SORTING OUT COMMUNITY PROPERTY RIGHTS IN EMPLOYEE BENEFIT PLANS

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ESTATE AND INCOME-TAX PLANNING WITH QUALIFIED PLANS AND IRAs

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I. TYPES OF PLANS

A. Qualified Plans**.** A "Qualified Plan" is retirement plan that meets the requirements of Section 401(a) and related sections of the Internal Revenue Code ("Code").

1. Types of Qualified Plans:

a. **Defined-benefit** ("DB") plans. The plan pays a benefit at retirement based on a formula. The amount of the benefit is determined independently of the plan's assets. Employer contributes annually amounts determined by an actuary to be necessary to pay eventual benefits.

b. **Defined-contribution** ("DC") plans. The plan pays a benefit based on the value of an employee's account. That value depends on how much is contributed to the account and how much is earned by the investment of the account. Examples: profit-sharing plans, 401(k) plans, money-purchase pension plans.

c. **Annuity-based plans** are plans that offer life annuities as benefit options. DB plans and money-purchase pension plans must be annuity-based plans. Other types of plans can be annuity-based but usually are not.

2. Tax Benefits of Qualified Plans:

a. Contributions to a qualified plan are generally tax-deductible by the employer and excluded from the employee's taxable income. Code Sections 402 and 404. However, a 401(k) plan can now have Roth accounts which are taxed like Roth IRAs (see page 3). It will be assumed in this outline that the benefit is not a Roth account.