefits are not subject to the "5-year rule" or the "at-least-as-rapidly" rule (§ 401(a)(9)(B)(i)). Unfortunately, TEFRA 242(b) elections have not proved as useful as originally expected for several reasons:

1. The requirements for a valid election, as set forth in Notice 83-23, 1983-2 C.B. 418, 420, are quite restrictive: "The designation must, in and of itself, provide sufficient information to fix the timing, and the formula for the definite determination, of plan payments. The designation must be complete and not allow further choice." P. 419. This does not mean the designation may not be amendable or revocable. Rather, the designation must be self-executing, requiring no further actions or designations by the participant to determine the size and date of distributions. Some purported TEFRA 242(b) elections do not meet this test.

2. Rolling over QRP benefits protected by a 242(b) election into an IRA causes loss of the 242(b) protection. However, grandfather protection is not lost if benefits are moved to another QRP without any election on the part of the participant (for example, as a result of a plan merger), if the transferee plan accounts for such benefits separately. Reg. § 1.401(a)(9)-8, A-14, A-15.

3. TEFRA 242(b) elections generally attempted to defer distributions for as long as possible. This turned out to be counterproductive, because an unrealistically long proposed deferral made it more likely that a participant who had made a 242(b) election would want to make withdrawals sooner than his "designation" indicates. However, "any change in the designation will be considered to be a revocation of the designation." Notice 83-23, p. 420.

4. If the 242(b) election is revoked, drastic results ensue. In effect the grandfathered status is revoked retroactively, and the participant is required to take make-up distributions—withdraw from the plan all the prior years' distributions he had skipped. Reg. § 1.401(a)(9)-8, A-16.

Thus, a participant relying on a TEFRA 242(b) election lives in a perilous state. The longer he defers his distributions, the larger becomes the make-up distribution that will be required if he ever changes his mind and modifies the designation.

An over-age-70½ participant whose TEFRA 242(b) election called for a lump sum distribution of the benefits at retirement can retire, take the lump sum, roll it over to an IRA, and commence taking RMDs from the IRA in the normal fashion, without being required to take make-up distributions. PLR 2005-10035. If his election had called for instalment or annuity payments rather than a lump sum, taking a lump sum would presumably be considered a modification, but there are no rulings on this point.

Where to read more: For how to compute RMDs for past years (for purposes of determining the amount of a required catchup distribution), see ¶ 1.9.04 of *Life and Death Planning for Retirement Benefits* and the author's *Special Report: Ancient History*, downloadable at www.ataxplan.com.

3. Participants born before January 2, 1936

Part I of this Seminar Outline explained what a "lump sum distribution" (LSD) is and described one particular "deal" available for LSDs, namely, the special deferred and lower tax applicable to the "net unrealized appreciation" (NUA) portion of employer securities. There is another "deal" available for some LSDs, namely, "special averaging." Special averaging is available to far fewer individuals than NUA is potentially available to. The NUA deal can apply to any employee who has employer securities in his or her QRP account. In contrast, special averaging is available only for LSDs paid to participants born before January 2, 1936, or beneficiaries of such participants.

Another difference: The definition of LSD is much narrower and stricter for purposes of the special averaging deal than for purposes of the NUA deal. For example, an employee who wants to use special averaging must NOT roll over any portion of his or her LSD. That limitation does not apply to the favorable NUA treatment.

To read about the advantages and requirements of this rarely-applicable grandfather rule, see ¶ 2.4.06–¶ 2.4.07 of *Life and Death Planning for Retirement Benefits*, or the author's *Special Report: Ancient History*, downloadable at www.ataxplan.com.

4. The estate tax exclusion lives?

A participant who separated from service before 1983, and dies without having changed the "form of benefit," is entitled to 100 percent exclusion of the retirement benefit from his gross estate for federal estate tax purposes. If he separated from service after 1982 but prior to 1985, the exclusion is limited to $100,000. See § 1852(e)(3) of TRA '86.

Therefore: If you are advising a client who still has benefits in a plan that qualify for this exclusion, do NOT roll over those benefits to another plan, and do NOT change the form of benefits. Doing so would cause loss of the exclusion. See PLR 9221030 for how this exclusion works.

III. SHOULD YOU ROLL OVER OR STAY PUT?

A participant who is entitled to take money out of a QRP, 403(b) plan, governmental 457(b) plan, or IRA can roll his distribution over to just about any other kind of eligible retirement plan. What are the reasons someone should stay in or roll over to any particular type of plan?

See Part IV(1) and (8)[¶ 2.1.11(c)] below for reasons to roll money *out of an IRA and into a QRP or 403(b) plan*. This Part III provides reasons to roll funds *from a QRP to an IRA* (or to leave the money in the QRP, or in an IRA for that matter). Following this are some tips on how to accomplish a rollover. These ideas are excerpted from the author's *203 Best & Worst Planning Ideas for Your Client's Retirement Benefits* (see "Resources," p. 5).

1. **Rollover from QRP to IRA: Effect on post-death distribution options for certain beneficiaries.** When deciding whether to leave money in a 401(k) plan or roll it over to an IRA, consider the effect the rollover will have on the planning options available to your beneficiaries.

A. Preserving the stretch: Nonspouse designated beneficiary. Many QRPs offer a lump sum as the only form of death benefit. A lump sum is fine if the beneficiary is the surviving spouse (because she can roll over the distribution to her own IRA or plan) or a charity (which is income tax-exempt). But if your beneficiary is a nonspouse designated beneficiary (i.e., an individual or a qualifying see-through trust), the beneficiary will probably want to use the deferred "life-expectancy" or "stretch" payout that the law would permit but that most QRPs do *not* permit. If the benefits are left to a nonspouse "designated beneficiary," the designated beneficiary can direct the plan to transfer the lump sum to an inherited IRA, thus preserving the life expectancy payout option (if he completes the rollover by the end of the year after the year of the participant's death; IRS Notice 2007-7, 2007-5 I.R.B. 395). However, by leaving it up to the beneficiaries to take care of that rollover after your death, you may be increasing the risk that mistakes will be made and the beneficiaries will end up with an immediately taxable lump sum distribution rather than a stretch IRA. You can reduce that risk by rolling the money to an IRA while you are still alive (so you *know* the beneficiaries will be entitled to the stretch payout, and they can use the stretch payout without having to incur the hazards of transferring funds to a different plan).

B. If leaving benefits to an estate or non-see-through trust: If the participant wants to leave his QRP benefits to his estate or to a non-see-through trust (i.e., not to a "designated beneficiary"), *and* wants the beneficiary to be able to use the 5-year rule or the participant's life expectancy (depending whether the participant dies before or after his RBD; see ¶ 1.5.06 and ¶ 1.5.08 of *Life and Death Planning for Retirement Benefits*) to stretch out the payments somewhat after his death, he needs to roll the benefits to an IRA *before* death, if the QRP requires an immediate lump sum distribution as the only form of death benefit. A beneficiary that is not a designated beneficiary cannot roll the lump sum distribution over even to an inherited IRA.

C. Pre-death rollover to IRA eliminates the option for Roth conversion by beneficiary. "A" and "B" above provide reasons why a participant SHOULD roll over funds from a QRP to an IRA while he is still alive if his goal is to maximize deferral options for his beneficiaries. Now here's a reason that cuts the other way. A nonspouse designated beneficiary who inherits a QRP can convert that inherited plan account to an inherited Roth IRA, by transferring the inherited plan benefit to an inherited Roth IRA, if the beneficiary is otherwise eligible to convert to a Roth. IRS Notice 2008-30, 2008-12 I.R.B. 638. But if the participant rolls the QRP to an IRA before death, so the beneficiary inherits only a traditional IRA rather than a QRP, the beneficiary can *not* convert that inherited IRA to an inherited Roth IRA! § 408(d)(3)(C), A-7. Thus, the potential desirability of a Roth conversion of the inherited account by the nonspouse designated beneficiary must be weighed when the participant is deciding whether to roll his benefits into an IRA during his lifetime.

Prior to enactment of Pension Protection Act of 2006 (P.L. 109-280) and issuance of IRS Notice 2008-30, improving post-death distributions options for all nonspouse noncharitable beneficiaries was a major incentive for rolling benefits OUT of a QRP and INTO an IRA prior to the participant's death, because so many QRPs offer only the lump sum distribution form of benefit. However, post-2006 this incentive for QRP-IRA rollovers is diminished (*if* the participant is leaving his QRP benefits to a designated beneficiary, i.e., an individual or see-through trust) because of the potential for a post-death rollover by the beneficiary to an inherited IRA or even to an inherited Roth IRA.

2. **Roll from QRP to IRA for investment flexibility, lower expenses.** Generally, an IRA offers more investment choices than the typical 401(k) plan (which limits investment choices to a handful of mutual funds).

Although some QRPs offer professional investment management that employees feel is superior to what they could do on their own, the average client who wants to do his own investing will prefer an IRA. Also, a QRP may have relatively high expenses; this could result in a higher cost of leaving benefits in the employer's plan. However, if the participant wants his account to hold a loan to himself, life insurance, or collectibles, he should leave the money in the QRP as these investments are not permissible in an IRA. § 408(a)(3), (e)(2), (m).

3. **Roll from QRP to IRA to eliminate federal spousal rights.** If the participant does not want his spouse to have the survivor's annuity rights granted by § 401(a)(11), the participant may be able to eliminate those rights by rolling the money over from the QRP to an IRA.

While all QRPs must grant an employee's surviving spouse some rights to any death benefits under the plan (the spouse's entitlement can be as much as 100% of the death benefits, depending on the plan), an IRA is not subject to the federal spousal rights.

<u>Pension plans</u>: Under all pension plans and some types of profit-sharing plans, the employee can take a distribution, and roll it over to an IRA, ONLY if his spouse consents to allow the benefits to be distributed in a form other than a "qualified joint and survivor annuity" (QJSA) under which the spouse has a survivorship benefit. § 417(a)(2). If the participant is planning to marry, and does not want his future spouse to have these rights, he can eliminate those rights by rolling the money over from the QRP to an IRA *before the wedding*. A prenuptial agreement can then be used to limit the new spouse's rights to the IRA. A prenuptial agreement cannot eliminate the spouse's QJSA and death benefit rights to the QRP (but might be effective to regulate her divorce rights).

<u>Profit-sharing plans</u>: With certain types of profit-sharing plans, a married employee can take the distribution and roll it over to an IRA *without* getting the spouse's consent (even though she would be entitled to 100% of the plan benefits if he died while the money were still in the profit-sharing plan). § 401(a)(11)(B)(iii)(I). Thus, even a married employee can deprive his spouse of federal death benefit rights in this type of profit-sharing plan simply by rolling the money out of the plan, while he is still alive, into an IRA. Of course, after the money is rolled to an IRA, state law may give the spouse rights to it even though federal law doesn't.

Where to read more: ¶ 3.4 of *Life and Death Planning for Retirement Benefits* explains the federal spousal rights in retirement plans.

4. Use a direct rollover if you will need college financial aid. There are two ways to roll money from a QRP to an IRA: trustee-to-trustee transfer (also called "direct rollover") (money is sent directly from the QRP to the IRA) and 60-day rollover (money or property is distributed to the participant, who then, within 60 days, contributes the same assets he received to the same or another eligible plan).

According to Thomas P. Brooks, writing as President of College Funding Advisors, Inc., (http://collegefundingadvisors.com/) in determining what income parents have available to contribute towards their child's tuition, money transferred in a direct rollover would never be considered "income," but money transferred in a 60-day rollover, because it appears as gross income on the parents' Form 1040 (even though it's not taxable, because of the rollover) WILL be counted as part of the parents' income by some financial aid offices.

Where to read more: I read this idea, and several other of Mr. Brooks's ideas about how to integrate retirement benefits with college funding-planning, in the October 2003 issue of the highly recommended newsletter, *Ed Slott's IRA Advisor* (see "Resources," p. 5). You can get that back issue by subscribing to the newsletter.

5. Use a direct rollover even if you DON'T need college financial aid. There are three problems with using a "60-day rollover" instead of a "direct rollover," even if you're not worried about how your income will look to a college financial aid office.

First, the QRP must withhold 20 percent for federal income taxes from any eligible rollover distribution made to the participant (meaning that to roll over 100% of the distribution the participant must supply the missing 20 percent by substituting other funds, then wait to receive a refund of the 20% withheld tax when he files his tax return). § 3405(c). *Second*, the participant must roll over the same property he received in the distribution (or the proceeds thereof, if he sold it after it was distributed). § 402(c)(1)(C), (6)(A). This can create a minor headache, namely, tracing the distributed assets. *Third*, the participant must complete the rollover within 60 days (though an extension may be available, at large expense, if the participant is unable to complete the rollover within 60 days due to hardship). § 402(c)(3). Skip all these problems: use the direct rollover.

6. For creditor protection: Keep QRP rollovers in one IRA, "regular" IRA contributions in a different IRA. Andrew J. Fair, Esq., in his seminar outline "Solving Business, Family and Tax Problems Using Qualified Plans" (Oct. 2003) pointed out that Federal bankruptcy and consumer protection law and/or state creditors' rights laws may make a distinction between IRA funds that arise from a rollover from a qualified plan and funds that represent "regular" IRA (or Roth IRA) contributions.

To avoid losing out on greater protections that may be available for QRPs and QRP rollovers, Fair suggested rolling QRP funds only to a "pure" rollover IRA (one that contains no traditional IRA/Roth IRA contributions)—and keeping this rollover IRA "pure" by not adding any

contributions to it (other than rollovers from other QRPs). This 2003 prediction came true in 2005, when Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPACPA). Under BAPACPA, there is an unlimited exemption for IRAs that contain only funds rolled over from QRPs; the exemption for IRAs funded with annual contributions is limited to $1 million (plus a COLA). If the two types of IRAs have been commingled, the Act does not specify how the exemption-limit applies.

7. **Do not roll money from one plan type to another without investigating creditor protection effects, if creditor protection is a significant issue.** For most people, protection from creditors' claims is best accomplished by purchasing the biggest "umbrella" liability insurance policy they can afford, to cover the biggest potential sources of tort claims, their homes, boats, pets, and cars. This will eliminate most creditors' claims risk for the typical salaried employee.

However, business owners, doctors and other professionals, people who serve on boards of directors, and some others need to worry about claims that cannot reasonably be insured against. For them, "asset protection" is a high priority. There is a myth that all retirement plans are exempt from creditors' claims. They are not, unless you go into personal bankruptcy. It's true that under BAPACPA (see #6 above) all types of tax-Code favored retirement plans are exempt assets in bankruptcy (subject to a $1 million cap on the exemption for IRAs funded with annual contributions). However, if you are merely sued by a creditor, and you are not bankrupt, the degree of protection of your retirement benefits depends on federal nonbankruptcy ("ERISA") law and on state law.

ERISA's rule exempting "employee benefit plans" from attachment (29 U.S.C. § 1056(d)(1), which can be found in Title 29, Chapter 18, Subchapter I, Subtitle B, part 2) does not provide 100 percent protection. For example, it *does not apply* if the only participants in the retirement plan are the business owner and/or his or her spouse. The business owner and spouse are not deemed "employees," therefore a plan that covers only them is not an "employee benefit plan"! Also, IRAs generally are not entitled to any ERISA protection. State law may shelter an IRA, but the state laws protecting retirement benefits are a crazy patchwork quilt. A person who is concerned about creditors' claims that cannot reasonably be insured against must investigate the relative protection of the various types of plans before rolling over funds from one to another.

Where to read more: Leimberg Information Services website, www.leimbergservices.com (see "Resources") has a chart summarizing all states' creditor protection laws applicable to IRAs. Under "Special Services," click the "State Law" tab, then select "IRA_Creditor_Protection_Guide." Each state's summary is written by an attorney who practices in that state. An excellent resource for Texas is "Can Creditors Reach a Person's Interest in a Qualified Plan or IRA?" by Noel C. Ice, Esq., which is sometimes available on line at his web site, www.trustsandestates.net. Subscribers to National Underwriter's Advanced Sales Reference have access to substantial material on creditors' rights.

8. **Roll DRAC money to a Roth IRA.** Roth IRAs are not subject to the lifetime minimum distribution rules; thus there are no RMDs from a Roth IRA until after the owner's death. Designated Roth accounts (DRACs), in contrast, are subject to both the lifetime and the post-death RMD rules.

Thus, generally a DRAC participant should roll his DRAC money over to a Roth IRA as soon as possible (typically, upon retirement or separation from service)—UNLESS #9 below applies!

Where to read more: See ¶ 5.7 of *Life and Death Planning for Retirement Benefits* regarding DRACs generally, and ¶ 5.7.03 for the differences between DRACs and Roth IRAs.

9. Do not roll from a DRAC to a Roth IRA shortly before meeting the requirements for a "qualified distribution" from the DRAC. This is tricky. In order to have tax-free "qualified distributions" from either a DRAC or a Roth IRA, the participant must satisfy a five-year holding period requirement and a triggering event requirement…but the holding period is computed separately for DRACs and Roth IRAs. Years accumulated in the DRAC don't count towards the five-year holding period for the Roth IRA into which the DRAC distribution is rolled.

If the DRAC distribution that is rolled into the Roth IRA is a "qualified distribution," then it comes into the Roth IRA as after-tax money (and so can later be withdrawn income tax-free at any time). But if the participant rolls out of the DRAC BEFORE he has met the requirements for a qualified distribution from the DRAC, he loses all benefit of the years accumulated in the DRAC. This can be quite a negative result if the participant (1) had several years in the DRAC and was close to meeting all the requirements for a qualified distribution and (2) rolls at a time when he has not owned a Roth IRA long enough to meet the 5-year requirement for his Roth IRA(s).

Where to read more: See ¶ 5.7.08 of *Life and Death Planning for Retirement Benefits* regarding the rules for DRAC-to-Roth IRA rollovers and the planning implications.

IV. APPROACHING THE RBD

A year for which an RMD is required is called a "Distribution Year" in this Seminar Outline ("distribution calendar year" in the regulations). The first Distribution Year is the year in which the individual reaches age 70½ (or, in the case of *certain* plans, the year in which the individual retires, if later). (The preceding sentence assumes no special grandfather rule applies! See Part II.) For ease of reference, this section will assume that the age 70½ year is the first Distribution Year.

1. Roll over (or convert) IRA BEFORE the first Distribution Year

An IRA owner (or a QRP participant who is a 5-percent owner of the employer that sponsors the QRP) must take annual RMDs from such IRA (or QRP) starting at age 70½, even if he is still working. There are only two legal ways to stop or prevent required minimum distributions (RMDs) from your IRA (or QRP, if you are a 5-percent owner) once you reach age 70½.

One is to convert the IRA or QRP to a Roth IRA. Roth IRAs are not subject to the minimum distribution rules until after the owner's death. Thus, there are no RMDs during the participant's life from a Roth IRA. Of course, Roth conversion is available only upon payment of the "price," which is inclusion in gross income of the conversion amount.

The other legal way to head off IRA RMDs is, if the participant is still working, and does not own more than five percent of the company he works for, to roll the IRA benefits over into the qualified plan (or 403(b) plan) of the employer that he works for. QRPs and 403(b) plans are not required to pay RMDs until the participant either retires or reaches age 70½, whichever is later. Similarly, a person who is still working after age 70½ for a company in which he is not a 5 percent owner can roll money into that company's QRP from the QRP of a company in which he IS a 5% owner (see PLR 2004-53026) to stop the flow of RMDs. § 401(a)(9)(C); Reg. § 1.401(a)(9)-2, A-2(e). RMDs are determined under the rules applicable to the plan that holds the benefits, not the plan that the benefits were originally in prior to a rollover. See Reg. § 1.401(a)(9)-7.

If using one of these strategies to prevent any IRA RMDs from ever accruing, the participant must convert or roll over the IRA no later than the year the participant reaches age 69½; see #2 below for why this is so. In later years, he can still use this strategy, but only after taking the RMD for the year (see ¶ 2.6.04, below).

Where to read more: See ¶ 1.4 of *Life and Death Planning for Retirement Benefits* regarding the RBD for various types of plans, ¶ 1.4.04 for definition of a 5 percent owner, ¶ 5.1.03 for the RMD rules applicable to Roth IRAs.

2. **Rollovers and conversions in the first Distribution Year (or later).** The IRA owner (or QRP 5 percent owner) can use the rollover or conversion strategy described at #1 above in his age 70½ year or any later year to stop the flow of RMDs, but unless the rollover/conversion occurs prior to the first Distribution Year, the participant will have to take the RMD for the year the rollover/conversion occurs before he can do the rollover or conversion.

Excerpt from Chapters 2 and 5 of *Life and Death Planning for Retirement Benefits*:

2.6.04 ***Rollover in a year in which a distribution is required***

A required minimum distribution (RMD) cannot be rolled over. § 402(c)(4)(B), § 408(d)(3)(E). The "trap" is that *the first distribution received in any year* for which a distribution is required is considered part of the RMD for that year and thus cannot be rolled over. Reg. § 1.402(c)-2, A-7(a). Another "trap" in this rule is that the participant's first Distribution Year is not the year in which the required beginning date (RBD) occurs; it is the year *before* the RBD. Thus the first Distribution Year is the year the participant reaches age 70½ (or retires as the case may be), even though the first RMD does not have to be taken until April 1 of the *following* year. Any distribution received on or after January 1 of the first Distribution Year will be considered part of the RMD for that year (until the entire RMD has been distributed), and thus cannot be rolled over. Reg. § 1.402(c)-2, A-7(a).

Leonard Example: Leonard turns 70½ on February 1, Year 1. On that date, he retires from his job at XYZ Corp. and asks the plan administrator of the retirement plan to send his benefits to his IRA in a direct rollover. The administrator replies that it will make a direct rollover of everything except the RMD for Year 1. Leonard is unhappy because he thought he could postpone all RMDs until his RBD in Year 2. Unfortunately, if he wants to not take any RMD in Year 1, then he also cannot do

a rollover in Year 1. Note that a direct rollover from a QRP to an IRA IS considered a "distribution" for purposes of the rule that RMDs cannot be rolled over, even though a direct rollover is NOT considered a distribution for income tax or withholding purposes!

…Also, beginning in the year the participant reaches age 70½, he will not be able to convert his IRA to a Roth IRA until *after* he has withdrawn the required minimum distribution (RMD) for the year of the conversion from the IRA, because of the rules explained above. This is true even though, in the year he reaches age 70½, he normally would not be required to take any RMD from his IRA until April 1 of the following year. Thus, if a participant wants to convert his entire traditional IRA to a Roth without ever having to take an RMD from the IRA, he needs to do so no later than the year he reaches age 69½.

3. **Don't blow your LSD with RMDs.** See Part I(1), above, for explanation of the special tax deals available for certain lump sum distributions from a QRP. If a QRP participant whose account holds appreciated employer stock (NUA), or who was born before 1936, has retired, but postponed taking any distributions, the day of reckoning comes when it is time for the first RMD. He MUST take the RMD no later than April 1 following the year in which he reaches age 70½ (or retires, if later, and if he is not a 5 percent owner). In order to get the favorable NUA or "special averaging" treatment he MUST take an LSD. That means the first year he takes any distribution (even if it is an RMD) he must take his ENTIRE account balance out of the plan by the end of the calendar year in which that first distribution occurred.

Sad Sam Example: Sam retired in 2006 at age 65, leaving his appreciated "NUA" employer stock and all other benefits in his account at the Acme Widget Co. Plan. He reached age 70½ in 2011, so April 1, 2012, was his required beginning date (RBD). The company hadn't heard from Sam since 2006, so it mailed him a check for his 2011 RMD in March 2012, then sent him his 2012 RMD later in the year. In 2013 Sam comes to see you about cashing in on his NUA deal. It's too late. He's lost the deal. Since he failed to take out the ENTIRE balance within one calendar year following the most recent triggering event (separation from service in 2005), he can no longer qualify for an LSD and has lost the NUA deal. RMDs are NOT an exception to the "all in one calendar year" rule (¶ 2.2.04). Only by dying can he revive the possibility of the favorable NUA deal (for his beneficiaries), since death would be a new triggering event.

Sam's situation is unfortunately not rare; the same thing can happen to beneficiaries who take the RMD for the year of the participant's death, but don't focus on the LSD/NUA deal until the following year. Perhaps Congress will some day create an RMD exception to the all-in-one-year rule, but so far they haven't.

The same risk exists if the participant was born before 1936. He may be eligible for "special averaging" treatment, which can result in a very low rate of income tax (regardless of the amount of his other income)—but that deal is also available only for an LSD. See Part II(3), above. If, instead of taking an LSD, the participant just takes the RMD following retirement, he will cease to be eligible for either of these deals the following year. An LSD means the distribution of all benefits in *no more than one calendar year* following separation from service (or other triggering event).

4. **Combining LSD with first RMD.** If the participant has postponed taking the LSD until the first or second Distribution Year, here is an example of how to combine the LSD with the first RMD:

Elizabeth Example: Elizabeth, who retired several years ago, turned 70½ in Year 1, so her RBD is April 1, Year 2. Neither Year 1 nor Year 2 is 2009 [most RMDs were "suspended" for the year 2009]. Her 401(k) plan with her former employer contains $1 million of employer stock (with basis of $200,000 and NUA of $800,000), plus $500,000 of cash. It is now February, Year 2, and Elizabeth, after consulting with several financial, tax, and estate planning advisors, has decided: to take an LSD in Year 2; keep the NUA stock in her own name (then later selling some of it or giving some to charity); and roll over the $500,000 of cash to her IRA. She wants the *stock distribution* to satisfy her combined RMD requirement for the 401(k) plan for both Year 1 and Year 2 (which is about $120,000). To make sure this happens, she takes a distribution of all of the NUA stock FIRST, in March, Year 2. Only AFTER that stock has been distributed to her does she request a direct rollover of the cash to her IRA (which of course must be completed by December 31, Year 2, in order to have an "LSD"). If she requested the rollover first, the plan would have to distribute her RMDs to her from the cash fund before it could do a direct rollover of the rest; see #2 above. Elizabeth would then have received a nonrollable RMD in cash, and she would IN ADDITION have to pay tax on the basis portion of the NUA stock when that was distributed later in Year 2.

5. **Should you postpone the first year's distribution?** Normally, each year's RMD must be taken by December 31 of that year. However, the RMD for the first Distribution Year can be postponed until April 1 of the following year. Should you take the first Distribution Year's distribution in the first Distribution Year or postpone it until the next year?

If you postpone the first year's distribution, you will have to take two distributions in the second distribution year (because the second year's distribution must come out by the end of the second year). Also, if you postpone, the second year's RMD will be higher than it would have been if you took the first year's RMD in the first year (because the prior-year-end balance on which the second year's RMD is calculated, i.e., the end-of-the-first-distribution-year balance, still contains the first year's RMD).

Postponing also makes your RMD computations more complicated: If you postpone the first year's RMD, your two RMDs in the second year will have *different deadlines* (the deadline for the postponed first year RMD is April 1 of the second distribution year, the deadline for the second year RMD is December 31 of the second distribution year). Also, the two RMDs will be computed using *different account balances* (the postponed first-year RMD is based on the account balance as of the end of the year preceding the first distribution year, the second year's RMD is based on the account balance as of the end of the first distribution year) and different divisors (the postponed first year's RMD is based on your age as of your birthday in the first distribution year, the second year's RMD is based on your age as of your birthday in the second distribution year). Whew!

This question must be analyzed client-by-client. A financial magazine once urged, "Don't postpone your first year's distribution, because that will double up your RMDs in the second year and push you into a higher bracket!" How does the person who wrote that know that the participant will be in a higher bracket next year? Another factor to consider is that, for a taxpayer who is in the "phaseout" ranges (see Table 3 at the end of this Seminar Outline), "bunching" income into Year

2 can lower overall taxes. For example, someone who has high medical expenses in the age-70½-year and does not expect to have high medical expenses in the next year will be able to deduct more of his age-70½-year medical expenses by postponing the age-70½-year RMD until the following year, even if technically he is in the same bracket both years. Don't give one-size-fits-all advice on this question!

Here are four examples in which postponement could make sense:

Griselda Example: Griselda is retiring on November 1 in Year 1, the year she reaches age 70½. Through October, her salary was $300,000, and with accrued vacation pay that is paid to her upon retirement her Year 1 income goes over $340,000. In Year 2, she will have no income other than her retirement plan RMDs, Social Security, and some investment income, totaling about $90,000 (without counting the Year 1 RMD). The total Year 1 RMDs from all her retirement plans come to about $30,000. Postponing the Year 1 RMDs until Year 2 makes sense for Griselda, because she will be in a *lower bracket* next year, as a result of her retirement in late Year 1. Even with the double distribution, her Year 2 income would be $120,000 if she postpones the Year 1 RMDs, versus $370,000 for Year 1 if she takes the Year 1 RMDs in Year 1.

Blossom Example: Blossom is an entrepreneur who earns over $500,000 per year from her business. She expects to be in the highest income tax bracket this year (the year she reaches age 70½) and to be in the same income tax bracket next year. She prefers investing inside her IRA where she does not have to keep track of basis, holding periods, and qualified versus "other" dividends. Postponing the age-70½-year RMD will not "put her in a higher bracket" because she is already in the highest bracket and always will be. (Of course, if the law is changed so that the "highest bracket" is much higher next year than this year, she loses her bet.)

Noah Example: Noah, who is unmarried, turns 70½ in 2011. He receives $18,000 a year of Social Security benefits. His 2011 "provisional income" (see Part V(3), below), before taking any RMDs, is $34,000, so half of his Social Security benefits ($9,000) are included in his adjusted gross income (AGI). His IRA RMD is about $10,000 per year. If he takes the age-70½ RMD in the age-70½ year, it will increase his provisional income to $44,000, meaning that the amount of Social Security benefits that would have to be included in his AGI would be $15,300 (85% of $18,000) rather than $9,000 (50% of $18,000). Thus, taking a $10,000 distribution would increase his AGI by $15,300. If he postpones the distribution until 2012, he will have to take $20,000 of RMDs (two years' worth) in 2012. Those RMDs will also cause 85% rather than 50% of his Social Security benefits to be taxable, but at least he will suffer that effect in only one year rather than two.

As the Noah Example reminds us, there are numerous provisions in the Code that provide "phaseouts" at higher levels of AGI, such as (in addition to the tax exemption for Social Security benefits) the alternative minimum tax (AMT) exemption, exemption for children, [in some years—not applicable 2018–2025] phaseout of personal exemptions and reduction of itemized deductions for high-income taxpayers, and (since 2007) the amount of Medicare Part B premiums (see "Table 2" at the end of this Seminar Outline):

Zeke Example: Zeke, who is single, turned age 70½ in 2014, which was also the year he turned age 71. His modified adjusted gross income (MAGI) for 2014 for purposes of determining his 2016

Medicare Part B premium was $80,000. His 12/31/13 IRA balance was $4.3 million, meaning that the 2014 RMD from his IRA was $162,264.15 ($4.3 million/26.5; see Table 1 at the end of this Seminar Outline). If he did not take the 2014 RMD in 2014, his MAGI would stay at $80,000, and his total Medicare Part B premium for 2016 would be $1,461.60. If he took the $162,264.15 in 2014, his 2014 MAGI would have zoomed up to $242,264.15, meaning that his annual 2012 Medicare Part B premium would increase to $3,800.40. **By postponing the first year's RMD to 2015 (all other things being equal) he saves over $2,300 on his Medicare premium for 2016.** Yes would have had to take a "double distribution" in 2015, and that might have put him into a higher income tax bracket in 2015, so that needs to be figured in, and might reduce the savings.

6. **Do you know where your basis is?** Retirement plan distributions are generally taxable. Distributions are nontaxable to the extent they represent return of the participant's "basis" or "investment in the contract."

There are a number of ways a participant can acquire basis in a retirement plan. This section explains how a participant gets basis in a plan, and how to tell what part of any part of any particular distribution constitutes return of basis. Then this Seminar Outline recommends "removing" the basis before starting RMDs (though this is not always possible); see #7 and #8.

The following is an excerpt from Chapter 2 of *Life and Death Planning for Retirement Benefits*, updated to reflect changes in the law that occurred in 2014:

2.1.07 ***Recovery of participant's basis***

A distribution is nontaxable to the extent it represents the recovery of the participant's "investment in the contract," or what might be more familiarly called his "basis." § 72(b)(2). To apply this rule in any situation requires two separate determinations:

❏ What is the participant's basis? Basis usually results from the participant's nondeductible contributions to the plan, but also (in the case of a QRP) can result from certain "deemed" distributions from the plan.

❏ How much of any particular distribution is treated as a tax-free return of such basis?

To answer these questions with respect to a particular plan, see ¶ 2.1.08 for a QRP or 403(b) plan, ¶ 2.1.09–¶ 2.1.11 for a traditional IRA [.... For treatment of tax-free return of basis under the minimum distribution rules, see #7 below.]

2.1.08 ***Participant's basis in a QRP or 403(b) plan***

The participant's "investment in the contract" in a QRP consists of the sum of the following two components, "A" and "B." In addition, some QRP participants may have "investment in the contract" in a life insurance contract held within the plan; see "C." A 403(b) plan participant may have basis attributable to nondeductible contributions; see "A."

A. **Nondeductible contributions.** Some QRPs permit (or formerly permitted) employees to make after-tax contributions. In a defined contribution plan, usually the employer maintains a separate accounting for the employ*ee* contribution account (i.e., the employee's after-tax contributions and the earnings thereon) and the employ*er* contribution account (i.e., the employer's contributions and the earnings thereon). The rules of § 72 may be applied separately to these separate accounts. § 72(d)(2). This rule is favorable to the employee, because typically he has a higher basis in the employee-contribution account, so a distribution from that account might be largely tax-free if it is treated separately from the rest of his plan benefits. This fact can be used when the employee starts taking RMDs or to do a tax-free Roth conversion (see Part IV(7), below).

Some 403(b) plans and government plans have mandatory employee contributions or permit participants to contribute their own after-tax money to the plan to purchase "past service credits." These contributions are *not* kept in a separate account; the plan pays a single benefit in the form of an annuity. A distribution from such a plan is treated as a pro rata distribution of pretax and after-tax money, based on the value of the employee's entire account (see ¶ 2.1.10 below), rather than as a distribution from a separate employee contribution account. However, there are exceptions and grandfather rules, so § 72 must be carefully studied in these cases. See § 72(e)(8)(D), PLRs 2001-15040, 2004-11051, 2004-19036. The employee can increase his investment in the contract just before retiring by making these types of contributions, if permitted by the plan, if he wants to convert the largest possible amount to a Roth IRA with the lowest possible tax cost (see Part IV(7), below).

B. **QRP loans that become deemed distributions.** See Part I(4) above for how a plan loan in violation of § 72(p) can be treated as an employee contribution to the plan and become part of the employee's "investment in the contract." See Part IV(7) for how to take advantage of this after-tax money in the plan.

C. **Basis in plan-held life insurance policy.** See Part I(2), above, regarding an employee's basis in life insurance held in a QRP.

It is unusual for an employee to have any basis (investment in the contract) in a QRP, since most employees do not have defaulted or improper plan loans, plan-held life insurance, or nondeductible employee contributions. If your client does have a chunk of such after-tax money in his employer's plan, the following section #7 explains how to remove it from the plan in a tax-advantaged manner.

7. **Get rid of your basis: QRPs.** As noted (see #6 above), a few QRPs contain after-tax contributions made by the employees. Usually, the employer keeps track separately, so each employee has two accounts, the "Employer Contribution Account" (containing the employer's contributions and earnings thereon; all pretax money) and the "Employee Contribution Account" (containing the employee's contributions and earnings thereon; partly pretax money and partly after-tax).

The two accounts are treated as one account for RMD purposes, but treated as separate accounts for purposes of determining how much of each distribution is taxable. § 72(d)(2); Reg. § 1.401(a)(9)-8, A-2(a)(1). *Thus, the employee determines the combined RMD (for both accounts), but can then take the entire RMD from the Employee Contribution Account, so that a high proportion of the distribution is tax-free*.

Tax-free distributions can be used to satisfy the RMD requirement just the same as taxable distributions. Reg. § 1.401(a)(9)-5, A-9(a). The nontaxable portion of any distribution is applied, first, to the RMD. Reg. § 1.402(c)-2, A-8. If the RMD amount exceeds the nontaxable portion of the distribution, then the rest of the RMD is "filled up" from the taxable portion, and any balance of the taxable portion is eligible for rollover. See PLR 9840041, for an example of someone using this technique to "front load" his RMDs with tax-free distributions. (If there is some reason why it would be desirable to postpone the tax-free RMD, do the opposite—take the first RMD from the Employer Contribution Account).

If the participant's basis in the QRP arises from repayment of a defaulted plan loan (see Part I(4)(A)), or from the participant's purchase of past service credits, then all distributions from the plan would be deemed to come proportionately from the after-tax money ("investment in the contract") and pre-tax money ("earnings") in the account. Thus, the technique of front loading the after-tax money into early RMDs will not work for this type of "investment in the contract."

If the investment in the contract comes from premiums paid on plan-held life insurance, see Part I(2), above.

Any plan (or account in a plan) that contains after-tax money (basis or investment in the contract) is an attractive candidate for a "cheap" Roth conversion. If the plan (or account) is converted to a Roth IRA, only part of the conversion (the pretax money in the plan or account) is taxable. For example, if the account is 30 percent after-tax money, and the account is transferred by direct rollover to a Roth IRA, only 70 percent of the transfer is taxable.

Beginning in September 2014, the IRS opened the door to an even more attractive option: Converting *only* the after-tax money to a Roth IRA, while rolling the pretax money to a traditional IRA for a traditional tax-deferred rollover. For who is eligible to do this and how to do it, see ¶ 2.2.04(C) below.

8. How to do a basis-ectomy: IRAs. A participant can have basis in a traditional IRA either as the result of rolling over a nontaxable distribution from a QRP, or by making nondeductible contributions to the IRA. IRA basis becomes a GIANT pain in the neck when it comes time to take RMDs, as the following explanation reveals.

IRA basis is such a pain (once distributions start) that some advise against ever making nondeductible IRA contributions in the first place; see Hoyt, Christopher, "Why Not to Invest in Non-Deductible IRAs," *Trusts & Estates*, Vol. 144, No. 9, p. 70 (Sept. 2005). Not everyone agrees with Hoyt, though; for one thing, investing inside an IRA is easier than investing outside an IRA because you don't have to keep track of holding periods, qualified versus nonqualified dividends, etc. Also, having more in your IRA (whether it's pre- or after-tax money) gives you more that you can convert to a Roth IRA someday. Finally, when you retire, you MAY be able to get that after-tax money out of the IRA up front (to avoid the hassles discussed below); this Seminar Outline points out a method that some people (perhaps not very many people) can use to get rid of the basis before starting RMDs.

Excerpt from Chapter 2 of *Life and Death Planning for Retirement Benefits:*

2.1.10 ***How much of IRA distribution is basis?***

The general rule is that, for purposes of determining how much of a traditional IRA distribution is nontaxable, all of the participant's traditional IRAs are treated as one traditional IRA, and all distributions in one taxable year are treated as one distribution. See § 408(d)(1), which provides that IRA distributions are includible in gross income "in the manner provided under § 72." § 408(d)(2) then provides that: "For purposes of applying section 72 to any amount described in paragraph (1)...(A) all individual retirement plans shall be treated as 1 contract, [and] (B) all distributions during any taxable year shall be treated as 1 distribution...."

Then, each distribution from any IRA is deemed to contain proportionate amounts of the pretax and after-tax money in the aggregated IRAs. § 72(e)(2)(B), (5)(A), (5)(D)(iii), and (8)(B).

Since the conversion of a traditional IRA to a Roth IRA is treated as a distribution from the traditional IRA, the same rules are used to determine how much income a taxpayer realizes when he converts part of his IRA to a Roth. Reg. § 1.408A-4, A-7(a).

Ed Slott: the Cream-in-the-Coffee Rule

Ed Slott, CPA, one of America's leading IRA experts and author of several books on retirement distribution planning and publisher of *Ed Slott's IRA Advisor* newsletter, calls § 408(d)(2) the "cream-in-the-coffee rule." Once after-tax money (cream) has been combined with the pretax money (coffee) in your IRA, every "sip" (distribution) taken from your IRA will contain some cream and some coffee.

The cream-in-the-coffee rule, combined with the rule that all IRAs are treated as one, trips up some taxpayers:

Gibbs Example: Gibbs has made a total of $12,000 in nondeductible contributions to his traditional IRA at X Mutual Fund, which is now worth $30,000. He also has a traditional IRA worth $205,000 at Y Mutual Fund. The larger IRA received no after-tax contributions; it contains only a rollover from a QRP maintained by Gibbs's former employer, plus some deductible IRA contributions Gibbs made prior to 1987. He has no other IRAs. In Year 1, he cashes out the $30,000 IRA. He thinks that, because that particular account contains his $12,000 of after-tax contributions, he will be taxable on only $30,000 - $12,000, or $18,000. Unfortunately, because of § 408(d)(2), Gibbs's $30,000 distribution is *deemed* to come proportionately from *both* of his IRAs (valued as of the end of Year 1), even though it *actually* came from only one of them. Therefore, the amount of the distribution that is deemed to come from his after-tax contributions is A/B x C, where:

A = the total amount of Gibbs's basis in both IRAs, $12,000;

B = the total value of both IRAs as of the end of Year 1, with any amounts distributed out of either traditional IRA in Year 1, including amounts rolled over to a Roth IRA, added back in for this purpose. Assume the Year 1 year-end value of his remaining IRA is $210,000, and there were no

distributions from either IRA in Year 1 other than the $30,000 distribution. Therefore, B = $240,000 ($210,000 + $30,000); and

C = the total amount of Year 1 distributions; in this case, the only Year 1 distribution was $30,000, so C is $30,000.

The amount of the $30,000 distribution Gibbs can exclude from his gross income is therefore $12,000/$240,000 x $30,000, or $1,500. The amount of gross income he must report is therefore $28,500 ($30,000 distribution minus $1,500 basis assigned to the distribution). His remaining basis in his traditional IRA is $10,500 ($12,000 total basis, less $1,500 used up in the Year 1 distribution).

2.1.11 ***Exceptions to the cream-in-the-coffee rule***

There are (at least?) three exceptions to the cream-in-the-coffee rule.

A. **Qualified charitable distributions.** One exception is for "Qualified Charitable Distributions" (QCDs; see Part VI). A QCD is the distribution of up to $100,000 from the IRA of an individual over 70½ directly to an eligible charity, is deemed to come first out of the pre-tax portion of the individual's IRA.

Thus, an individual who is over 70½ and who has $100,000 of pretax money in his aggregated IRAs, plus some after-tax money, can give the $100,000 to charity via a QCD, leaving just the after-tax money in the IRA. He then cash out this "stub" IRA tax-free or convert it to a Roth IRA if his is eligible…and the fact that the QCDs were excluded from his income will help him on the Roth-conversion eligibility test!

B. **QHSA funding distributions.** The second exception is for a qualified Health Savings Account funding distribution, which (like the QCD) is deemed to come entirely from the pretax money in the individual's IRAs until that has been exhausted. § 408(d)(9)(E). Unlike with the transfer from an IRA to a QRP or 403(b) plan, the individual can also transfer after-tax money from an IRA to an HSA if all the pretax money in the account has been used up.

C. **Rollovers from an IRA to a QRP or 403(b) plan.** Another exception to the cream-in-the-coffee rule: The proportionate allocation rule does not apply to rollovers from an IRA to a QRP or 403(b) plan. Instead, a distribution that is rolled from an IRA to a QRP or 403(b) plan is deemed to come entirely out of the *taxable* portion of the IRA. § 408(d)(3)(H)(ii). This exception is necessary because the *nontaxable* portion of an IRA cannot be rolled to a QRP or 403(b) plan. § 402(c)(8)(B)(iii), (iv), (v), (vi).

This third exception creates the opportunity for a tax-free distribution from a traditional IRA. In the Gibbs Example, if Gibbs participates in a QRP that accepts rollovers, Gibbs could roll over, from his two IRAs to the QRP, every dollar above his $12,000 basis. Now Gibbs is left with one IRA containing just $12,000, all of it after-tax money. He can then close out this IRA, and take a

distribution of the $12,000 tax-free. Or he can use the same sequence to create a tax-free Roth IRA conversion for the $12,000 IRA.

In the past, some retirement plans were reluctant to accept rollovers from IRAs, due to the lack of clear IRS guidelines on the procedures for such rollovers. In 2014, the IRS issued Rev. Rul. 2014-9, 2014-17 IRB 975 (4/3/14) , laying out in detail the procedures for a direct rollover of pretax money from an IRA to a QRP: The IRA owner causes the IRA provider to write a check for all or almost all of the pretax money in the IRA, payable to the QRP plan. This is delivered to the QRP administrator, along with a certification from the employee that this is a rollover and is coming entirely from pretax money.

Once the pretax money is safely transferred to the QRP, the IRA owner is left with a "stub" traditional IRA that is all or mostly after-tax money. He then converts this "stub" account to a Roth IRA totally tax-free (or very nearly tax-free if he didn't quite transfer all of the pretax money to the 401(k) plan).With clear IRS guidance now published, presumably plans will now be more open to accepting such rollovers.

2.2.04 ***QRP distributions from account that contains after-tax money***

Under the "cream-in-the-coffee" rule of § 72 (¶ 2.2.02), a distribution from a QRP generally carries out a pro rata share of the participant's pre- and after-tax money in the plan. § 72(e)(8)(A), (B), (5)(D). Thus, for example, the employee cannot tell the plan administrator, "Send me a check for all my after-tax money, and keep the pretax money inside the plan for now"; the plan administrator generally cannot distribute the after-tax money separately from the pretax money or vice versa.

This Section Matters Only If There Is After-tax Money in the Plan

If the participant doesn't have any after-tax money in his retirement plan, you can skip this ¶ 2.2.04: All distributions from his account(s) will consist entirely of pretax money...there is no after-tax money to be prorated or allocated. Most participants do not have after-tax money in their qualified plan accounts; for how and why some people do have after-tax money in their plan accounts, see ¶ 2.2.03.

On the bright side, unlike with IRAs (see ¶ 2.2.08), there is no "aggregation rule" requiring multiple nonIRA plans to be considered as "one plan" for purposes of determining how much of any distribution constitutes after-tax money. Thus, for example, a solo practitioner lawyer who has both a 401(k) plan and a defined benefit plan does not aggregate his two plans for purposes of determining the taxable proportion of a distribution from one or the other.

Now we know the general rule: Distributions from the plan carry out pre- and after-tax money pro-rata. There are two exceptions to the general rule, one for separate accounts maintained by the plan (see "A") and one for pre-1987 after-tax contributions (see "B").

Prior to September 2014, the IRS maintained that a single distribution that was "split" among multiple destinations (such as partly outright to the employee, partly direct rollover to an IRA; or direct rollovers to multiple IRAs) would be treated as multiple distributions for purposes of the cream-in-the-coffee rule. The funds sent to each "destination" would be considered a separate

"distribution." The IRS has reversed that position, so now funds distributed as part of a single distribution event are considered "one distribution" even if sent to multiple destinations; see "C."

A. Separate employee contribution accounts may be distributed separately. In a defined contribution plan that accepts employee contributions, the employer typically maintains a separate accounting for the employ*ee* contribution account (i.e., the employee's after-tax contributions and the earnings thereon) and the employ*er* contribution account (i.e., the employer's contributions and the earnings thereon). § 72 is applied separately to these separate accounts. § 72(d)(2). In the lingo of § 72, the employee contribution account is treated as a "separate contract" for purposes of § 72. This rule is favorable to the employee, because typically he has a higher proportion of after-tax money in the employee-contribution account, so a distribution from that account (or direct Roth conversion of that account; see ¶ 5.4.08) might be largely tax-free if it is treated separately from the rest of his plan benefits. Since issuance of Notice 2014-54 (see "C"), enabling pre- and after-tax money in a single plan account to be rolled or distributed to separate "destinations" (see ¶ 2.2.05) this advantage has become less significant.

Some employees are confused by this exception and think it means they can withdraw their after-tax contributions separately from any pretax money in the plan. That is not correct. The "employee contribution account" includes not only the employee's own contributions (which are indeed after-tax money) but *also* the earnings that have accrued on those contributions. The earnings are pretax money. A distribution from the employee contribution account is subject to the same rules of § 72 (though applied only to that separate account) as usual, meaning that a partial distribution from the employee contribution account would carry out proportionate amounts of the pre- and after-tax money *in that account* (unless some other exception applies; see "B").

Under some plans that allow the employee to make after-tax contributions to purchase "past service credits," the employee's after-tax contributions are not kept in a "separate account." Rather, the plan pays a single benefit based on both employer and employee contributions. A distribution from such a plan is generally treated as a pro rata distribution of pretax and after-tax money, based on the value of the employee's entire account, rather than as a distribution from a separate employee contribution account. However, there are exceptions and grandfather rules, so § 72 must be carefully studied in these cases; see § 72(e)(8)(D) and PLRs 2001-15040, 2004-11051, and 2004-19036.

B. "Cream" rule exception for pre-1987 balances. Some pre-1987 balances are not subject to the general rule applicable to other balances. The Code provides that: "In the case of a plan which on May 5, 1986, permitted withdrawal of any employee contributions before separation from service, subparagraph (A) [of § 72(e)(8)] shall apply only to the extent that amounts received before the annuity starting date (when increased by amounts previously received under the contract after December 31, 1986) exceed the investment in the contract as of December 31, 1986." § 72(e)(8)(D).

In other words, to the extent the money in the employee's account consists of the employee's pre-1987 nondeductible contributions (and this can be documented in the plan's accounting for such funds), the employee can withdraw that money separately from other money in the account. The employee can indeed say with respect to these funds, "Send me a check for an amount equal to my

pre-1987 contributions, and keep all the earnings thereon (and other pretax money) inside the plan for now."

In the form of notice the IRS provides to plan administrators (to give to a retiring employee receiving a distribution from his account), the IRS suggests telling the employee "If a payment is only part of your benefit, an allocable portion of your after-tax contributions is generally included in the payment. If you have pre-1987 after-tax contributions maintained in a separate account, a special rule may apply to determine whether the after-tax contributions are included in a payment"—but there's no statement of what that "special rule" is. Notice 2009-68 (9/28/09), 2009-39 IRB 423, p. 428.

C. One "distribution" may be sent to multiple destinations; Notice 2009-68 reversed

When an employee is entitled to a distribution from the employer's qualified retirement plan, the employee can request that the employer divide the distribution and send varying amounts of it to different "destinations." The potential destinations are: outright to the participant; direct rollover to one or more traditional IRAs; direct rollover to one or more Roth IRAs; and direct rollover to another qualified plan. If the multiple checks or transfers sent to multiple destinations are all part of a single distribution event, the multiple checks and transfers will be considered a single distribution for purposes of the cream-in-the-coffee rule. The pre- and after-tax portions of that distribution can then go separately to the different "destinations" to the extent explained in ¶ 2.2.05.

From the Notice: "For purposes of determining the portion of a disbursement of benefits from a plan to a participant, beneficiary, or alternate payee that is not includible in gross income under the rules of § 72, all disbursements of benefits from the plan to the recipient that are scheduled to be made at the same time (disregarding differences due to reasonable delays to facilitate plan administration) are treated as a single distribution without regard to whether the recipient has directed that the disbursements be made to a single destination or multiple destinations." Notice 2014-54, 2014-41 IRB 670 (10/6/14) ("Guidance on the Allocation of After-tax and Pretax Amounts").

Darcy Example: Darcy works for Omega Widget Co. Darcy has $250,000 in his account in the Omega Profit-Sharing Plan, of which $50,000 (20%) is after-tax money and $200,000 (80%) is pretax money. The funds are all in a single plan account [see "A" for why this matters] and none of his account is attributable to pre-1987 contributions [see "B" for why this matters]. None of the money is in a designated Roth account (¶ 5.7). Darcy leaves the employment of Omega and requests a distribution of $100,000 from his plan account. Under the cream-in-the-coffee rule of § 72, this distribution carries out proportionate amounts of the pre- and after-tax money in his account, so the pretax portion of the distribution is $80,000 (80%) and the tax-free after-tax portion is $20,000 (20%). See Notice 2014-54, Example 1. This is considered a single distribution even if Darcy directs that part of the money be sent directly to a traditional IRA and part to a Roth IRA (see ¶ 2.2.05(B)), or directs that part of the money be rolled directly into a traditional IRA and part be paid to him personally (see ¶ 2.2.05(C)).

Note that Darcy still cannot simply request a separate distribution of his after-tax money. He can request a partial distribution from his account, but the partial distribution will contain pro rata amounts of the pre- and after-tax money in that account. What's changed is that he can now separate

the pre- and after-tax portions of any particular distribution and have them sent to different destinations (see ¶ 2.2.05).

Prior to issuance of Notice 2014-54, the IRS's position was that a distribution that was sent to multiple different "destinations" would be treated as *multiple* distributions, one separate distribution to each "destination." See Notice 2009-68, 2009-39 IRB 423 (9/28/09), providing a "safe harbor" form of notice that plan administrators could use to tell employees about their distribution options; Reg. § 1.402A-1, A-5(a), third sentence (discussed at ¶ 5.7.06); and the Instructions for IRS Form 1099-R (2014), p. 4 ("If part of the distribution is a direct rollover and part of it is distributed to the participant, prepare two Forms 1099-R").

If the money sent to each separate destination is treated as a separate distribution, then each "destination" will receive a pro rata share of the pre- and after-tax money in the employee's account, with no ability to send the pre- and after-tax money to different "destinations." This IRS rule was controversial—for one thing, it contradicted other IRS pronouncements. For example, the IRS's own regulation dealing with income tax withholding treats the direct rollover and outright payment as *two portions of a single eligible rollover distribution*, when the "distributee elects to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to receive the remainder of the distribution…." Reg. § 31.3405(c)-1, Q-6. See also PLR 2009-26041, in which the IRS blessed a "direct rollover of the [participant's] entire account balance from Plan X into Plan Y, except the after-tax contributions…which were to be distributed directly to" the participant; such a split-up of the pre- and after-tax money is not possible if the direct rollover and outright distribution must be treated as two separate distributions as was stated in Notice 2009-68.

According to anecdotal evidence, some plan administrators simply ignored the Notice 2009-68 rule on this point (they have been well rewarded; see ¶ 2.2.05(G)). Now Notice 2014-54 formally reverses the rule; contains a proposed amendment to Reg. § 1.402A-1, A-5(a); and states that the IRS "intends to revise the safe harbor explanations that may be provided to recipients of eligible rollover distributions from an employer plan."

Although the new rule is formally effective January 1, 2015, plan administrators can use it for pre-2015 distributions as well. For the effect this has on distributions that occurred between Notices 2009-68 and 2014-54, see ¶ 2.2.05(G).

2.2.05 ***Partial and split rollovers, conversions: QRP distributions***

This ¶ 2.2.05 explains what happens to the pre- and after-tax portions of a distribution made from a "traditional" QRP account to the participant if the distribution is sent via direct rollover to both a traditional and a Roth IRA, or if only *part* of the distribution is rolled over to an IRA. Most of these rules come from IRS Notice 2014-54, 2014-41 IRB 670 (10/6/14) ("Notice 2014-54").

A. Introduction: Please read this first

This ¶ 2.2.05 does not tell you what constitutes a "distribution" (see ¶ 2.1.03). Nor does it tell you how much of a particular distribution constitutes after-tax or pretax money; for that, see ¶ 2.2.04 instead.

Once you have identified a particular "distribution" made from the participant's account, *and* you have determined how much of that distribution is after-tax money, this ¶ 2.2.05 tells you what

happens to the pre- and after-tax money included in that distribution when the distribution is paid to different “destinations,” or (following the distribution) is partly rolled over:

“B” explains what happens when a single distribution is sent, via direct rollover, partly to a Roth IRA and partly to a traditional IRA.

“C” explains the tax treatment of a QRP distribution that is partly paid outright to the participant and partly sent via direct rollover to an IRA.

“D” explains the tax treatment of a QRP distribution that is paid outright to the participant then partly rolled over by the participant, within 60 days, to one or more IRA(s).

“E” explains the effect of having a distribution sent, via direct rollover, entirely into multiple traditional IRAs or multiple Roth IRAs.

“F” explains how this section applies to beneficiaries who have inherited QRPs.

“G” discusses the effective date of Notice 2014-54 and the options for participants who took QRP distributions between 9/28/09 (issuance of Notice 2009-68) and 10/6/14 (issuance of Notice 2014-54).

This Seminar Outline does not cover direct rollovers from one QRP to another. See instead Notice 2014-54, Examples 2 and 3.

The rules discussed in this ¶ 2.2.05 also apply to distributions and rollovers from 403(b) plan accounts and governmental 457(b) plan accounts that contain after-tax money. Notice 2014-54, “Purpose,” “Background.”

However, these rules do not apply to:

♦ Partial rollovers and split distributions from a Designated Roth Account (DRAC); see ¶ 5.7.06 instead of this section.

♦ Distributions that are in the form of annuities. If the participant’s plan account has been “annuitized,” that is, converted from an individual account plan (also called a defined contribution plan) into a true annuity (stream of fixed payments for the life or lives of one or more individual(s) or for a term of years), different rules apply. Notice 2014-54, “Background.”

B. Part direct rollover to Roth IRA, part direct rollover to traditional IRA

If the participant instructs the plan administrator to transmit part of his distribution to a Roth IRA and part to a traditional IRA, the participant should also instruct the plan administrator which IRA should receive the after-tax money. The participant should tell the plan administrator to transfer the after-tax money to a Roth IRA. The pretax money should be directed to a traditional IRA (assuming the participant wants to continue deferring tax on it). This enables a participant who is retiring (or for some other reason receiving a distribution from a QRP) to do a “tax-free Roth conversion” of the after-tax money in his QRP account, while continuing to defer tax on the pretax money in his account. See Notice 2014-54, Examples 1 and 4.

This option to “separate the cream from the coffee” when taking a QRP (or 403(b), or governmental 457) distribution that includes after-tax money, by doing a tax-free Roth conversion of just the after-tax money, is an extremely valuable option. EVERY QRP PARTICIPANT WHO IS RECEIVING A DISTRIBUTION THAT INCLUDES AFTER-TAX MONEY SHOULD USE THIS APPROACH, BLESSED BY THE IRS IN NOTICE 2014-54, IN ORDER TO ACHIEVE A

TAX-FREE ROTH CONVERSION OF THE AFTER-TAX MONEY IN HIS ACCOUNT. The only exception would be someone who has an immediate need for all of the after-tax cash; he or she would instead use the option for cash distribution of the after-tax money (see "C"), rather than bothering to have it first transferred into a Roth IRA.

Darcy Example, cont: See the Darcy Example at ¶ 2.2.04(C). Darcy directs the plan administrator to transfer $20,000 of his $100,000 distribution via direct rollover to Darcy's Roth IRA and $80,000 via direct rollover to Darcy's traditional IRA. Before the transfers occur, Darcy instructs the plan administrator to treat the $20,000 Roth conversion as consisting entirely of after-tax money and to allocate all the pretax money in the distribution to the traditional IRA rollover. The plan administrator honors this request. Darcy has achieved a tax-free Roth conversion of the $20,000 of after-tax money included in his distribution and a tax-free (tax-deferred) rollover to a traditional IRA of the $80,000 of pretax money included in the distribution. Only if Darcy knows he needs the $20,000 of cash for spending or investment in the near future would it make sense for him to NOT request a direct rollover of the after-tax money to a rollover, and to request a cash distribution of that instead (see "C").

C. Part outright distribution, part direct rollover into any IRA(s)

If a participant requests a distribution from his account, and asks that part of the distribution be paid directly to himself and part be sent via direct rollover to an IRA, the two separate checks or transfers will be considered a single distribution; and if this "single distribution" contains both pre- and after-tax money, the pretax money will be allocated first to the direct rollover. Pretax money will be allocated to the part paid outright to the participant only to the extent the amount he receives outright exceeds the total after-tax amount included in the single distribution. Notice 2014-54, Example 1.

The tax result is identical to an outright distribution to the participant of the entire amount, followed by a partial 60-day rollover (see "D"), except that using the direct rollover avoids the 20 percent mandatory income tax withholding that would be applicable to an outright distribution of pretax money. Note:

♦ This strategy would be appropriate for someone who wants to get some assets out of his retirement plan account upon retirement (or other distribution occasion) tax-free while continuing to defer tax on as much of the plan as possible. Requesting that the after-tax portion be distributed to him gives him some spending (or investing) money outside the plan, with no tax impact, and sending the rest of the account via direct rollover to a traditional IRA allows continued deferral on the rest of the funds.

♦ Another advantage of this strategy is that it becomes much easier, in retirement, to report distributions taken from the traditional IRA if such distributions are 100 percent taxable. If an IRA contains any after-tax money, each distribution carries out proportionate amounts of the pre- and after-tax money in the participant's aggregated IRA accounts, and that proportion must be recalculated every year; see ¶ 2.2.08. Avoiding this complication makes retirement living much easier!

- ♦ This strategy would not be appropriate for someone who wants to do a Roth conversion in connection with his distribution. If the portion of the distribution that is transferred directly to an IRA is transferred to a *Roth* IRA, that portion will be taxable to the extent pretax money is included in it. For how to do a Roth conversion weighted towards the after-tax money see “B.” The partial-cash-distribution/partial-direct-rollover strategy is appropriate ONLY if the direct rollover is to a traditional IRA.

D. Distribution outright to participant followed by one or more 60-day rollover(s)

Note: the sequences described here (outright distribution followed by partial rollover, or two successive rollovers) will presumably never be used again. The purpose of this two- or three-step dance was to accomplish the goal of cashing out after-tax money while continuing to defer tax on the pretax money, or the goal of sending after-tax money to a Roth IRA and pretax money to a traditional IRA. Since Notice 2014-54 has made this two- or three-step dance unnecessary to accomplish those goals (see “B” and “C”), this subsection “D” will presumably be of interest only with respect to employees who used the “dance” when they took distributions prior to September 2014.

Myron Example. Myron is retiring. His $150,000 profit-sharing plan account at Acme Widget consists of $50,000 of after-tax money and $100,000 of pretax money. He does not have “separate accounts” for employer and employee contributions (¶ 2.2.04(A)); all this money is in one “account.” None of the money is “pre-1986 contributions” (¶ 2.2.04(B)). None of the money is in a DRAC (¶ 5.7). Myron directs the plan to distribute the entire $150,000 to him. Within 60 days after that distribution, Myron “rolls” $100,000 to a traditional IRA. He keeps the rest of the distribution ($50,000) in his taxable account.

The Code has a specific rule, in § 402(c)(2), dealing with the partial rollover of a QRP distribution that contains both pre- and after-tax money. The pretax money is deemed to be rolled over “first.” Here is how we reach that conclusion. § 402(a) tells us that distributions from QRPs are includible in gross income. ¶ 2.1.01. § 402(c)(1) then tells us that § 402(a)’s general rule of income-inclusion does *not* apply to the “portion” of any eligible rollover distribution that is transferred to another retirement plan. In other words, amounts properly “rolled over” to another plan are excluded from gross income despite § 402(a).

Then comes the mysterious § 402(c)(2). This section seems to say that, notwithstanding § 402(c)(1), the participant cannot roll over any after-tax money that was included in his plan distribution; except that (A) he *can* transfer after-tax money to a nonIRA plan *if* such transfer is accomplished via direct rollover, and (B) he *can* roll over after-tax money to an IRA. The last sentence of § 402(c)(2) then says that “in the case of a transfer described in subparagraph (A) or (B)” (i.e., *any* rollover to an IRA, or a *direct rollover* to another QRP), the amount transferred into the plan or IRA that receives the rollover “shall be treated as consisting first of the portion of the distribution that” would have been includible in gross income if it were not rolled over.

This last sentence of § 402(c)(2) clearly says that, if the employee receives a distribution from the plan, then rolls over only *part* of the distribution, the part rolled over is deemed to come first from the pretax money included in the distribution. This rule enables the employee to isolate the after-tax money *outside* the plan, while rolling over the pretax money to keep it tax-sheltered in

an IRA. The IRS agrees with this conclusion; see Regs. § 1.402A-1, A-5(b), and § 1.402(c)-2, A-8; PLR 9840041; and IRS Publication 575, *Pension and Annuity Income* (2009), p. 26, which says: "If you roll over only part of a distribution that includes both taxable and nontaxable amounts, the amount you roll is treated as coming first from the taxable part of the distribution."

The taxable portion of Myron's distribution is $100,000. A plan distribution that could have been rolled over by direct rollover but which the employee chooses to, instead, take as an outright distribution to himself, is subject to mandatory 20 percent income tax withholding on the taxable portion, so the withheld income tax on Myron's distribution would be $20,000, leaving Myron with $130,000 of cash. He then could roll $100,000 of this into a traditional IRA. If that is all he does, he would be deemed to have rolled the pretax money entirely into the traditional IRA. He will then be left with zero tax on the distribution, plus $30,000 of cash in his taxable account, and a $20,000 credit for the withheld tax on his income tax return for the year of the distribution.

Prior to Notice 2014-54, this circuitous route was the only way (according to Notice 2009-68) that a participant could "cash out" his after-tax QRP money while continuing to defer tax on the pretax money. Thanks to Notice 2014-54 it is no longer necessary to engage in this two-step dance. Myron can instead request, upon retirement, that the after-tax money be distributed to him outright and the pretax money be sent via direct rollover to an IRA. See "C."

Suppose Myron, after receiving the $150,000 cash distribution of his entire account from the plan (minus $20,000 mandatory income tax withholding), and after rolling $100,000 over into a traditional IRA within 60 days, later (but still within 60 days after the original distribution) rolls the final $50,000 of the distribution into a Roth IRA. (Because $20,000 of his distribution was sent to the IRS as withheld income taxes he will have to make up that $20,000 using "substituted funds" in order to complete a rollover of the entire distribution; see Reg. § 1.402(c)-2, A-11.)

Now his entire $150,000 distribution has been rolled over. Did he succeed in rolling the pretax money to a traditional IRA and the after-tax money into a Roth IRA? Or has he simply rolled proportionate amounts of each into each IRA?

Experts disagreed on the answer to this question. Fortunately, it is no longer necessary to wonder about the answer; thanks to Notice 2014-54, Myron can now split his distribution into a direct rollover to a Roth IRA (for the after-tax money) and a direct rollover into a traditional IRA (for the pretax money). That approach is far preferable to using successive 60-day rollovers. But for participants who took distributions between 2009 and 2014 and thus (under the regime of Notice 2009-68) saw a need to use the circuitous route, it is nice to know the IRS has answered the question. In Notice 2014-54, in making this entire three-step dance unnecessary, the IRS gave as one of its justifications the fact that IRA owners could accomplish the desired tax result by taking an outright distribution and rolling over the pretax portion to a traditional IRA within 60 days. Then "The remaining amount of the distribution would be after-tax, which the participant could *either roll over into a Roth IRA* or retain without incurring any tax liability." Notice 2014-54, "Background." emphasis added.

E. Direct rollover into multiple traditional (or Roth) IRAs

If the participant requests that his entire distribution be sent, via direct rollover, to multiple traditional IRAs, but does not request any outright distribution or direct rollover to a Roth IRA as part of the transaction, the allocation of his after-tax money among the multiple "destinations" (i.e., the multiple traditional IRAs into which the money is transferred) does not matter. All his IRAs will

be aggregated (treated as a single account) for purposes of determining how much of any later distribution from any one of his IRAs constitutes after-tax money. See ¶ 2.2.08.

Similarly, If the participant requests that his entire distribution be sent, via direct rollover, to multiple Roth IRAs, but does not request any outright distribution or direct rollover to a traditional IRA as part of the transaction, the allocation of his after-tax money among the multiple Roth IRAs into which the money is transferred does not matter. All his Roth IRAs will be aggregated (treated as a single account) for purposes of determining the income tax treatment of any later distribution from any one of his Roth IRAs. See ¶ 5.2.03(B).

F. How these options apply to QRP beneficiaries

A designated beneficiary is entitled to request a direct rollover of inherited QRP benefits into a traditional or Roth IRA. See ¶ 4.2.04 for explanation of the requirements of such "beneficiary rollovers," including the definition of "designated beneficiary." A designated beneficiary has the same options as a living participant to request partial outright distribution combined with partial direct rollover to traditional IRA (see "B"), or to request partial direct rollover to a Roth IRA combined with partial direct rollover to a traditional IRA (see "C"). However, a designated beneficiary who is not the surviving spouse does not have the option to use a distribution followed by rollover(s) (see "D"); nonspouse beneficiaries are not permitted to do "60-day rollovers." ¶ 4.2.02(A).

G. Effective date and retroactivity of Notice 2014-54

The transition rules of Notice 2014-54 are generous to people who totally ignored Notice 2009-68, but offer no relief to people who "obeyed" it.

According to the Notice's "Proposed Regulation and Transition Rules," Notice 2014-54 applies to distributions made on or after January 1, 2015. However, for distributions prior to that date any "reasonable interpretation" of the allocation rules of § 402(c)(2) will be accepted, and "reasonable interpretations" would include *either* the old "separate distribution" rule of Notice 2009-68 *or* the new allocation rules blessed in Notice 2014-54. (Note: This ability to use the new rules retroactively does not apply to distributions from Designated Roth Accounts; see ¶ 5.7.06).

A person who, between 9/28/09 and 10/6/14, took a retirement plan distribution that included after-tax money will therefore have very different results depending on whether his plan administrator and tax preparer were sticklers for the rules or defiant free spirits.

2. <u>Direct Rollover Split Between Roth and Traditional IRAs: Examples</u>

Mary Example: Mary retired in 2010 and took a total distribution of her $100,000 account at the Newco Profit-Sharing Plan of which $20,000 was post-1986 after-tax money. She requested a direct rollover of the $20,000 of after-tax money to her Roth IRA and a direct rollover of the $80,000 of pretax money to her traditional IRA. Her plan administrator and tax preparer reported this as a tax-free "conversion" rollover of the after-tax money to the Roth IRA combined with a tax-free (tax-deferred) rollover of the pretax money to the traditional IRA, in defiance of the "separate distributions" rule of Notice 2009-68. This tax treatment is retroactively blessed by Notice 2014-54. By "violating" Notice 2009-68, Mary and her advisors got the tax treatment she wanted and are all

set now—they do not need to do anything further, or worry about the IRS attacking what they did in 2010.

V. HOW TO TAKE RMDs

1. **Know which distributions counts towards the RMD.** The following is reproduced from ¶ 1.2.02 of *Life and Death Planning for Retirement Benefits*:

Regs. § 1.401(a)(9)-5, A-9(a), and § 1.408-8, A-11(a), state that, except as otherwise provided in A-9(b) or A-11(b) of such regulations, or as may later be otherwise provided by other IRS pronouncements, "all amounts distributed" from a plan or IRA "are taken into account in determining whether section 401(a)(9) is satisfied…." Here is the RMD status of various types of distributions:

A. **Distribution of an annuity contract does not count.** When an employee's benefit is used to purchase an annuity contract, distributions under the contract must comply with RMD rules. Distribution of the contract itself is a nontaxable event and does not count as a distribution for RMD purposes. Reg. § 1.401(a)(9)-8, A-10. Later, as the participant receives distributions from the annuity contract, those distributions will be taxable (and cannot be rolled over, as they are considered RMDs).

B. **Corrective and deemed distributions do not count.** Contributions that are returned to the participant because they exceed the 415 limits or the limits on elective deferrals do not count towards the RMD requirement. Reg. § 1.401(a)(9)-5, A-9(b)(1)–(3); § 1.408-8, A-11(b)(1)–(3). Neither do plan loans that are treated as distributions due to failure to comply with the plan loan rules (see Part I(4)), or the imputed income arising from life insurance held by a plan (see ¶ 8.2.05, in Part I(2), above). Reg. § 1.401(a)(9)-5, A-9(b)(4), (6).

C. **ESOP dividends do not count.** Dividends on employer stock held in an ESOP can be paid directly to the participant or beneficiary. § 404(k). Such dividend payments do not count towards the RMD requirement. Reg. § 1.401(a)(9)-5, A-9(b)(5).

D. **Nontaxable distributions do count (for exception see "A").** Reg. § 1.401(a)(9)-5, A-9(a), § 1.408-8, A-11(a). See PLR 9840041 in which an employee took a distribution of his entire balance from an employer plan, rolled over the taxable portion of the distribution, and did not roll over the nontaxable amounts. The IRS ruled that the nontaxable distribution, which exceeded the RMD, satisfied the RMD requirement. The nontaxable portion is applied, first, to the RMD. Reg. § 1.402(c)-2, A-8. If the RMD amount exceeds the nontaxable portion of the distribution, then the rest of the RMD is "filled up" from the taxable portion, and any balance of the taxable portion is eligible for rollover.

E. **Distributions in kind do count.** …[(See "A" above for exception.) See #6 below.]

2. Give your RMD to charity (directly from the IRA, to the extent allowed). One way to reduce the income tax impact of RMDs is to give the distributions to your favorite charity. SEE PART VI, BELOW.

3a. Integrate distribution planning with Social Security benefits. Under an extremely elaborate formula, part of an individual's Social Security (SS) benefits may be taxable if his "provisional income" exceeds a certain base amount.

"Provisional income" means the individual's adjusted gross income (with certain modifications), plus his tax-exempt interest income, plus one-half of his SS benefits. If provisional income exceeds $25,000 for a single person ($32,000 for married taxpayers filing jointly), then half of the individual's SS benefits (or, if less, half the excess of provisional income over the base amount) must be included in the individual's gross income. If provisional income exceeds $34,000 for a single person ($44,000 for married taxpayers filing jointly), then 85 percent of the SS benefits (or, if less, 85% of the excess of provisional income over the base amount) must be included in the individual's gross income.

For a high-income taxpayer (someone whose "provisional income" will exceed the base amounts regardless of how much he takes out of the retirement plan) these rules for taxation of SS benefits are irrelevant to the decision as to when to take money out of a plan. However, for a low-income retiree, retirement plan distributions (except tax-free Roth IRA distributions) increase "provisional income," and can accordingly cause a greater portion of his SS benefits to be subject to income tax.

This person should analyze the effects on the taxability of his SS benefits in deciding whether to postpone the first year's RMD. See Noah Example at Part IV(5), above. He might also consider a Roth IRA conversion for the sole purpose of getting all his IRA distributions "over with" in one year, if the effect will be to keep his SS benefits nontaxable for the rest of his life. For this person, the usual rule of thumb (take extra distributions in a low-income year) might be reversed: he might want to take extra distributions in a *high-income* year (when his SS benefits are already 85% taxable, due to his already-high income), to reduce the plan balance, so that perhaps RMDs in later, low-income, years will not be large enough to cause more of his SS benefits to become taxable.

3b. Integrate distribution planning with Medicare. Monitor the effect of plan distributions on future Medicare premiums, which vary depending on income. See the "Zeke Example" at Part IV(5) above and Table 2 at the end of this Seminar Outline.

4. What to do with hard-to-value assets. If your IRA contains a hard-to-value asset (*e.g.*, a limited partnership, "LP"), you run the risk of undervaluing that asset in computing your RMD, and then the IRS will say that you didn't take the full RMD.

For example, you estimate the LP is worth $200,000, the other assets in your account are worth $300,000, and your RMD percentage for the year is five percent, so you withdraw five percent of the $500,000 total, taking out $25,000 cash. The IRS later says the LP was worth $500,000, and therefore your RMD fell short: it should have been five percent of $800,000 or $40,000. The result

is a 50 percent penalty on the $15,000 shortfall. Besides paying for expensive appraisals every year, what should you do with a hard-to-value IRA asset once RMDs start?

A. Distribute the required percentage of the hard-to-value asset. At the beginning of each year, take out of the IRA the required proportionate amount of (1) the hard-to-value asset (in this example, that would mean withdrawing 5% of the LP units in January), and (2) the other (non-hard-to-value) assets (in this example, that would mean withdrawing 5% of the $300,000 non-LP assets, or $15,000). Now you are sure you have satisfied the RMD requirement. If the IRS later revalues the LP to $500,000, that means the LP units that were distributed to you were worth $25,000 (5% of $500,000), not $10,000 as you had thought. Therefore your total distribution was $40,000 ($25,000 worth of LP units plus $15,000 of other assets), and you fulfilled the RMD requirement. You will owe back income taxes (because you under-reported the amount of your distribution), but at least you won't owe a penalty.

B. Distribute (or convert) the entire asset. Better yet, use Reg. § 1.408-8, A-9 (see #7 below) to take ALL of the hard-to-value assets out of the IRA sooner rather than later, so that, in the future, these assets will not complicate your RMD calculations and will begin generating capital gains (on post-distribution appreciation) instead of ordinary income. Or convert that asset to a Roth IRA so you keep it inside a retirement plan and its future fluctuations in value will have no impact on your income taxes or RMDs.

5. Should you take your RMD early or late in the year? Take the annual RMD early in the year so that, if you happen to die late in the year, you won't burden your beneficiaries with the need to race around to get the RMD out before the end of the year just to avoid a penalty.

On the other hand, take it LATE in the year in case Congress adds new planning opportunities in the middle of the year. For example, in mid-2006, with the Pension Protection Act, Congress started allowing transfers from the IRA to charity to count towards the RMD (see PART VI); anyone who had already taken his/her IRA RMD for 2006 at the time the new law was adopted (August 2006) could not take advantage of this.

6. Take distributions in kind. It is not necessary to keep a sufficient portion of your IRA liquid to cover anticipated RMDs for the next year or two. Doing so could cause you to waste commission money and/or investment opportunity. There is no requirement that RMDs be paid in cash.

If your account is fully invested, take your RMDs in kind rather than in cash to save commissions. See IRS Form 1099-R, Instructions (to the payer), Box 1 (p. 9). Don't sell the investment, distribute cash, and then rebuy the investment outside the plan. You can instruct the administrator to distribute shares of stock, or bonds, or mutual fund shares. Those are treated as distributions, and thus they count toward fulfilling your RMD requirement.

The value for RMD purposes (and the value you must report as income) is the fair market value of the securities on the date distributed to you. Reg. § 1.402(a)-1(a)(1)(iii). Keep track of the value of the investments on the date they were distributed to you; that value also becomes your tax basis for the assets going forward. Rev. Rul. 80-196, 1980-2 C.B. 32 (holding #2).

When choosing which assets to take out of the plan to satisfy your RMD, take assets you consider most likely to provide further capital appreciation after the distribution (e.g., a stock that you consider temporarily "undervalued," rather than a short-term bond). If the asset does indeed appreciate, your future gain could be long-term capital gain or it could receive a stepped-up basis upon your death, neither of which is possible for appreciated assets held inside a retirement plan. Your holding period (for long-or short-term capital gain purposes) begins the day after the investment is distributed to you (as if you had purchased the stock on the date it was distributed), not when it was originally purchased inside your IRA. See § 1223(2), Reg. § 1.402(a)-1(b)(1), Rev. Rul. 70-598, 1970-2 C.B. 168.

7. **Close out smaller accounts.** If you have multiple IRAs, take advantage of Reg. § 1.408-8, A-9 (descendant of now-superseded IRS Notice 88-38) to close out smaller accounts. Under this rule, a distribution from *any* IRA counts toward your RMD requirement for *all* your IRAs.

So determine the total of your RMDs for all your IRAs for the year, then clean out smaller accounts as necessary to fill up the year's total RMD for all your IRAs. Eliminating multiple smaller accounts will make estate planning (as well as future RMD calculations) easier. The same thing works for multiple 403(b) plans. However, you can't use IRA distributions to satisfy 403(b) RMDs or vice versa; and you can't use an inherited IRA or 403(b) to satisfy the RMD requirement for non-inherited IRAs or 403(b)s (or vice versa), or for IRAs or 403(b)s inherited from another person.

8. **Use withholding from RMDs to reduce or eliminate estimated taxes.** Most IRA providers will permit mutually voluntary withholding of income taxes from IRA distributions. See IRS Publication 575 and IRS Form W-4P. Income taxes withheld from retirement plan distributions (just like income taxes withheld from wages) are treated (for purposes of computing whether a taxpayer owes the penalty for underpayment of estimated taxes) as if paid equally on the four due dates of estimated tax payments. § 6654(g)(1).

Thus, an IRA distribution in December that is sent to the IRS by the IRA provider as withheld income taxes will be treated (for estimated tax purposes) as if paid in four equal installments on the preceding April 15, June 15, and September 15, and the following January 15. A wealthy individual who does not need his RMDs to pay living expenses can kill two birds with one stone by using these required distributions to pay his estimated taxes. Late in the year, the participant requests a distribution (to satisfy the RMD requirements for the year), but (by filing Form W4-P) instructs the IRA provider to send the distribution to the IRS as withheld income taxes. Some planners prefer to take part of the distribution (1%?) in cash rather than having 100 percent of it withheld.

By paying part of his estimated taxes late in the year through withholding, the participant gets a few more months' interest on money he would otherwise have had to pay to the IRS in April,

June, and September. There is a risk in using this idea: If the participant dies before the withheld-taxes distribution occurs, he (being dead) won't be able to take the distribution, and his estate will owe the penalty for underpayment of estimated taxes.

Where to read more: See ¶ 2.2 of *Life and Death Planning for Retirement Benefits* regarding the tax-withholding rules for retirement plan distributions.

9. Don't take more than the RMD. Lifetime RMDs are computed using the Uniform Lifetime Table. Reg. § 1.401(a)(9)-9, A-2. This table (reproduced at the end of this Seminar Outline) is designed to liquidate the account over the joint-and-survivor life expectancy of the participant and a hypothetical beneficiary who is 10 years younger than the participant, recalculated annually.

Thus, if the participant only takes the RMD from the account each year, the account is *guaranteed* to last beyond his lifetime (assuming it is not wiped out by investment losses of course). *Your IRA cannot run out of money during your lifetime if you do not take more than the RMD*. For retirees who need their RMDs to live on, this should be comforting, and a good reason not to take more than the RMD. A participant whose sole beneficiary is his spouse, and whose spouse is more than 10 years younger than he is, can use an even more favorable table for computing required distributions, so the account can last even longer.

Where to read more: See ¶ 1.3–¶ 1.4 of *Life and Death Planning for Retirement Benefits* regarding lifetime RMDs; ¶ 1.1.03 explains the economics of the minimum distribution rules.

VI. QUALIFIED CHARITABLE DISTRIBUTIONS

7.6 Qualified Charitable Distributions

The preceding sections have discussed leaving retirement benefits to charity *at death*. This and the following section discuss ways to transfer retirement benefits to charity *during life*.

Generally, lifetime gifts of retirement benefits are not a tax-favored way to deal with such benefits; see ¶ 7.7.01. One minor but very popular exception is the "qualified charitable distribution" (QCD)—the ability of *some people* to transfer *a limited amount* of funds directly from *certain types of IRA* to *certain types of charities*. Specifically, an over-age-70½ IRA owner or beneficiary (see ¶ 7.6.02) can instruct the administrator of the IRA (see ¶ 7.6.03) to transfer up to $100,000 in any calendar year (see ¶ 7.6.04) to one or more eligible charities (see ¶ 7.6.05). The amount(s) so transferred is not includible in the gross income of the IRA owner-donor (see ¶ 7.6.07), even though it is a distribution from his or her IRA, and even though it may be used to satisfy the required minimum distribution (see ¶ 7.6.09(B)).

This ¶ 7.6 explains QCDs—the requirements, mechanics, limitations, benefits, and complications.

*7.6.01 **Where to find the law***

The QCD is created by § 408(d)(8), which has in effect been part of the Tax Code since 2006—"in effect" because it was enacted several times on a temporary and often retroactive basis before being made a permanent part of the Code in December 2015.

The Treasury's only authoritative pronouncement on QCDs to date is IRS Notice 2007-7, 2007-1 CB 395, Q&A 34 through 44.

The QCD is a watered down version of the "charitable IRA rollover" that the philanthropic community has sought to get enacted since at least the late 1990s. Under this "dream" charitable IRA rollover, which does not yet exist and may never exist, unlimited transfers would be allowed from any retirement plan by any participant to any tax-exempt charitable entity including charitable remainder trusts. The QCD is a distant relation to this "dream" charitable rollover.

*7.6.02 **Who can make QCDs: Individuals over age 70½***

Only individuals who are age 70½ or older can make QCDs. § 408(d)(8)(B)(ii).

The QCD donor can be either an IRA participant donating from his own IRA or a beneficiary donating from an inherited IRA. IRS Notice 2007-7, A-37. The only requirement is that the donor (whether owner or beneficiary) must be age 70½ or older.

This is the only tax code provision to make the age 70½ "birthday" itself a significant event. Required minimum distributions are based on the *year* the participant reaches age 70½, not the *day* he reaches that age. Someone who reaches age 70½ on (say) December 30 could have a tough time getting his IRA provider to make the QCD on the last day of the year. It would have been easier for all concerned to allow QCDs to occur anytime during or after the calendar year the individual reaches age 70½—but that's not what the law says.

Example: In 2017, Jonathan inherited an IRA from his mother. He also has an IRA of his own. Jonathan's 70th birthday was April 1, 2018. He turns 70½ on October 1, 2018. He can make QCDs from either his own IRA or the inherited IRA he holds as beneficiary of his mother (or both) any time on or after October 1, 2018.

*7.6.03 **From IRAs only (other than "ongoing" SEPs or SIMPLEs)***

QCDs may be made *only* from IRAs. § 408(d)(8)(B). So, a QCD can not be made from a "qualified retirement plan," i.e., a plan qualified under § 401(a) of the Code, such as a pension, profit-sharing, Keogh, or 401(k) plan); or from a 403(b) plan; or from a 457 plan.

A QCD can be made from any type of IRA subject to the following exceptions/limitations:

- A QCD may not be made from an "ongoing" SEP-IRA or SIMPLE IRA. SEPs and SIMPLEs are IRAs funded directly by contributions from the individual's employer. See § 408(k) and § 408(p). An "ongoing" SEP or SIMPLE in any particular year is one that receives an employer contribution for such year. IRS Notice 2007-7, A-36.

- A QCD can come from a Roth IRA—theoretically. Since one requirement of a QCD is that it must be a distribution that would (but for the QCD provision) have been included in the

taxpayer's gross income (§ 408(d)(8)(B), last sentence; see ¶ 7.6.07), a QCD is unlikely to come from a Roth IRA. For one thing, most Roth IRA distributions are income tax-free, and so not eligible to be the subject of a QCD; see ¶ 5.3.01(A). Even if an over-age 70½ person holds a Roth IRA distributions from which could be partly includible in income (because the person had not held a Roth IRA for the required 5-year holding period of § 408A(d)(2)(B); see ¶ 5.3.03), the Roth IRA owner can expect that these funds eventually will qualify for income-tax free treatment and it would not be advantageous to throw away that future tax benefit just to make a QCD.

Example: Carl is age 76 and still working at Acme Widget. In 2018, he holds an IRA he inherited from his father, a Roth IRA he had owned for 10 years, a SEP-IRA to which Acme Widget is contributing in 2018, and a 401(k) plan account in the plan of his prior employer. He can make a QCD in 2018 from the inherited IRA. He cannot make a QCD from the Roth IRA because anything distributable to him from that account would be excludible from his income and thus not QCD-eligible. He cannot make a QCD from the SEP-IRA this year because it is "ongoing" (receiving an employer contribution) in 2018. He cannot make a contribution from the 401(k) plan because it is not an IRA.

The fact that QCDs cannot be made from a qualified plan such as a 401(k) plan creates an insurmountable obstacle for retirees who chose to leave their benefits in their former employer's plan but would like to make QCDs:

Lorraine Example: Lorraine is 73. She retired some years ago from Wealthy Funds Inc. She chose to leave her $500,000 Wealthy 401(k) plan balance in the Wealthy 401(k) plan because (as a plan member) she had continued access to the company's excellent investment management services, not generally available to the investing public. Now she would like to take her $20,000 2018 RMD in the form of a QCD...but there is no way she can do so. She can't make a QCD directly from her 401(k) account because QCDs are allowed only for IRA distributions. She can't "roll" the $20,000 out of the 401(k) plan and into an IRA because the first distribution she takes from the 401(k) plan in 2018 will be considered her RMD for that year—and as an RMD it is not eligible to be rolled over (see ¶ 2.6.03). What if she takes $50,000 out of the 401(k), keeps $20,000 in her taxable account (representing her 2018 RMD) and rolls the other $30,000 into the IRA? That's fine...and she can then make a 2018 QCD from the IRA with all or part of the $30,000 she just rolled into the IRA...but that will not be her 2018 RMD because she already took that in (fully taxable) cash. If she leaves the $30,000 in the IRA, that still won't help her avoid tax on her 401(k) plan RMD next year, because next year (in 2019) she will still have to take a (nonrollable) RMD from the 401(k) plan!

The only way Lorraine can use QCDs to reduce her taxable RMDs is to roll ALL of her 401(k) balance into an IRA (after taking the RMD for the rollover year)...but then she will lose her inside track to the Wealthy Funds Inc. investment management services.

7.6.04 ***How much? Up to $100,000 per year per IRA owner***

The QCD income exclusion is limited to $100,000 per year. § 408(d)(8)(A). The limit is per IRA owner, not per IRA. "For married individuals filing a joint return, the limit is $100,000 per

individual IRA owner." IRS Notice 2007-7, A-34. So, a husband and wife who are both over age 70½ and who both have IRAs can each transfer up to $100,000 to charity from their respective IRAs in the same year. But if (for example) wife has an IRA and husband does not, wife cannot "borrow" husband's limit and give $200,000 from her IRA.

The donor does not have to give that much. $100,000 per IRA owner per year is the maximum and there is no minimum (other than what the IRA provider may impose administratively).

Example: Jody, age 83, gives $5,000 per year to her church and does not make any other charitable gifts. Since 2006 she has made these annual gifts directly from her IRA as QCDs. Her sister Agatha, age 81, gives $200,000 a year to charity. She makes half her annual gift in the form of a QCD and the rest using appreciated stock held in her taxable account.

7.6.05 ***Which charities can and cannot receive QCDs***

A QCD can be made to any charity described in § 170(b)(1)(A) *other than* a donor-advised fund (§ 4966(d)(2)) or a supporting organization (§ 509(a)(3)). § 408(d)(8)(B)(i).

§ 170(b)(1)(A) charities are those donations to which can generate the largest deduction, as a percentage of gross income (generally 50%, but 60% for certain donations in 2018–2025), for individual donors, such as churches, schools, nonprofit medical facilities, and publically-supported nonprofit organizations engaged in charitable work. Certain private foundations can also receive QCDs; consult the statute for details.

Although donor-advised funds (DAFs; ¶ 7.5.03) and "supporting organizations" are normally treated as full-fledged charities for purposes of the income tax charitable deduction, they are excluded by statute from receiving QCDs.

7.6.06 ***Requirements applicable to the gift***

The QCD gift must pass three tests: First, it must be an IRA distribution that would (but for the QCD exemption) be 100% includible in the donor's gross income. See ¶ 7.6.07 regarding that requirement. The other two tests are discussed in this ¶ 7.6.06:

Second, it must be a gift that would be 100% deductible as a charitable contribution under § 170 if made *outside* the IRA (except that, for this purpose, the percentage-of-income limits in § 170(b) are ignored). § 408(d)(8)(C). And, third, it must meet all the requirements applicable to non-QCD gifts for which an income tax charitable deduction is sought under § 170 (such as the "substantiation requirement" of § 170(f)(8) for gifts of $250 or more). IRS Notice 2007-7, A-39.

For the requirements of the income tax charitable deduction generally, see IRS Publication 526, "Charitable Contributions," or the Instructions for IRS Form 1040, Schedule A. Regarding the substantiation requirement in particular see ¶ 7.6.08.

The requirement that the gift must be of the "100% deductible"-type means that:

- A "split-interest gift" cannot qualify as a QCD. Thus, QCDs cannot be made to a charitable remainder trust (¶ 7.5.04), pooled income fund (¶ 7.5.10), or charitable gift annuity (¶ 7.5.08). The gift must go 100% directly to the qualifying charity.

- For taxable years after 2017, if the gift is made to an educational institution, and the gift entitles the donor to purchase tickets to an athletic event, then the gift is totally nondeductible and accordingly cannot be made via QCD. § 170(l).

- The donor cannot receive from the charity, in exchange for his QCD, any "goods or services" except those that the IRS allows to be disregarded. Reg. § 1.170A-1(h)(i). "Goods or services" means "cash, property, services, benefits, or privileges." Reg. § §1.170A-13(f)(5).

Under the IRS's rules, the following goods or services can be disregarded even if received in exchange for the gift:

1. Goods or services that have insubstantial value under the guidelines provided in Revenue Procedures 90-12, 1990-1 CB 471, 92-49, 1992-1 CB 987, and any successor documents.

2. Certain "membership benefits" offered for dues of $75 per year or less. Disregardable membership benefits include such standard "percs" as free parking and gift shop discounts. Reg. § 1.170A-13(f)(8)(i)(B).

3. Apparently, "intangible religious benefits" ("any intangible religious benefit which is provided by an organization organized exclusively for religious purposes and which generally is not sold in a commercial transaction outside the donative context"). See § 170(f)(8)(B).

The no-consideration requirement can raise thorny questions. If the "goods or services" the donor receives exceed in value the de minimis amounts permitted by IRS rules, it may not be possible to make the gift using a QCD. For example, a coffee mug with the charity's logo on it may be disregardable based on its cost and fair market value and the amount of the donation relative to that cost and fair market value—but if the donor also received a calendar or a tote bag along with the mug, the combined value may mean the value she received is not "insubstantial." It is to be hoped that each charity would have its tax counsel review these IRS guidelines, and the goods and services the charity is providing, and then provide each donor with written confirmation that the full gift is tax-deductible (i.e., the membership or other benefits or token gifts can be disregarded as of insubstantial value). Unfortunately, charities (especially smaller ones) may not be well versed enough in these rules to know what is "disregardable" and what isn't.

A different problem arises when you get back something that definitely is not "disregardable," even if it has small value compared to the gift—for example, you buy a $10,000 ticket to a charity ball which entitles you to $100 worth of dinner. If you make the gift using outside assets, it's easy to handle the value you get back—just reduce the amount you deduct on Schedule A by the value of the goods or services received, for a net deduction (in this example) of $9,900. But with a QCD the existence of the "something valuable you get back" means the entire gift cannot be a QCD.

Could the charity-ball transaction be done as a "bifurcated" donation, under which the charity would accept two checks totaling $10,000, one for $100 (from the donor's taxable account) to pay for the dinner and one for $9,900 from the IRA as a charitable donation and QCD? The

charity would give two separate receipts; the receipt for the $9,900 IRA distribution would show no goods or services received in exchange. There is no IRS pronouncement on this.

Professor Christopher Hoyt of the University of Missouri-Kansas City Law School has pointed out that, in the field of private foundations, such "bifurcated donations" are considered self-dealing transactions and are therefore forbidden. See PLR 9021066, where the IRS ruled that, since the individual could not have attended the dinner without the foundation's having made a contribution (even though the individual paid personally for the cost of the meal), the foundation's donation was conferring a financial benefit on the individual. Some are concerned that what would be forbidden self-dealing in the private foundation context might be a "prohibited transaction" in the IRA context, since the retirement plan prohibited transaction rules grew out of and in some ways copy the private foundation self-dealing rules.

However, the rationale of the private foundation ruling does not extend to the IRA context. A private foundation is forbidden to confer benefits on the donor-disqualified person. In contrast, an IRA is *required* to confer benefits on the IRA owner. In fact an IRA is forbidden to confer benefits on anyone *other than* the IRA owner and his beneficiaries. Whether the transfer to the charity is or is not a QCD, it is definitely *not* a prohibited transaction. IRS Notice 2007-7, Q&A 44.

Because of the muddy rules about "stuff you get back for your gift," you have three choices when seeking to make a QCD to an organization where you are a "member" or otherwise getting something "back" from the organization. Either you sit down with your and the organization's tax lawyers and prepare a written memorandum, with citations, about why what you are getting back is disregardable under IRS regulations (so your QCD qualifies as a "100% deductible gift"), or you find a way to sever your IRA-funded donation from your membership or event ticket—perhaps by making a bifurcated donation as above described. Or, simply do not use QCDs to fund any charitable gift or membership where you will receive something back.

7.6.07 ***Income tax aspects; special basis recovery rule***

The QCD is excluded from the individual's gross income for all purposes. § 408(d)(8)(A). Thus it cannot be counted as part of the individual's gross income for purposes of applying the percentage-of-income limits in § 170(b) with respect to his other charitable gifts. Of course, there is no income tax charitable deduction for the QCD. IRS Notice 2007-7, A-39.

The QCD must be a distribution that would otherwise (i.e., but for the special dispensation for QCDs) be includible in the donor's gross income. § 408(d)(8)(B), last sentence. Here is the effect of this rule on:

- <u>Distributions from Roth IRAs</u>: A qualified distribution from a Roth IRA (see ¶ 5.3.01(A)) cannot be a QCD because a qualified Roth IRA distribution is nontaxable. Thus, QCDs could be made from a Roth IRA only if the Roth IRA had not yet met the requirements for a "qualified distribution." Even then it would normally not be good planning to make a QCD from a Roth IRA; see ¶ 7.6.03.

- <u>If IRA owner has no after-tax money in any IRA</u>: If the traditional-IRA owner does not have any after-tax money in any of his IRAs, this rule is "no problem" since all distributions from any of his IRAs will consist 100 percent of pretax money (includible in gross income).

- If the IRA owner has any "basis" (after-tax money; also called "investment in the contract") in any of his IRA accounts, then the requirement that QCDs must be all pretax money could pose a problem. Under the rule nicknamed the "cream-in-the-coffee rule" of § 72 (see ¶ 2.2.08), any distribution from an IRA normally carries out proportionate amounts of the pre- and after-tax money in the individual's IRAs (with all of his traditional IRAs being treated as single account for purposes of determining the proportions). If the cream-in-the-coffee rule applied to QCDs, an individual who had any after-tax money in his IRA(s) could never make a QCD. Accordingly, QCDs are one of the few exceptions to the cream-in-the-coffee rule.

To accommodate the entirely-includible-in-income requirement, there is a special "basis recovery rule" in the Tax Code for QCDs: QCDs are deemed to come out of the IRA's pretax money first. § 408(d)(8)(D).

Burton Example. Burton is a charitably-inclined individual age 71 who does not like to pay taxes. He owns a $70,000 IRA with a $20,000 basis resulting from nondeductible contributions in prior years. He owns no other IRAs. He directs the IRA provider to transfer $50,000 from his IRA directly to the Red Cross. This is a QCD, so the $50,000 is deemed to come entirely from the IRA's pretax money. Now he is left with a $20,000 IRA which is 100 percent after-tax money. If he wishes, he can then convert this small "stub" IRA to a Roth IRA tax-free, or cash it out tax-free.

Note: A state's "basis recovery rule" for IRA distributions may or may not accommodate this special federal rule for QCDs. The client and preparer must determine the client's income tax basis (investment in the contract) both before and after the QCD occurs, for both federal and (if applicable) state purposes.

7.6.08 ***How to do a QCD; how to report it***

To effect a QCD, the IRA owner directs the IRA provider to transfer funds from the IRA to the charity. The donor-IRA owner should communicate with her IRA provider regarding its policies and preferred procedures for carrying out these transfers. One acceptable procedure is for the IRA provider to cut a check payable to the charity and have the donor physically deliver the check to the charity. IRS Notice 2007-7, A-41.

QCDs are allowed only for direct transfers from the IRA to one of the permitted types of charitable recipients. If the money is first distributed to the individual, then donated to charity, it is not a QCD, and all the usual limits and drawbacks described at ¶ 7.7.01 will apply (there was an exception to this for certain charitable transfers in January 2013).

The IRA owner-donor must obtain the Code-required substantiation if the QCD is $250 or more: The donor must obtain from the charity a contemporaneous receipt that meets the requirements of § 170(f)(8). See Reg. § 1.170A-13 for these requirements (one of which is the charity must state that "no goods or services were provided" in exchange for the gift; ¶ 7.6.06). If this receipt is not obtained the gift is not a valid QCD and will be treated as an ordinary distribution to the IRA owner—even if the gift was in fact made to the charity and nothing was received in exchange for it.

The IRA custodian is supposed to report the QCD on Form 1099-R, just as if it had paid the distribution to the individual rather than to a charity. There is no special coding or other indication on Form 1099-R signaling that the distribution is a QCD. Thus, nothing in the 1099-R will reveal that the distribution is nontaxable! As the IRS put it in the Instructions for IRS Form 1099-R (2017), p. 1, "There's no special reporting" that IRA providers have to do for qualified charitable distributions.

Instead, it's up to the IRA owner-donor to report the nontaxable status, in the following manner: First, he enters the total distribution (as shown on Form 1099-R) on Line 15a of his personal income tax return, Form 1040. Then he enters the taxable portion of the distribution (zero, if the QCD was the only distribution for the year) on Line 15b. See Instructions for IRS Form 1040, 2017, pp. 25-26, Lines 15a and 15b, Exception 3. Then the donor is supposed to "Enter 'QCD' next to line 15b."

This method of reporting QCDs presumably means that some QCD-donors will not get the benefit of the income tax exclusion. This will happen if the IRA owner-donor simply turns over all his 1099-Rs to his tax preparer without alerting the preparer to the fact that there was a QCD. The preparer will then presumably simply report the entire distribution as taxable, and if the client doesn't notice that discrepancy but simply signs and files the return, the U.S. Treasury will collect a bit more money than it's entitled to.

7.6.09 ***Advantages, planning uses, and pitfalls of the QCD***

The QCD will not save anyone millions of dollars of taxes, but it is nevertheless a safe legal tax-favored way for an over-age-70½ client to use his IRA to benefit charity. Despite a few kinks and pitfalls, the QCD is a low-tax way to fulfill the minimum distribution requirement for the charitably inclined client.

A. **Advantages of the QCD.** The QCD eliminates *some* of the problems that arise when making lifetime charitable gifts from an IRA (see ¶ 7.7.01). A QCD does not increase AGI and therefore does not: increase the individual's adjusted gross income for purposes of determining the extent to which his "net investment income" will be taxed (§ 1411); decrease the deductibility of medical expenses (§ 213(a), (f)); increase the taxability of Social Security benefits (§ 86); increase Medicare premiums (42 U.S. Code §1395r(i)); or increase state income taxes (in a state that uses federal AGI as the basis for computing state income tax but does not allow a charitable deduction). Since there is no itemized charitable deduction for the QCD gift, the gift does not "count" for purposes of the percentage-of-income limits on charitable deductions in § 170(b), and is in effect "deductible" even for someone who does not itemize deductions. The substantial increase in the standard deduction as a result of the TCJA 2017 will increase the attraction of QCDs for some individuals.

Betty Example: Betty is single, age 73. For 2018, her standard deduction is $13,600 ($12,000 for a single individual, plus additional $1,600 for age 65 or older) She lives in low-tax state and has no mortgage, so her only significant "itemized deduction" is her annual $8,000 charitable donation. If she makes the donation from her taxable account, she gets no tax benefit from it, because her total itemized deductions will still be less than $13,600. If she makes the contribution using a QCD, she

excludes the $8,000 IRA distribution from her income—and still gets her full standard income tax deduction of $13,600.

B. **Use QCD to fulfill RMD.** A QCD will count as a distribution for purposes of determining whether an individual has fulfilled the RMD requirement. IRS Notice 2007-7, A-42. This is consistent with Regs. § 1.401(a)(9)-5, A-9(a), and § 1.408-8, A-11(a), which state that, except as otherwise provided in A-9(b) or A-11(b) of such regulations, or as may later be otherwise provided by other IRS pronouncements, "all amounts distributed" from a plan or IRA "are taken into account in determining whether section 401(a)(9) is satisfied…."

C. **Confusing QCDs and RMDs.** Someone who has already taken his RMD for a particular year cannot use a QCD later in the year to fulfill his RMD requirement for that year; he cannot roll the already-taken RMD back into the IRA (to enable him to use a QCD instead) because RMDs are not eligible rollover distributions. See ¶ 2.6.03. He can still make a QCD from his IRA; it just will not be his RMD. People will get confused about the RMD/QCD relationship. The two things have nothing to do with each other (other than the fact that a QCD counts towards the RMD, to the extent the RMD has not already been taken). A person can make QCDs for up to but not more than a combined total of $100,000 per year, *regardless* of: whether his RMD for the year is more or less than $100,000; *regardless* of whether he has already taken the RMD; and *regardless* of what other distributions he has taken or later takes from the IRA.

D. **Using QCD to fulfill charitable pledge.** A QCD is considered a payment "to" the participant for purposes of the prohibited transaction rules. Thus, it is not a prohibited transaction even if it is used to fulfill a pledge to the charity. IRS Notice 2007-7, A-44.

E. **When a QCD may not be best.** While it might appear desirable for an over-age 70½ individual to use QCDs to fund all of his charitable contributions, there will be practical limits on this—for one thing it is a cumbersome way to make small donations. Also, an IRA owner who wants to give more to charity than just the amount of his RMD should determine whether another form of charitable gift would be more advantageous for such additional gifting (such as gifts of appreciated stock from a taxable account).

VII. ROTH CONVERSIONS FOR THE REST OF US

The decision whether to convert a traditional IRA to a Roth IRA is a momentous one that faces every owner of a traditional IRA.

The following is excerpted from Chapter 5 of *Life and Death Planning for Retirement Benefits*. An ellipsis (…) indicates an omission of text; omissions of cross-references to other parts of the book are not noted. [Brackets] indicate additions to the text; however, an addition that constitutes substitution of a citation for a cross reference to another part of the book is not bracketed.

5.8 Putting it All Together

> *"Tax-free compounding is the best thing in the world."*
> –Jonathan G. Blattmachr, Esq.

¶ 5.8.01 discusses the Roth decision process generally. ¶ 5.8.02 lists factors that favor adoption of a Roth plan. ¶ 5.8.03 lists contrary factors. ¶ 5.8.04–¶ 5.8.09 look at how the Roth decision applies in some particular typical client situations.

5.8.01 ***Which is better, a Roth plan or a regular plan?***

A Roth retirement plan is a nice asset to own. It offers the ability to invest in the stock and (nonmunicipal) bond markets and generate totally income tax-free investment accumulations that can be spent in retirement or left to heirs. The Roth IRA offers the additional advantage of no required distributions during the participant's life. [§ 408A(c)(5).]

The question is what price must be paid to acquire this wonderful asset. Generally, the price is payment of income taxes on the amount going *in* to the Roth retirement plan—taxes that could have been deferred (via a traditional retirement plan) until the money in question was taken *out* of the retirement plan.

So which is better: to pay the taxes up front and get tax-free distributions later or to defer the taxes?

One thing is sure: If you take $A, pay income tax on it at B percent, deposit the net after-tax amount in a Roth IRA, earn an investment return of C percent and withdraw the accumulated funds ($D) on date E, the amount of money you will have ($D) will be *exactly the same* as if you had deposited $A in a traditional IRA, earned a return of C percent, withdrawn the accumulated funds on date E, and paid income tax on that distribution at B percent. For the Roth approach to *produce more dollars* than the traditional plan one or more of the factors in the equation must be different as between the Roth and traditional options. See ¶ 5.8.02(A)–(D), ¶ 5.8.08, ¶ 5.8.09.

Some clients considering a Roth plan will evaluate the financial impact using computer projections. Computer projections of the benefits of converting an existing IRA to a Roth IRA are based on assumptions as to future tax rates, investment returns, and withdrawal amounts. Most such projections assume a constant rate of investment return; that today's tax rates will last forever; and that participants and beneficiaries will withdraw from the account no more than required by today's minimum distribution rules. Other possible scenarios should be considered; see ¶ 5.8.03.

One might conclude that financial projections regarding the profitability of a Roth contribution are too speculative to be useful, or the projections may indicate that the Roth choice is financially neutral. There are several reasons one might choose a Roth despite the lack of a clear projected profit. See ¶ 5.8.02(E)–(F), ¶ 5.8.05, ¶ 5.8.09(C).

5.8.02 ***Reasons to adopt a Roth retirement plan***

Here are factors in the equation that can tilt the balance in favor of a Roth plan.

A. **Best: Pay taxes neither now nor later.** If you can duck the "pay now or pay later?" question by not paying taxes *either* when the money goes into the Roth plan *or* when it comes out, then you can get the advantages of a Roth retirement plan "free." That deal is irresistible. An otherwise eligible individual can get that deal if he is in a zero tax bracket, (due, for example, to a net operating loss from a business); or in some cases through a series of rollovers leaving after-tax money as the only money in his traditional IRA (see ¶ 2.1.11, at Part IV(8), above).

B. **Future tax rate expected to be higher.** Anyone who believes his personal income tax rate will go up in the future will want to pay taxes at today's "cheap" rate and get it over with. This factor is also at work in setting up Roth IRAs for young family members, and in converting an IRA to a Roth for the benefit of heirs (¶ 5.8.09(B)). [Similarly, someone who is subject to AMT is effectively taxed at a 26 or 28 percent marginal rate, not the nominal 39.6 percent highest top rate; if he thinks his rate will go up later, he should go Roth.]

C. **No required lifetime distributions.** Money can stay in a Roth IRA much longer than in a traditional IRA, because of the different minimum distribution rules that apply…[§ 408A(c)(5)]. Thus more tax-free compounding can occur in a Roth IRA during the owner's life than is possible with a traditional IRA (from which the owner must take lifetime distributions).

D. **Pay tax with assets outside the plan.** Since taxes on a Roth plan contribution can be paid with money that is not in a retirement plan, outside assets can in effect be used to increase the amount inside the retirement plan.

Eric Example: Eric, age 62, wants to maximize his retirement savings. He figures that by contributing $23,000 to a "regular" 401(k) in 2013, he's really only stashing away about $13,800 in the plan, because the plan "owes" the government roughly 40 percent income taxes on the contribution. He'll have to pay that "debt" when he withdraws money from the regular 401(k) plan. With a Roth account, he's in effect increasing his plan contribution. Contributing $23,000 ($17,500 maximum 2013 basic CODA contribution, plus $5,500 catchup contribution) to a Roth plan is equivalent to contributing $38,300 to a regular plan.

E. **Diversification:** "A" has substantial funds accumulated in several traditional retirement plans. He wants to hedge his bets. Since he is already heavily weighted in pretax retirement plans, he wants to place a bet on the Roth.

F. **Cash flow:** "B" has her retirement income (including income taxes) carefully projected for the next 10 years. If she needs a chunk of extra cash, it would be nice to be able to take it out of a Roth plan tax-free so as not to upset the income tax projections. "C" does not want to be forced to start liquidating her retirement savings at age 70½. The Roth IRA appeals to her because it does not require any distributions prior to the owner's death. § 408A(c)(5). She plans to contribute to a Roth 403(b) plan at her job, then roll that to a Roth IRA at retirement.

5.8.03 ***Risks, drawbacks, of Roth retirement plans***

It would be a shame to pay income tax on today's stock values, only to find out later that this was the all-time market high. This exact scenario happened to many who converted to Roth IRAs in the halcyon investment era of 1998–1999, or 2007–early 2008, then endured the stock market declines of 2000–2001 or late 2008.

The Roth deal also turns bad if the benefits would be subject to income taxes at a substantially lower rate when they come out than the rate the participant paid when he contributed to the plan. Prepaying the income tax would also presumably turn out to be a bad deal if the income tax is replaced by a value-added tax. One skeptic won't "Roth" because he expects that retired baby boomers will use their electoral clout to cause Congress to make *all* pensions tax-free.

Also, Congress could change the minimum distribution rules to require that all benefits be distributed within some much shorter period of time after the deaths of the participant and spouse. Or Congress could decide that the Roth IRA was too good a deal, and take away some of its favorable tax features (presumably only prospectively).

Another significant factor may be the loss of the money spent paying the taxes on the Roth conversion. One planner reported that his clients, an elderly couple who had rejected the Roth conversion temptation some years earlier, found themselves facing extremely high medical expenses including nursing home care. Had they spent their "outside" cash on a Roth conversion they would not have had enough money to pay these expenses. Furthermore, their high medical expense deduction substantially reduced the income taxes payable on their withdrawals from their traditional IRAs.

5.8.04 ***Annual contributions: Traditional IRA vs. Roth IRA***

An individual who has compensation income and whose AGI is under the limits described at § 408A(c)(3)(A), (C)(ii), has the option to contribute to a Roth IRA. If he is under age 70½ (as of the end of the tax year) he also has the option to contribute to a traditional IRA instead of to a Roth IRA, or to contribute part of his maximum permitted "regular" contribution amount (§ 219(b)(5)) to each type of IRA. Reg. § 1.408A-3, A-3(d), Example 4. Assuming he wants to contribute to an IRA, which type should he contribute to?

The decision is easy if the individual (or his spouse) is an active participant in an employer plan, and his (or their) AGI exceeds the amounts specified in § 219(g)(3)(B); then his only choice is between a nondeductible traditional IRA and a Roth IRA. Since he can't get a tax deduction for his contribution no matter which kind of IRA he contributes to, he gives up nothing by choosing the Roth IRA. The decision is also easy if the individual's taxable income is so low he is not subject to income tax, since, again, he gives up nothing by opting to contribute to the Roth IRA.

If neither the individual (nor his spouse) is an active participant in an employer plan; or, if he (or his spouse) is an active participant in an employer plan, but his (or their) AGI is low enough that he can get a tax deduction for a contribution to a traditional IRA; *and* his (or their) tax bracket is higher than zero; then his choice is between a *deductible* traditional IRA contribution (which could save him some current income taxes) and the nondeductible Roth IRA contribution, considering the factors discussed at ¶ 5.8.02–¶ 5.8.03.

5.8.05 ***Choosing between a DRAC and a regular 401(k)/403(b)***

Which 401(k) and 403(b) plan participants should choose the designated Roth account (DRAC) instead of a traditional pre-tax 401(k) or 403(b) account for their elective deferral contributions?

By choosing the DRAC, the individual gives up the immediate tax savings of having the contribution excluded from his income. The savings could be as high as 39.6 percent of the contribution amount (maximum regular federal income tax rate as of 2013). If the individual is subject to the alternative minimum tax (AMT; § 55), contributing to a regular 401(k) plan saves income taxes at the AMT rate (26%–28%) rather than at the individual's theoretical usual tax rate.

However, for many, the choice will not be based on elaborate projections regarding whether taxes are higher or lower now than they will be later. Rather, the choice will be based on how badly the individual wants a Roth account versus an immediate tax deduction:

Bunny and Honey are both 60-year-old lawyers with incomes over $500,000, looking to maximize savings for a planned retirement in five to ten years. Both are in 401(k) plans that offer DRACs.

Bunny is a partner in large firm. The only tax-deferred retirement savings plan she has is the firm's 401(k) plan, where her account is now worth $600,000. Her only "tax shelter" is her annual 401(k) salary deferral contribution, which will be $23,000 in 2013. She does not want to give up the tax deduction. She opts for a regular 401(k) account contribution.

Honey is a solo practitioner with a defined benefit pension plan now worth $1 million. She also has a self-employed 401(k) plan worth $50,000 and a traditional IRA worth $600,000. Her contribution to the defined benefit plan in 2013 will be $120,000, tax deductible. She feels that the tax-deferred side of her balance sheet is already large enough and it will only get larger through internal growth and future plan contributions. She opts for a DRAC, to start building up a different type of tax-advantaged retirement plan.

Where to read more: ¶ 5.7 of *Life and Death Planning for Retirement Benefits*.

5.8.06 ***Clients who may profit from Roth conversion***

The client most likely to profit from converting to a Roth IRA is one who: has sufficient other wealth that he will never need to draw from the account during life (not drawing anything out of the account is the way to maximize the tax-free accumulations of the Roth IRA); plans to leave the account to young generation beneficiaries, to be drawn down over their life expectancy after the client's death (again, the long life expectancy payout available for distributions to a young designated beneficiary maximizes the tax-free build-up of the Roth IRA) or leave the Roth IRA to his spouse (to roll over to the spouse's own Roth IRA, and continue tax-free accumulation during her lifetime); and can afford to pay the income tax on the conversion, and the estate tax on the account's date-of-death value, from other assets, without sacrificing other goals such as his own financial security (so that the income tax-free Roth IRA is not depleted by paying tax bills). Add steady to rising income tax rates, no negative tax law changes, and positive investment returns and the conversion is a definite winner....

5.8.08 ***How Roth conversions can help retirees***

A. Take advantage of lower brackets; reduce future RMDs. This is an idea for the retired individual who has not yet reached age 70½ and has a substantial IRA; whose income dropped significantly following retirement; and who is living comfortably on his Social Security benefits and total taxable income of between $50,000 and $100,000.

This person is now in a very low tax bracket. In a few years, when he turns 70½, he will be in a high tax bracket again, when the required minimum distribution (RMD) rules start forcing distributions out of his IRA. He will not be happy when his IRA starts shrinking (and his taxable income skyrockets) once RMDs start. Now is the time to blunt the future force of RMDs (and take advantage of the low income tax brackets) by doing partial Roth IRA conversions each year. For example, if the retiree's taxable income (before Roth conversion) is $60,000, he is only in the 15 percent tax bracket (2013 rates, joint filers). He could convert more than $350,000 of his IRA to a Roth IRA without getting into the top 39.6 percent bracket (which applies to taxable income in excess of $450,000 for married taxpayers filing jointly). This will reduce future RMDs from the traditional IRA (thus saving income taxes in the future), allow greater in-plan asset accumulation (since Roth IRAs do not have lifetime RMDs), and give the retiree a financial safety valve for tax-free later distributions (from the Roth IRA) for extra needs in later retirement.

B. Above average life expectancy. Roth IRAs have appeal for retirees who expect to live well beyond the average life expectancy due to their genetic heritage and/or health.

A traditional IRA participant approaching age 70½ faces forced distributions that may substantially diminish the account over a long life. With a traditional IRA, the way to maximize tax deferral is to die prematurely, leaving benefits to a young beneficiary. By converting the traditional IRA to a Roth IRA, this person can eliminate the forced lifetime distributions and reverse the usual rule of thumb: The way to maximize tax deferral with a *Roth* IRA is to live as long as humanly possible, deferring the commencement of ANY distributions until that way-later-than-normal death (and then leave the benefits to a young beneficiary to get the long life expectancy payout).

C. Control taxable income levels. Under an extremely elaborate formula, part of an individual's Social Security (SS) benefits may be taxable if his "provisional income" exceeds a certain base amount.… [See Part V(3), above. A person whose provisional income could be under the base amount if it were not for RMDs, could (if he could afford to do so, which seems unlikely for such a low-income individual) convert his IRA to a Roth in one taxable year, thereby reducing the taxability of his SS benefits for future years.]

*5.8.09 **How participant's conversion helps beneficiaries***

Beneficiaries of a traditional IRA can NOT convert that inherited IRA to a Roth. § 408(d)(3)(C). If the participant converts his IRA to a Roth IRA prior to death, that conversion can benefit his beneficiaries:

A. **Reduce estate taxes.** Converting to a Roth IRA just before death can reduce *estate taxes* by removing the income taxes due on the Roth conversion from the gross estate.

B. **Low bracket parent, high bracket children.** A participant may do a Roth conversion to save *income taxes* for his beneficiaries:

Rhonda Example: Rhonda is a widow, age 65, living happily on her Social Security payments plus $50,000 a year withdrawn from a substantial traditional IRA. Her children are all in the highest income tax bracket, and some day those high brackets will apply to distributions the children take from the traditional IRA they inherit at her death. She can convert some of the traditional IRA to a Roth IRA each year to use up her lower income tax brackets. The high-bracket children will pay no income tax on distributions from the inherited Roth IRA.

C. **Simplify beneficiaries' lives.** Even if the pure mathematics indicate no advantage to having the participant pay the income tax now rather than having the beneficiaries pay it later, it would be a convenience to the beneficiaries to inherit a Roth IRA (distributions from which are tax-free) rather than a traditional IRA, so they do not to have to wrestle with the valuable but complicated IRD deduction every year.

Where to read more: See ¶ 4.6 of *Life and Death Planning for Retirement Benefits* regarding income in respect of a decedent (IRD), ¶ 4.6.04 regarding the IRD deduction for beneficiaries.

*5.8.10 **Nine safe legal and maybe even cheap ways to get a Roth IRA***

[This section was first published as the author's November 2017 monthly column for www.MorningstarAdvisor.com (free website) under the title "Roths for the Rest of Us."]

Imagine an investment account with no income tax whacking the returns. There is such a thing. It's called a Roth account. Here's a list of nine safe legal ways to acquire a Roth retirement account—without a costly conversion of your existing traditional plans.

These are thumbnail sketches to spur thinking. See disclaimers and resources at the end to follow up. All dollar limits are for 2017.

You work for a company that has a 401(k) plan. The Tax Code permits employees to have up to $18,000 ($24,000 if 50 or older) withheld from their paycheck and contributed directly to the 401(k) plan. This is called a "cash or deferred arrangement" (CODA). **#1:** If permitted by your company's plan, the CODA contribution can be made to a traditional pretax account (so you don't pay tax on it the year it's contributed; this is attractive if you're in a high bracket) *or to a designated Roth account* ("DRAC") (you pay tax on the contribution, future qualified distributions will be tax-

free). **#2:** If your plan allows DRACs, find out if it *also* permits voluntary nondeductible employee contributions. If allowed, and you are within applicable contribution limits, make a nondeductible contribution, then do an "in-plan conversion" to *convert the after-tax contribution into the designated Roth account*.

You have AGI under $133,000/$196,000 and compensation income. Compensation income includes salary, wages, tips, taxable alimony and combat pay. **#3:** You can contribute $5,500 to a Roth IRA ($6,500 if 50 or older), if your modified adjusted gross income (MAGI) is under $118,000 (single) or under $186,000 (married filing jointly). You can contribute a reduced amount if your AGI is between $118,000 - $133,000 (single) or between $186,000 - $196,000 (married filing jointly). In either case your contribution may not exceed your compensation income. **#4:** If your MAGI is too high to contribute directly to a Roth IRA, and you will not be 70½ or older in 2017, make a nondeductible contribution to a traditional IRA of $5,500 ($6,500 if 50 or older) (but not more than your compensation income), then convert the IRA to a Roth. The conversion will be all or mostly nontaxable if you have no other traditional IRAs. This is sometimes called a "back-door Roth contribution."

#5: You have after-tax money in your company's qualified retirement plan and you are entitled to take a distribution from the plan (*e.g.*, because you are retiring). You open a traditional IRA and a Roth IRA (if you don't have such accounts already). You direct the plan administrator to send the after-tax money from your plan account via direct rollover to the Roth IRA (tax-free Roth conversion), and to send the pretax money from your plan account via direct rollover to the traditional IRA (traditional tax-free rollover).

#6: You inherited a 401(k) or other qualified retirement plan directly as named "designated beneficiary" (not through an estate). Your deceased benefactor had after-tax money in the plan. You open a new traditional "inherited IRA" account and a new "inherited Roth IRA" account. You direct the plan administrator to send the after-tax money from your inherited plan account via direct rollover to the inherited Roth IRA (tax-free Roth conversion), and the pretax money from the inherited plan account via direct rollover to the inherited traditional IRA (traditional tax-free rollover). Or convert it all to the inherited Roth IRA if income tax on the conversion would be low (perhaps due to a large 691(c) deduction).

#7: You have a traditional IRA that has after-tax money in it and you also participate in a qualified retirement plan that accepts rollovers from IRAs. You roll the pretax portion of your IRA accounts (*all* your traditional IRA accounts—multiple IRAs are considered one account for income tax purposes) into the qualified plan. This leaves your traditional IRA holding nothing but after-tax money. You convert the traditional IRA to a Roth IRA, tax-free. Do not roll money into or otherwise contribute to any traditional IRA for the rest of the calendar year.

You are self-employed with no employees. #8: Determine your "net self-employment income" (Schedule C net profit reduced by the deductible portion of the self-employment tax). Now adopt a "solo 401(k) plan" that allows designated Roth accounts and voluntary nondeductible employee contributions. You can do a CODA contribution of up to $18,000 ($24,000 if 50 or older), or up to your total net self-employment income if less, to either a regular traditional 401(k) account

(if you want to reduce current taxes) *or a designated Roth account*. **#9:** You can also (subject to applicable dollar/percentage contribution limits) make additional voluntary nondeductible contributions and then convert them to the Roth account (in-plan conversion).

You can't take the above ideas to the bank. Instead take them to your tax advisor to figure out which idea(s) might work for you. For example, though the Code permits total annual qualified retirement plan contributions up to 25% of compensation (the CODA contribution is not subject to that limit) or (if less) $54,000 ($60,000 if 50 or older) (including the CODA contribution), your employer's plan may impose lower limits. Also, the CODA dollar limit applies per individual not per plan. So don't try this at home—consult a tax expert!

Where to read more: For aspects of Roth accounts and conversions, see Chapter 5 of Natalie Choate's book *Life and Death Planning for Retirement Benefits* (www.ataxplan.com). For income and contribution limits applicable to Roth IRAs, see *Appleby's IRA Quick Reference Guides* (2017), www.IRAPublications.com. Major mutual fund families offer "solo" or "individual" 401(k) plans with or without designated Roth options; see their websites.

5.8.11 ***Worst Roth conversion ideas***

Do you want to know the WORST Roth conversion ideas? They usually involve trying to shift otherwise-taxable business income into a tax-exempt Roth IRA. For example, you form a shell company inside your Roth IRA. Your real business company (which you own personally) sells its products at a bargain price to its "distribution company" (the Roth-owned corporation), which then makes a huge "tax-free" profit reselling the products at market price to the actual customers. Don't try this. You will have taxes and penalties and may even go to jail!

Here are some more Roth "planning ideas" I do not recommend:

1. ☹"Since I have to take an RMD from my traditional IRA anyway and pay tax on it, I might as well convert the RMD to a Roth IRA so I at least get some benefit." Sorry, you cannot convert an RMD to a Roth IRA.

2. ☹"I'll convert everything in my traditional IRA except the RMD; I'll take that near the end of the year, to maximize deferral." This doesn't work because the first dollars out of the IRA in any year ARE the RMD, so you can't leave the RMD in and convert the rest.

3. ☹"I'll convert everything to a Roth IRA right now, then I'll 'recharacterize' in September next year by transferring the contribution back to a traditional IRA just before the recharacterization deadline. This never did work but now it REALLY doesn't work because post-2017 Roth conversions cannot be recharacterized.

4. ☹"I'll transfer my NUA stock in a lump sum to a Roth IRA, pay tax on only the plan's basis, and the NUA will later be distributed tax free from the Roth IRA." Forget it. The IRS treats this as if you transferred the stock to a traditional IRA FIRST, meaning you pay ordinary income tax on the entire conversion. Furthermore you lose your NUA deal permanently.

5. ☹"I'll just convert my contributory IRA. It is mostly after-tax money, so the conversion will be almost tax-free. I'll leave my rollover IRA as is, because it's all pretax money." Out of the question. Both accounts are aggregated for purposes of determining how much of the conversion is taxable (the "cream-in-the-coffee rule").

7. ☹"My kids are in a lower tax bracket than I am. I'll leave them my IRA and they can convert it to a Roth after I die." No, they can't convert an inherited IRA (but they could convert an inherited QRP benefit if you left them that instead...see Part III below).

VIII. THE 10% "PENALTY" ON DISTRIBUTIONS BEFORE AGE 59½

[Much of the following is reproduced from Chapter 9 of the author's book *Life and Death Planning for Retirement Benefits*, 7th ed. 2011. Cross references that do not begin with "9" refer to portions of the book not reproduced here.]

9.1 10% Extra Tax on Early Distributions

§ 72(t) imposes a 10 percent "additional tax" on retirement plan distributions made to a participant who is younger than age 59½. This ¶ 9.1 describes the § 72(t) tax. ¶ 9.2 and ¶ 9.3 discuss one useful exception to the tax, the "series of substantially equal periodic payments" (SOSEPP). ¶ 9.4 explains the other 13 exceptions.

For application of the § 72(t) tax in connection with Roth retirement plans, see ¶ 5.5. See ¶ 3.2.08 for how the tax applies to an under-age-59½ surviving spouse-beneficiary.

This chapter will illustrate over and over how arbitrary, capricious, and onerous this "additional tax" is. It falls almost exclusively on young people who are in serious financial trouble, and its 13 Byzantine exceptions help very few of them.

9.1.01 ***What practitioners must know***

Be aware that distributions (even inadvertent distributions) to a participant under age 59½ generally trigger a 10 percent penalty in addition to income taxes. Note carefully the requirements of any possibly applicable exception (*e.g.*, make sure it is available for the type of plan involved). Do not expect the exceptions to operate in a logical, fair, or consistent manner.

The penalty does not apply to post-death distributions (see ¶ 9.4.01), but a surviving spouse who rolls over death benefits to her own retirement plan loses the exemption for death benefits. See ¶ 3.2.08.

Though popularly called a "penalty," the § 72(t) tax is actually just an "additional tax" on certain plan distributions; it is not a "penalty." A penalty, as that term is used in the Tax Code, implies a punishment for wrongdoing (such as underpaying a tax or filing a return late), whereas the § 72(t) tax involves no such implication. Because the § 72(t) tax is not a tax "penalty," the burden of proof is on the taxpayer (as is the case with all other income taxes); in the case of true penalties, the IRS has a greater burden of proof. See *El v. Comm'r*, 144 T.C. 9 (2015).

9.1.02 ***The § 72(t) penalty on early distributions***

§ 72(t) imposes a 10 percent additional tax on retirement plan distributions. The penalty does not apply to distributions made "on or after the date on which the employee attains age 59½." § 72(t)(2)(A)(i); PLR 2004-10023. The tax is *25 percent* rather than 10 percent on certain early distributions from "SIMPLE" (¶ 8.3.13) retirement plans; § 72(t)(6). This additional tax is usually referred to as the 10 percent penalty on "early distributions" or "premature distributions."

§ 72(t)(1) says that the penalty applies to any distribution from a "qualified retirement plan (as defined in § 4974(c))." § 4974(c)'s definition of "qualified retirement plan" includes 401(a) plans (true "qualified" retirement plans) as well as 403(b) arrangements and IRAs (both of which are not normally included in the term "qualified retirement plan"). It also includes other types of plans not dealt with in this book. *Although § 72(t) includes all of these plans in the term "qualified retirement plan," in this book the term "qualified retirement plan" (QRP) refers only to plans qualified under § 401(a), as distinguished from 403(b) arrangements and IRAs*; see ¶ 8.3.12.

There are no regulations. The IRS's position is revealed in IRS publications, Notices, cases, and private letter rulings. Several aspects of the penalty (and its ever-growing list of exceptions) are not clear.

9.1.03 ***How the penalty applies to particular distributions***

The penalty is not necessarily 10 percent of the total distribution. Rather, the 10 percent is calculated only with respect to "the portion of [the distribution] which is includible in gross income." § 72(t)(1); Notice 87-16, 1987-1 C.B. 446, Question D9. To the extent the distribution is income tax-free because (for example) it represents the return of the participant's own after-tax contributions (¶ 2.2.01), or because it is rolled over to another plan (¶ 2.6.01), it is also penalty-free. Here is how the 10 percent penalty applies to various types of distributions (and deemed distributions) to a participant who is under age 59½ if no exception (¶ 9.2–¶ 9.4) applies:

A. **Employer stock and NUA.** An employee who receives employer stock in a lump sum distribution from a QRP is entitled to certain favorable tax treatment regarding the "net unrealized appreciation" in the stock; see ¶ 2.5. The penalty will apply to the portion of the distribution that is includible in the employee's gross income. It will not apply to the NUA (because the NUA is excluded from income for purposes of § 72; § 402(e)(4)(A), (B)) or to the income resulting from later sale of the stock (¶ 2.5.01) (because that event is not a retirement plan distribution subject to § 72).

B. **IRA contributions withdrawn before return due date**. If an IRA contribution for which no deduction has been taken is withdrawn from the account (together with the net earnings on that contribution) before the extended due date of the participant's tax return for the year for which the contribution was made, the withdrawal of the *contribution* is not a taxable distribution (¶ 2.1.08(D)) and accordingly is *also* not subject to the penalty. However, any *earnings on the contribution* that are included in the corrective distribution will be subject to the penalty. Notice 87-16, 1987-1 C.B. 446, Question C2; *Hall*, T.C. Memo 1998-336. According to the Instructions for IRS Form 5329 (2009) (line 23, p. 4), the penalty is

reportable for the year the contribution was made (i.e., the same year in which the income is reportable).

C. **Deemed distribution due to plan-owned life insurance.** When a QRP purchases life insurance on the life of a plan participant, § 72(m)(3) generally requires that the cost of the insurance protection be included currently in the participant's gross income. See ¶ 2.1.04(H). This deemed income is not treated as a distribution for purposes of the 10 percent penalty. Notice 89-25, 1989-1 C.B. 662, A-11.

D. **Deemed distribution from failed plan loan.** If an employee borrows, from a QRP, a loan that fails to meet the requirements of § 72(p), the loan is treated as a taxable distribution rather than a loan; see ¶ 2.1.07. The resulting gross income is subject to the penalty. Notice 87-13, 1987-1 C.B. 432, A-20; *Plotkin*, T.C. Memo 2001-71; *Martinez*, T.C. Memo 2016-182.

E. **Deemed distribution resulting from prohibited transaction.** The penalty apparently applies to the deemed distribution resulting from a prohibited transaction (¶ 8.1.06); see Instructions for IRS Form 5329 (2009), line 1.

9.1.04 ***Enforcement of early distributions penalty***

f an under-age 59½ participant takes money from a retirement plan, and does not qualify for any of the very precise and limited exceptions (see ¶ 9.2–¶ 9.4), the penalty is imposed, regardless of the taxpayer's ignorance of the rules, good intentions, or other excuse. Surprisingly many taxpayers litigate their liability for this penalty when they do not have even a colorable argument that they qualify for an exception. The IRS and the courts will (almost) never waive the penalty unless the requirements for an exception are met.

Here are examples of ingenious (but losing) arguments:

✓ Mr. Vigil (age 36) left his job and received a distribution from the employer's plan. He argued that he should owe the penalty on only half the distribution because it was community property, therefore his wife owned half of it, and she was over 55 and she therefore qualified for the "early retirement" exception. Aside from the fact that she had never worked at the company (and therefore couldn't have retired from its service), community property laws are irrelevant in imposing the income tax on qualified plan distributions. *Vigil*, TC Summary Opinion 2012-111.

✓ An argument that the distinctions between QRP withdrawals and IRA withdrawals are "arbitrary and capricious" lost in the *Kim* case.

There is no "hardship exception" to this penalty; *Reese*, T.C. Summ. Op. 2006-23; *Gallagher*, T.C. Memo 2001-34; *Deal*, T.C. Memo 1999-352. See, *e.g.*, *Baas*, T.C. Memo 2002-130, and *Czepiel*, T.C. Memo 1999-289, aff'd. by order (1st Cir., Dec. 5, 2000); and *Robertson*, T.C. Memo 2000-100.

Though 401(k) plans are generally not allowed to distribute anything to an employee from his "elective deferral" account until he either reaches age 59½ or terminates employment, there is an exception: If the employee meets the financial hardship criteria set out in Reg. § 1.401(k)-1(d)(3)(iii)(B)(4), the plan can legally distribute funds to him. But the employee will have to pay the 72(t) tax on that hardship distribution unless he also meets one of the totally separate exception categories of 72(t)! *Kott*, TC Summary Opinion 2015-42; *Mayer*, TC Summary Opinion 2013-39.

9.2 Exception: "Series of Equal Payments"

One exception stands out as a useful planning tool: the "series of substantially equal periodic payments."

9.2.01 ***Series of substantially equal periodic payments (SOSEPP)***

The penalty does not apply to a distribution that is "part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary." § 72(t)(2)(A)(iv). While at first this exception sounds rather rigid, in fact it is highly flexible because:

1. Rollovers and/or IRA-to-IRA transfers can be used to create an IRA of exactly the right size to support the desired payment amount. See ¶ 9.2.04.

2. The payments do not in fact have to continue for the entire life or life expectancy period. The distributions must continue only until the participant reaches age 59½, or until five years have elapsed, whichever occurs later. See ¶ 9.3.02.

3. The IRS allows several methods for determining the size of the "equal payments" (which do not in fact have to be equal). See ¶ 9.2.05.

This is the most significant exception for planning purposes. All the other exceptions are tied to a specific use of the money (home purchase, college tuition), or to some type of hardship situation (death, disability), or are otherwise narrowly limited; see ¶ 9.4. In contrast, everyone who has an IRA (or who can get one via a rollover from some other type of plan) can use the SOSEPP exception.

There is one significant limitation on the SOSEPP exception: Drastic consequences generally ensue if the series is "modified" before the end of the five year/age 59½ minimum duration; see ¶ 9.3.01.

9.2.02 ***How this exception works***

The SOSEPP exception starts from the premise that there is a fund of money (the retirement plan account) that will be gradually exhausted by a series of regular distributions over the applicable period of time (¶ 9.2.01). Thus, the SOSEPP must be designed so that, *if* it continued for that period

of time (which it won't; see ¶ 9.3.02), it would exactly exhaust the fund. The participant cannot take annual distributions that are too small to exhaust the account, even if they are equal, regular, payments designed to continue over the applicable time period. See Notice 87-16, 1987-1 C.B. 446, A-12, and PLR 9805023. For how to get around this limitation; see ¶ 9.2.12.

9.2.03 ***Notice 89-25 (A-12) and its successor, Rev. Rul. 2002-62***

Notice 89-25, 1989-1 C.B. 662, A-12, laid out three methods a participant could use to compute the payments in his SOSEPP. Revenue Ruling 2002-62, 2002-42 I.R.B. 710, which supercedes Notice 89-25, A-12, continues the same three methods but changes the rules regarding which life expectancy tables, interest rate, and account balance may be used in designing a SOSEPP; see ¶ 9.2.05. Rev. Rul. 2002-62 applies to any SOSEPP commencing after 2002. The IRS posted a document called "FAQs regarding Revenue Ruling 2002-62" at its web site, which is "for general information only and should not be cited as any type of legal authority"; see http://www.irs.gov/retirement/article/0,,id=103045,00.html.

9.2.04 ***Steps required to initiate a SOSEPP***

The first step in initiating a SOSEPP is to decide what size payments the participant wants to take. Ideally, the payments desired will not require the participant to use his entire plan balance. With the help of an actuary, the participant determines what size of IRA would be required to support a SOSEPP of the amount he wants, and that amount is transferred into a separate IRA from which the SOSEPP payments are made. This leaves the balance of his funds in a plan or IRA that is not involved in the SOSEPP and which is therefore available for the participant's later needs to, *e.g.*, take an extra payment (on which he would pay the 10 percent penalty) without being deemed to have impermissibly "modified" the SOSEPP (¶ 9.3.01) or even to start another SOSEPP (¶ 9.2.13).

The participant must make several choices about the design of the series: Choose one of the three permitted methods. ¶ 9.2.05. Choose a life expectancy table. ¶ 9.2.07–¶ 9.2.09. If using the amortization or annuitization method, choose an interest rate (¶ 9.2.10) and decide whether or not to use "annual recalculation" (¶ 9.2.06). Choose an initial account balance valuation date. ¶ 9.2.11. Decide whether payments will be monthly, quarterly, or annually. The "periodic payments" must be paid at regular intervals at least annually. Rev. Rul. 2002-62, § 1.02(b). Though Rev. Rul. 2002-62 and its follow-up "FAQs" (¶ 9.2.03) use only annual payments in their examples, monthly payments are apparently also popular (see, *e.g.*, PLRs 2002-14029, 2002-14034, 2002-03072).

9.2.05 ***The three methods: RMD, amortization, annuitization***

The participant has a choice of three IRS-approved methods for the design of his SOSEPP:

A. **RMD method.** Under the "RMD method," the "series" payments are calculated in the same manner as lifetime minimum required distributions under § 401(a)(9) (called "MRDs" elsewhere in this book, "RMDs" by the IRS): The account balance (revalued annually) is divided by a life expectancy factor each year to produce the required payment. See ¶ 1.3.01. Since the youngest age covered under the "real" RMD table (see Table 1, Appendix A) is

70, the IRS created a special under-age-60 "RMD table" for users of this method. See ¶ 9.2.07(A).

"Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payments are redetermined for each year." Rev. Rul. 2002-62, § 2.01(a). Because this method requires annual revaluation of the account, payments fluctuate (both up and down) with investment performance. The advantage of annual revaluation is that the account will never be wiped out by the SOSEPP payments, as can occur with the fixed payments usually used under the other two methods. The drawback of the RMD method (or any method that employs annual recalculation) is the unpredictability of the payments.

B. **Amortization method:** Under this method, the participant chooses a reasonable interest rate (¶ 9.2.10), and a life expectancy table (¶ 9.2.07–¶ 9.2.09.), then takes regular payments as if the account were a self-amortizing level payment mortgage (except that he is receiving, rather than making, the payments). Once the amount of the first payment is determined, the payments never vary, regardless of the investment performance of the account (unless annual recalculation is used; see ¶ 9.2.06). If using the amortization method, the participant has the option, in any year after the first year, to switch to the RMD method. See ¶ 9.3.04.

C. **Annuitization method:** Under this method, the participant chooses a reasonable interest rate (¶ 9.2.10), and single or joint life expectancy (¶ 9.2.07), then divides the account balance by an annuity factor, as if the account were being annuitized over the applicable life expectancy. "The annuity factor is derived using the mortality table in Appendix B [of Rev. Rul. 2002-62] and using the chosen interest rate." Once the amount of the first payment is determined, the payments never vary, regardless of the investment performance of the account (unless annual recalculation is used; see ¶ 9.2.06). If using the annuitization method, the participant has the option, in any year after the first year, to switch to the RMD method. See ¶ 9.3.04.

*9.2.06 **Variations on the three methods***

The three methods are not the only possible ways to design a SOSEPP; however, if varying from these pre-approved models it is necessary to obtain advance approval from the IRS via a private letter ruling. See IRS FAQs (¶ 9.2.03), last question.

The IRS has issued several letter rulings blessing SOSEPP designs that incorporated annual adjustments (to reflect changes in the account balance and/or interest rate), within the amortization or annuitization method. See PLRs 2004-32021, 2004-32023, 2004-32024, 2005-51032, 2005-51033, 2005-44023, and 2009-43044. The key to the IRS's approval in these rulings is that approval is sought IN ADVANCE, before the participant starts taking any distributions, and even though the payments will vary in amount, the payment is determined the same way each year. Someone who has already started a fixed-payment SOSEPP using the amortization or annuitization method cannot later change to a recalculation method; see ¶ 9.3.07(D).

9.2.07 ***Choose single or joint life expectancy***

The participant must choose a single or joint life expectancy period for the hypothetical duration of his SOSEPP. The choice is among three life expectancy tables if the participant is using the RMD or amortization method ("A"), or among two (three?) "factors" if using the annuitization method ("B"). The choice of payout period is irrevocable if the SOSEPP commenced after 2002. Rev. Rul. 2002-62, § 2.02(a), last two sentences. See ¶ 9.2.08–¶ 9.2.09 for more on these tables.

A. **Three tables for RMD or amortization method.** Rev. Rul. 2002-62 provides that a taxpayer using the RMD or amortization method must select one of three life expectancy tables for calculating his SOSEPP: the Single Life Table, the Joint and Survivor Life Table, or the Uniform Lifetime Table. Rev. Rul. 2002-62, § 2.01(a), (b), § 2.02(a).

The Single and Joint and Survivor Life Tables are contained in Reg. § 1.401(a)(9)-9, A-1, A-3. The Uniform Lifetime Table (showing the joint and survivor life expectancy of the participant and a hypothetical beneficiary who is 10 years younger than the participant) is contained in Appendix A of Rev. Rul. 2002-62 and of this book (Table 2). It is an expanded version of the Uniform Lifetime Table contained in Reg. § 1.401(a)(9)-9, A-2, extended down to age 10!

B. **Only two choices for annuitization?** For an annuitization-method SOSEPP, the annuity period is "the life of the taxpayer (or the joint lives of the individual and beneficiary)." Notice 89-25 permitted use of any "reasonable mortality table" under the annuitization method. Rev. Rul. 2002-62 took away that option, and supplies its own table of mortality factors that must be used in determining payments under the annuitization method. Rev. Rul. 2002-62, § 2.02(a).

9.2.08 ***Notes on Joint and Survivor Life Table***

If the participant elects the Joint and Survivor Life Table, then the factor used to determine the first payment in the series is based on the joint life expectancy of the participant and his ACTUAL beneficiary. Rev. Rul. 2002-62, § 2.02(b). If the participant is using the RMD method (¶ 9.2.05(A)), then the beneficiary (for purposes of determining the factor under the Table) is redetermined every year, as of January 1 of the distribution year, using the same rules as apply for determining the beneficiary for minimum distribution purposes (see ¶ 1.3.03(B)).

Under the annuitization or amortization method, subsequent changes of beneficiary will have no effect on the payments so long as the participant continues using that method—but if he switches in mid-stream to the RMD method (¶ 9.3.04), and is required (or chooses) to continue using the Joint and Survivor Life Table, then his subsequent payments would be determined using the joint life expectancy of himself and his actual beneficiary.

9.2.09 ***Notes on Single, Uniform Lifetime Tables***

The only difference between the Single Life Table and the Uniform Lifetime Table is the size of the annual payment relative to the size of the account. A participant who wants larger payments would choose the Single Life Table. A participant who wants smaller payments would use

the Uniform Lifetime Table. When using the "separate IRA" SOSEPP recommended at ¶ 9.2.04, the Single Life Table should always be used, to generate the largest possible payments relative to the account size.

With both these tables, you find the appropriate factor for the first year's payment based on the participant's age on his birthday in that year. Rev. Rul. 2002-62, § 2.02(a). If using the RMD method, you then go back to the originally-chosen table every year to get that year's factor, based on the participant's new age. If using the amortization or annuitization method, you don't go back to the table every year because the payments are fixed in amount (unless your series design is based on annual recalculation; see ¶ 9.2.06).

9.2.10 ***What interest rate assumption is used***

For the amortization and annuitization methods, it is necessary to choose an interest rate (representing the hypothetical projected investment return on the account during the period of the SOSEPP). The participant may use "any interest rate that is not more than 120 percent of the federal mid-term rate (determined in accordance with section 1274(d) for either of the two months immediately preceding the month in which the distribution begins)." Rev. Rul. 2002-62, § 2.02(c). You can find the monthly federal mid-term rates at the IRS web site www.irs.gov/tax_regs/fedrates.html, or at www.tigertables.com or www.leimbergservices.com.

9.2.11 ***What account balance is used***

Whichever method the participant is using, he must apply a certain factor to an account balance. The account balance "must be determined in a reasonable manner based on the facts and circumstances." Rev. Rul. 2002-62, § 2.02(d).

Under all three methods, the participant must select a valuation date for the first year's payment. The IRS provides an example the gist of which is that any date from the last prior year end to the day before the distribution would be fine. There is no specific prohibition against using a date earlier than the last prior year-end, but it would seem that the prior year-end (or any subsequent valuation date, up to the date of the first distribution) would be a safe harbor.

Under the *amortization* and *annuitization* methods, the account balance is determined only once, at the beginning of the series. Since the payments do not fluctuate, there is no need to look at the account balance again after the first year (unless annual recalculation is part of the series design; see ¶ 9.2.06). Under the *RMD method* the account balance is always redetermined annually.

9.2.12 ***Applying the SOSEPP exception to multiple IRAs***

Generally, all of an individual's IRAs are aggregated (treated as one account) for purposes of determining how much of any distribution is *included in gross income*. See ¶ 2.2.08(F). However, no provision requires IRAs to be aggregated for purposes of the *penalty* under § 72(t), or the SOSEPP exception.

For purposes of structuring a SOSEPP, the participant has several choices: The series can be based on all of his IRAs, aggregated; or on some of the IRAs aggregated, with others excluded; or on one IRA to the exclusion of others. As the IRS said in PLR 9747039, "If a taxpayer owns more than one IRA, any combination of his or her IRAs may be taken into account in determining the

distributions by aggregating the account balances of those IRAs. *The specific IRAs taken into account are part of the method of determining the substantially equal periodic payments....*" Emphasis added.

All IRAs aggregated: In each of PLRs 9830042, 9824047, and 9545018, all of the participant's IRAs were aggregated for purposes of computing the series payments.

Some IRAs aggregated, others excluded: In PLRs 9816028, 9801050, and 2000-31059, the participant had several IRAs, some of which were aggregated to form the basis of his proposed SOSEPP and the rest of which were not to be counted. The IRS ruled favorably in all cases, requiring only that the series payments be made from the aggregated IRAs and not from the other accounts.

Take series from one IRA, not aggregated with others: In PLR 9818055 the participant was taking a SOSEPP from one of her two IRAs. In PLR 9812038 the participant was taking a SOSEPP from one of his three IRAs and wanted to start a second SOSEPP from a new, fourth, IRA, to be created by transfer of funds from one of the other IRAs (not the IRA that was already supporting the first SOSEPP). The IRS permitted this; the ruling stated more than once that the taxpayer's IRAs were not aggregated. In PLRs 9747045, 2001-22048, and 2009-43044, the participant's IRS-approved SOSEPP was taken from one of the participant's multiple IRAs; the accounts were not aggregated.

The account or accounts included in the initial design of the SOSEPP must be the sole source of payments in the series. Once the SOSEPP begins, funds must not be transferred *out of* the IRAs that are being used to support the series (except to make the SOSEPP payments), or *into* any IRA that is part of the support for the series. See ¶ 9.3.09 regarding tax-free rollovers involving IRAs supporting a SOSEPP.

9.2.13 ***Starting a second series to run concurrently***

A participant receiving a SOSEPP from one or more IRAs may initiate a *second* series of equal payments from a different IRA or set of IRAs. See, *e.g.*, PLR 9812038, discussed at ¶ 9.2.12. PLR 9747039 also permitted starting a second SOSEPP from a different IRA. See PLR 2003-09028 for a good model of exactly how to do this.

However, the participant may not start a second SOSEPP from *the same IRA* (or plan) that is already supporting the first SOSEPP; such a second series would constitute an impermissible "modification" of the first series. ¶ 9.3.01.

9.2.14 ***Procedural and reporting requirements***

There is no specific format for electing one of the three methods. There is no requirement that any of the elections or choices be in writing, or that notice of any choices be delivered to anyone in particular. The usual procedure is for the participant and his advisor to prepare a memorandum or worksheets showing the design of the series and how the distributions are calculated. This normal approach is recommended as the best safeguard for ensuring that the series qualifies for the SOSEPP exception and that such qualification can later be proved to the IRS should that become necessary.

9.3 Modifying the SOSEPP

9.3.01 ***Effects of a forbidden modification of series***

If the participant "modifies" his SOSEPP before a certain period of time has elapsed, he is severely punished. His qualification for the SOSEPP exception (¶ 9.2) is retroactively revoked, and he owes the penalty for all series payments he took prior to age 59½, with interest. Once the participant has modified his series, he cannot start a new SOSEPP from the same plan until the following calendar year, according to PLR 2000-33048.

9.3.02 ***When the no-modification period begins and ends***

The beginning date of the no-modification period is the date of the first payment in the series. The ending date is the fifth anniversary of the date of the first payment in the series, or*, if later*, the date on which the participant attains age 59½. § 72(t)(4)(A). Once this ending date is passed, payments may be freely taken from the plan without penalty (or the series may be suspended—*i.e.*, the participant can STOP taking payments).

Note that the ending date of the five years is not simply the date of the fifth year's payment. The five years ends on the *fifth anniversary of the first payment*. *Arnold*, 111 T.C. No. 250 (1998).

9.3.03 ***Exceptions for death or disability***

If the series is modified "by reason of death or disability" there is no penalty. § 72(t)(4)(A). Presumably death *automatically* ends the requirement of continuing the series, since death benefits are exempt from the penalty; ¶ 9.4.01. Presumably the same is true of a total disability that justifies penalty-free distributions; see ¶ 9.4.02. Whether a modification that was "caused by" any lesser disability would escape the penalty remains to be seen.

9.3.04 ***Changing to RMD method after the SOSEPP commences***

One type of change in the series is specifically permitted: Changing to the "RMD method" of computing the payments (¶ 9.2.05(A)) will not be considered a modification. Rev. Rul. 2002-62 allows a participant using the annuitization or amortization method to change (permanently) to the RMD method; see § 2.03(b) of the Rev. Rul. for details on making this switch.

Because the RMD method requires annual revaluation of the account balance, a downturn in the account value will translate, under the RMD method, into a reduction in the subsequent year's payment. Thus, the series payments will shrink along with the account value and the account will never run dry. Similarly, if the investments perform substantially better than the growth assumption used in designing the SOSEPP (¶ 9.2.10), switching to the RMD method allows the participant to increase his payments to capture some of that investment growth.

9.3.05 When taking an extra payment is not a modification

Generally, taking an "extra" payment out of your IRA over and above the prescribed SOSEPP payments would be considered a modification of the series (see ¶ 9.3.07(B)), but not necessarily always.

A. Qualified hurricane distributions. Taking a qualified hurricane distribution (¶ 9.4.13) over and above the participant's SOSEPP payments is not a modification of the SOSEPP. Notice 2005-92, I.R.B. 2005-51, Section 4(H).

B. Other payments that qualify for another exception. If the extra distribution qualifies for some *other* penalty exception, the extra payment is not a modification of the SOSEPP, according to *G.T. Benz*, Dec. 7,810, 132 TC 15 (5/11/09).

C. Administrative error. The IRS generally will rule that there is no modification when a change in the SOSEPP is caused by an administrative action or error of the SOSEPP-paying financial institution; see ¶ 9.3.06(A), (E). However, there is no Revenue Ruling, regulation, or other authority supporting this as a general exception, leaving participants with the unpleasant choice of either applying for their own ruling (expensive) or relying on other peoples' PLRs (with attendant uncertainty).

9.3.06 What other changes do NOT constitute a modification?

Converting a SOSEPP-supporting account to a Roth IRA does not constitute a modification; see ¶ 5.5.03 for details. The following other types of changes in a SOSEPP have either been ruled not to be modifications, or have occurred without negative comment in cases or rulings involving other issues:

A. Computer system change. When the paying agent, as part of a change in its computer systems, changed the date of monthly payments in a series to the first day of the month (instead of the last day of the preceding month), the change was ruled to be "ministerial," and not a "modification," even though the change meant that the recipient's income would include one less payment for the year the switch was made. PLR 9514026.

B. Plan termination. The participant in PLR 9221052 was receiving monthly payments from a pension plan. When that plan terminated in the middle of his SOSEPP, he sought to roll over the termination distribution to an IRA and continue taking the same monthly payments from the IRA. The IRS ruled that this change would not constitute a modification.

C. Payments not on anniversary date. In the case of annual payments, it does not appear to be required that each year's payment occur on the anniversary of the first payment. See Rev. Rul. 2002-62, § 2.02(d). See PLR 9747039, in which the IRS ruled that the participant would qualify for the exception "if [he] received at least five annual payments of $510,000 from IRA Y (at least one during each of the years 1997, 1998, 1999, 2000 and 2001) and does not otherwise modify his IRA distribution scheme."

D. **Plan exhausted.** If investment performance is poor, fixed payments under the amortization or annuitization method might exhaust the account. Running out of money due to taking the payments called for by the SOSEPP will not be considered a modification of the series. Rev. Rul. 2002-62, § 2.03(a).

E. **IRA provider error.** In several cases, the IRS has ruled that a change in a SOSEPP did not constitute a SOSEPP-disqualifying modification where the change was the result of a financial institution error. See PLRs 2005-03036, 2006-31025, 2009-29021 (¶ 9.3.09), and 2009-30053. However: In PLR 2010-03033, the participant was receiving a monthly-payment SOSEPP. Because of financial institution error, an extra payment was sent, so that she received 13 payments instead of 12 in one year. The IRS granted her request for a late rollover of the extra payment (see ¶ 2.6.07), but expressed "no opinion" as to whether the extra payment constituted a modification of the SOSEPP.

F. **Participant error.** In PLR 2006-01044, the participant started an amortization method SOSEPP from four IRAs, but due to a math error his first payment was too small by less than 2/10ths of one percent. The IRS ruled that the underpayment (and subsequent "catch up distribution" to correct the error) did not constitute modifications of the series.

*9.3.07 **What changes DO constitute a modification?***

Here are some examples of prohibited modifications of a SOSEPP; see also ¶ 9.3.09 regarding transfers into or out of the SOSEPP-supporting IRA.

A. **Stopping the payments.** See PLR 9818055, in which the participant terminated the series because she went back to work; she had to pay the penalty.

B. **Taking extra payment.** Taking a payment that is over and above the payments required as part of the series is a modification. See *Arnold*, ¶ 9.3.02. See ¶ 9.3.05 for exceptions.

C. **Changing the "period" of periodic payments.** Changing from annual payments to quarterly or monthly payments (or vice versa), even if the total payments for the year add up to the right amount, *could* be considered a modification; there is no authority for the proposition that the size of individual payments in the series does not matter so long as the total is the same each year.

D. **Changing how the payments in the series are determined.** See PLRs 9821056 and1999-43050.

*9.3.08 **Effect of divorce on the SOSEPP***

If the participant gets divorced in the middle of his SOSEPP, the divorce court may award a share of the retirement plan that is supporting the SOSEPP to the participant's ex-spouse. Usually the spouse's share is transferred tax-free to the spouse's account under a QDRO (§ 414(p)) or the IRA equivalent (§ 408(d)(6)). The participant needs to apply for an IRS ruling allowing the SOSEPP

payments to be reduced proportionately to reflect the transfer of part of the participant's SOSEPP-paying retirement plan to the participant's ex-spouse. See PLRs 9739044, 2000-27060, 2000-50046, 2001-16056, 2002-02074, 2002-02075, 2002-02076, 2002-14034, and 2002-25040.

9.3.09 ***Transfers to, from, or among IRAs supporting a SOSEPP***

As explained at ¶ 9.2.12, two or more IRAs can be aggregated for purposes of calculating and paying a SOSEPP. Once the SOSEPP commences, it is essential that no assets be transferred into (or out of) those IRAs from (or to) any other IRA (or plan), because of the following rule: "Under all three methods, substantially equal periodic payments are calculated with respect to an account balance as of the first valuation date selected…. Thus, a modification to the series of payments will occur if, after such date, there is (i) any addition to the account balance other than gains or losses, [or] (ii) any nontaxable transfer of a portion of the account balance to another retirement plan…." Rev. Rul. 2002-62, § 2.02(e)(ii).

Note that this rule appears to have two parts, a "no additions" rule and a "no nontaxable transfers" rule. Whether there is any relation or distinction between these two sections of the rule is unclear. See PLR 2009-25044, discussed at "B."

Despite this rule, the IRS ruled in PLR 2009-29021 that there was no modification when, due entirely to a financial institution error, distributions from the participant's workplace retirement plan were rolled into the IRA from which the participant was receiving SOSEPP payment; the participant had asked for these funds to be rolled to a different IRA. See ¶ 9.3.06(E).

A. **Transfers among IRAs supporting the SOSEPP.** This rule does not preclude moving assets *among the multiple IRAs that are included in the SOSEPP account balance* (¶ 9.2.12). PLR 2000-31059.

B. **Transfer into a new IRA might or might not constitute a modification.** The principle stated at "A" *should* also protect the individual who is taking a SOSEPP from an IRA and wishes to transfer all or part of the IRA to a different custodian, just for investment reasons, without altering the amount or timing of his SOSEPP payments. (Needless to say, the IRA into which the SOSEPP-supporting IRA is being transferred cannot have in it any other funds.) In this case, the "IRAs supporting the SOSEPP" would be the old IRA and the new IRA, with no commingling of funds from any *other* IRA or plan.

Unfortunately, the IRS has never clearly stated this corollary principle, and there are letter rulings supporting both the principle and its opposite.

There are now four PLRs supporting the conclusion that a SOSEPP-paying IRA may be transferred tax-free to a new, otherwise-empty, IRA account with a different custodian, without causing a modification of the SOSEPP:

PLR 2006-16046 dealt primarily with an inadvertent commingling of the SOSEPP IRA with other IRA funds (due to a financial institution error). In providing the factual background for its ruling regarding the institutional error, the IRS noted *without comment* that, during the SOSEPP (and prior to and unrelated to the occurrence of this financial institution error), the taxpayer had rolled the entire SOSEPP-paying IRA ("IRA M") into a different IRA ("IRA P"), from which he continued taking the SOSEPP payments. The fact that the IRS ruled that he still had a valid SOSEPP after this

rollover supports the conclusion that merely transferring the SOSEPP IRA to a different custodian does not violate the no-transfers rule.

There are three other similar PLRs where the IRS was ruling that a financial institution error did not constitute a modification of the series, and in which it is stated as part of the factual background that the IRAs in question had been transferred (prior to and unrelated to the financial institution error incidents) from one custodian to another for investment reasons. If such prior transfers were "modifications," then the subsequent financial institution errors would have been irrelevant because the series would already have been ended via "modification." Since in each of these case the IRS ruled the series had not been modified, this must mean that the prior tax-free transfers were NOT modifications. See PLRs 2006-31025, 2009-29021, and 2009-30053.

And yet…in two other PLRs, the IRS has indicated that the transfer of a SOSEPP-paying IRA to a different account for investment reasons DOES (or might) constitute a modification!

The IRS ruled in PLR 2009-25044 that a participant's trustee-to-trustee transfer of her SOSEPP-supporting IRAs from one financial institution to another, solely for the purpose of changing the investments in the account, was a modification of the series. In this ruling, the SOSEPP-supporting IRA (IRA X) was commingled with funds from another IRA (IRA Y), not involved in the SOSEPP, when both were transferred into a new combined IRA, IRA Z, at the new financial institution. The ruling stated that the problem could not be corrected by unmingling the IRA Y funds and sending them back to IRA Y. Unfortunately, the ruling does not state that it was *only the commingling* that caused the IRS to rule this a modification; rather, they base the ruling on the provision in Rev. Rul. 2002-62 prohibiting *any* nontaxable transfers in or out of the SOSEPP-supporting IRA.

In PLR 2010-03033, discussed at ¶ 9.3.06(E), the participant's SOSEPP-supporting IRA was moved to a different financial institution when her advisor changed firms, but the IRS did not rule on whether the SOSEPP qualified as a SOSEPP or was modified.

9.4 Other Exceptions to the Penalty

We now turn to the other exceptions to the § 72(t) penalty. Although these lack the broadly applicable planning possibilities of the SOSEPP, each can be useful in particular situations.

9.4.01 ***Death benefits***

A distribution "made to a beneficiary (or to the estate of the employee) on or after the death of the employee" is exempt from the penalty. § 72(t)(2)(A)(ii). This exception applies to distributions from all types of plans. Thus death benefits may be distributed penalty-free from any type of plan or IRA, regardless of whether the *beneficiary* is under age 59½ and regardless of whether the *participant* had attained age 59½ at the time of his death.

Despite the unique clarity of this exception, it generates confusion for the following reason: If a surviving spouse rolls over benefits inherited from the deceased spouse to the surviving spouse's *own* IRA, the rolled-over funds cease to be death benefits; they become part of the surviving spouse's own retirement account. Thus, distributions from the rollover IRA will once again be

subject to the § 72(t) penalty rules if the surviving spouse is under age 59½—even if the deceased spouse was over age 59½. See ¶ 3.2.08 for planning implications.

9.4.02 ***Distributions attributable to total disability***

A distribution (from any type of plan) that is "attributable to the employee's being disabled" is not subject to the penalty. § 72(t)(2)(A)(iii).

Disabled is defined in § 72(m)(7): It means "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration." See Reg. § 1.72-17A(f)(1), (2). Generally the IRS requires that the individual be eligible to receive Social Security disability benefits to qualify for this exception.

§ 72(m)(7) also states that "An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof [sic] in such form and manner as the Secretary may require." IRS Publication 590 (2009), p. 52, states that "A physician must determine that your condition can be expected to result in death or to be of long, continued, and indefinite duration." This requirement is not waived for those whose religious beliefs prohibit them from consulting physicians. *Fohrmeister*, 73 T.C. Memo 2483, 2486 (1997).

Depression and similar psychiatric problems typically will not constitute "disability" for this purpose, even if they lead to termination of employment or allow the individual to collect disability payments, because these problems are usually temporary.

It is not clear to what extent the plan distribution must be shown to be "attributable" to the disability. In PLR 2001-26037 the IRS said any distributions made after the participant was disabled would be exempt from the penalty

9.4.03 ***Distributions for deductible medical expenses***

Distributions from any type of plan are penalty-free to the extent they "do not exceed the amount allowable as a deduction under § 213 to the employee for amounts paid during the taxable year for medical care (determined without regard to whether the employee itemizes deductions for such taxable year)." § 72(t)(2)(B). "During the taxable year" means "during the taxable year in which the distribution is received." *Evers*, T.C. Summ. Op. 2008-140.

9.4.04 ***QRPs, 403(b) plans: Early retirement***

A distribution made to an employee "after separation from service after attainment of age 55" is exempt from the penalty. This exception is available for qualified (¶ 8.3.12) and 403(b) (¶ 8.3.03) plans, but *not* for IRAs. § 72(t)(2)(A)(v), (3)(A). For government plan distributions to firemen, policemen, and emergency medical personnel, the age is 50 not 55. § 72(t)(10).

Although § 72(t) limits the exception to distributions made after a separation from service occurring after the employee's 55th birthday, Notice 87-13, 1987-1 C.B. 432, A-20, provides that the separation from service can occur on or after *January 1* of the year the employee reaches age 55. See PLR 2002-15032.

An employee who separates from the company's service *before* the year he reaches age 55 is not entitled to use this exception; he cannot simply wait until age 55 and then take a penalty-free

distribution. The exception is available only for distributions "after your separation from service in or after the year you reached age 55." IRS Publication 575, "Pension and Annuity Income" (2009), p. 31; *Humberson*, 70 TCM 886 (1995).

"John" leaves the employment of "Company A" when he is 54 and goes to work at "Company B," then retires from Company B at age 55 or older. He can withdraw penalty-free from the Company B plan, but he cannot withdraw penalty-free from the Company A plan; the IRS requires that the post-age-55 retirement must be from the service of *the company maintaining the plan*. John could have avoided this problem if only he had hired an expert tax advisor to tell him to roll the Company A plan benefits into the Company B plan while he was still employed there.

If the employee retires between the ages of 55 and 59½ but rolls his plan distribution into an IRA, he will lose his ability to claim this exception; distributions from the IRA will be subject to the penalty if made before 59½ unless some other exception applies. *Kim*, 7th Cir. 2012.

9.4.05 ***QRPs, 403(b) plans: QDRO distributions***

Distributions from a *qualified retirement plan or 403(b) arrangement* made to an "alternate payee" under a qualified domestic relations order (QDRO; see § 414(p)(1)) are exempt from the early distributions penalty. § 72(t)(2)(C). This allows a divorcing spouse who is under age 59½ to receive penalty-free distributions from the share of her ex-spouse's QRP or 403(b) plan that is awarded to her in the divorce proceedings (if the QDRO procedures are followed).

However, even though, in § 408(d)(6), Congress provided a means for the tax-free division of *IRAs* between divorcing spouses, analogous to the QDRO procedures for qualified plans, Congress did NOT extend the penalty exception of § 72(t)(2)(C) to IRAs. Thus, a divorced spouse who receives part of her ex's IRA under § 408(d)(6) cannot withdraw from the account prior to reaching age 59½ unless she pays the 10 percent penalty or qualifies for some other exception.

9.4.06 ***ESOPs only: Dividends on employer stock***

Under § 404(k), a company can take a tax deduction for dividends paid on stock that is held by an employee stock ownership plan (ESOP), and the ESOP can pass these dividends out to the plan participants, if various requirements are met. Such dividend payments are not subject to the 10 percent penalty. § 72(t)(2)(A)(vi).

9.4.07 ***IRAs only: Unemployed's health insurance***

An unemployed individual can take penalty-free distributions from his IRA (but NOT from a qualified plan or 403(b) arrangement) to pay health insurance premiums. See § 72(t)(2)(D) for details.

9.4.08 ***IRAs only: Expenses of higher education***

The 10 percent penalty will not apply to *IRA distributions* that do not exceed the participant's "qualified higher education expenses" paid in the taxable year of the distribution. § 72(t)(2)(E).

The distribution does not actually have to be used to pay the education expenses; the exemption applies to the extent the distribution does not exceed the education expenses incurred in

the same year the distribution occurs. IRS Publication 590 (2009), p. 52. Using the distribution to repay a loan does *not* qualify for the exception, even if the loan proceeds were used to pay education expenses, if the education expenses were not paid in the same year as the distribution. *Lodder-Beckert*, T.C. Memo. 2005-162.

The distribution must be to pay for education furnished to the participant or his spouse, or to any child or grandchild of either of them. This exception borrows definitions from the Code section allowing various tax breaks to "qualified state tuition programs" (§ 529(e)(3)) for the type of expenses covered ("tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution") and eligible institutions. The costs of providing the student's computer, housewares, appliances, furniture, and bedding are not qualified expenses. *Gorski*, T.C. Summ. Op. 2005-112.

"Eligible Institutions" include "virtually all accredited public, non-profit, and proprietary post-secondary institutions," according to Notice 97-60, 1997-46 I.R.B. 1, § 4, A-2, which provides details regarding this exception, including the fact that room and board are among the covered expenses if the student is enrolled at least half-time.

To the extent the education expenses in question are paid for by a scholarship, federal education grant, tax-free distribution from an Education IRA (§ 530), tax-free employer-provided educational assistance, or other payment that is excludible from gross income (other than gifts, inheritances, loans, or savings), they cannot also be used to support a penalty-free IRA distribution. § 72(t)(7)(B), § 25A(g)(2); Notice 97-60, § 4, A-1.

9.4.09 ***IRAs only: First-time home purchase***

"Qualified first-time homebuyer distributions" from an IRA are not subject to the penalty. § 72(t)(2)(F). An individual can withdraw from his IRA (but *not* from a qualified plan or 403(b) arrangement!) up to $10,000, without penalty, if the distribution is used "before the close of the 120th day after the day on which such payment or distribution is received to pay qualified acquisition costs with respect to a principal residence of a first-time homebuyer who is such individual, the spouse of such individual, or any child, grandchild, or ancestor of such individual or the individual's spouse." § 72(t)(8)(A). A home purchased in the name of the IRA owner's brother does not qualify for this exception. *Laura Ung* TC Memo 2013-126.

The "date of acquisition" is the date "a binding contract to acquire" the home is entered into, or "on which construction or reconstruction of such a principal residence is commenced"—but, if there is a "delay or cancellation of the purchase or construction" and, solely for that reason, the distribution fails to meet the 120-day test, the distribution can be rolled back into the IRA; this will be a qualified tax-free rollover, even if it occurs more than 60 days after the distribution, so long as it occurs within 120 days of the distribution. See ¶ 2.6.06(A).The rollover back into the IRA will not count for purposes of the one-rollover-per-year limit (¶ 2.6.05(D)). § 72(t)(8)(E).

The $10,000 is a lifetime limit. It applies to the person making the withdrawal (the IRA owner), not the person buying the home. If you withdraw $10,000 in one year to help your son buy a first home, you cannot later withdraw another $10,000 to buy your own first home.

"Principal residence" has the same meaning as in § 121 (exclusion of gain on sale of principal residence), according to § 72(t)(8)(D)(ii). § 121 itself does not contain a definition of "principal residence"; Reg. § 1.121-1(b) says the determination depends on all the "facts and circumstances."

“Qualified acquisition costs” are the costs of “acquiring, constructing, or reconstructing a residence,” including “usual or reasonable settlement, financing, or other closing costs.” § 72(t)(8)(C). A “first-time homebuyer” is a person who has had no “present ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the” residence being financed by the distribution. If the homebuyer is married, both spouses must meet this test. § 72(t)(8)(D).

Finally, to the extent the distribution in question qualifies for one of the *other* exceptions (*e.g.*, a distribution to pay higher education expenses), it will not count as a “first-time homebuyer” distribution (so it will not count towards the participant’s $10,000 limit) even if it is used to pay expenses that would qualify it for the first-time homebuyer exception. § 72(t)(2)(F).

9.4.10 ***IRS levy on the account***

Forced distributions after 1999 resulting from an IRS levy under § 6331 will not be subject to the penalty. § 72(t)(2)(A)(vii).

9.4.11 ***Return of certain contributions***

Certain excess contributions to “CODA” plans (see ¶ 8.3.02) may be distributed penalty-free if various requirements are met. See § 401(k)(8)(D) and § 402(g)(2)(C). Regarding return of an IRA or Roth IRA contribution prior to the due date of the tax return for the year for which such contribution was made, see ¶ 9.1.03(B).

9.4.12 ***Qualified reservist distributions***

The penalty does not apply to “qualified reservist distributions” (QRDs). A QRD is a distribution from an IRA or from the elective-deferral portion of a QRP (¶ 8.3.02), that is made after September 11, 2001, to an individual reservist who is called to active duty. The active duty call or order must be for more than 179 days or for an indefinite period, and occur after September 11, 2001. The distribution must occur on or after the date the participant is called up and before the end of the active duty period. § 72(t)(2)(G)(iii). See ¶ 2.6.06(C) regarding the ability to “roll over” QRDs without regard to normal rollover deadlines and contribution limits.

9.4.13 ***Exceptions for tax-favored disasters***

Congress likes to enact special exceptions for individuals affected by natural disasters, provided the disaster is on the national news for at least a week. Someone who lives in a county affected by Hurricane Katrina may thereby qualify for a penalty exception, while someone who suffered worse losses in a local disaster that affected only a few people will not qualify. For penalty exceptions applicable to certain hurricane victims, see § 1400Q, Notice 2005-92, 2005-51 I.R.B.1165, IRS Publication 4492, and IRS Form 8915.

Table 1: The "Uniform Lifetime Table"

...for determining lifetime required distributions for (almost) everyone

Table for Determining Applicable Distribution Period (Divisor)			
Age	**Distribution period**	**Age**	**Distribution period**
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115 and older	1.9

Under the final Minimum Distribution Regulations, the above "Uniform Lifetime Table" may be used by all taxpayers to compute their lifetime annual required minimum distributions for 2002, and must be used for 2003 and later years (for exceptions see below). For each "Distribution Year" (i.e., a year for which a distribution is required), determine: (A) the account balance as of the preceding calendar year end; (B) the participant's age on his or her birthday in the Distribution Year; and (C) the "applicable divisor" for that age from the above table. "A" divided by "C" equals the required minimum distribution for the Distribution Year. In the age-71½ Distribution Year, do NOT reduce the "A" number by the amount of any required distribution for the age-70½ year that had not been taken out by the end of that year; this adjustment has been eliminated.

Exceptions: This table does not apply to beneficiaries of a deceased IRA owner; or if the sole beneficiary of the IRA is the participant's spouse who is more than 10 years younger than the participant. This table may not be used for distribution years prior to 2002. This table does not apply in 2009; there were no required minimum distributions for the year 2009.

Table 2: Medicare "Part B" Premiums

Medicare "Part B" Premiums are determined actuarially, then reduced by a "subsidy." The subsidy is reduced for higher-income taxpayers. This "subsidy reduction" for high-income taxpayers started in 2007, and was fully phased in as of 2009. 42 U.S. Code §1395r(i). As a result, higher income taxpayers pay more than triple the Medicare Part B premium paid by low-income taxpayers.

The "subsidy reduction" is based on "modified adjusted gross income," which is regular AGI determined under § 62 (line 37 on the 2017 Form 1040), with certain normally-excluded income added back in, namely: tax-exempt interest, U.S. savings bond interest used to pay tuition, etc. (§ 135), and certain income from foreign or U.S. possession or territory sources (§ 911, § 933, § 935). 42 U.S.C. § 1395r(i). Note the following:

- Medicare Part A is free for most enrollees. The following Table applies only to Part B.

- Roth distributions that are excluded from gross income do *not* increase MAGI for Medicare premium purposes, unlike traditional IRA distributions.

Each year's premium is calculated based on the individual's MAGI for the second prior year (e.g. 2016 income determines 2018 premium; 2018 income will determine 2020 premiums).

For an excellent discussion of the Medicare premium "subsidy", visit www.kitces.com.

The following Table shows the ANNUAL Part B Medicare premium for 2018 as adapted from the table at www.medicare.gov. "Yearly Income" means MAGI for the year 2016.

If Your Yearly Income in 2016 was:		**You Pay:**
File Individual Tax Return	**File Joint Tax Return**	**For 2018 (annual):**
$85,000 or less	$170,000 or less	$1,608.00
$85,001-$107,000	$170,001-$214,000	$2,250.00
$107,001-$133,500	$214,001-$267,000	$3,214.80
$133,500-$160,000	$267,001-$320,000	$4,179.60
Above $160,000	Above $320,000	$5,143.20

Note that this is a "cliff" system. If a husband and wife filing jointly are both on Medicare, and they had $320,000 of MAGI in 2016, their combined annual 2018 Medicare premium would be $8,359.20. If their MAGI in 2016 was $320,001 ($1 more of income) their combined premium would increase by $1,927.20 to $10,286.40!

There is a procedure for requesting a reduced premium if income has dropped dramatically since the base year due to certain specified "life-changing events" such as divorce or retirement; see Form SSA-44. But a one-time capital gain or Roth conversion that created an "unusually high income" in one year is *not* the type of life-changing event that qualifies you for a reduced premium!

Table 3: 2018 Income Tax Thresholds

The following chart shows the levels of adjusted gross income or taxable income at which various tax-increasing provisions kick in for 2018. The formerly-applicable "phaseout" of itemized deductions and personal exemptions for higher-income taxpayers (§ 68, § 151(d)) is not applicable to any taxpayer in the years 2018–2025.

	A. 37% Tax Rate on Ordinary Income Begins	**B. 20% Rate on Qualified Dividends and Long-term Capital Gain Begins**	**C. 3.8% Extra Tax on Net Investment Income Begins**
Code Section:	§ 1		§ 1411
AGI or taxable income?	Taxable income	Adjusted gross income	Adjusted gross income
Married Filing Jointly	$600,000	$479,000	$250,000
Single	$500,000	$425,800	$200,000
Trust or Estate	$12,500	$2,600	$12,500

Notes:
A: The top federal income tax bracket was lowered from 39.6% to 37%, and the levels of taxable income at which the highest bracket hits individuals were raised, by the Tax Cuts and Jobs Act of 2017 (TCJA 2017).

B: As amended by TCJA 2017.

C: The rate and income levels for this tax were not touched by TCJA 2017.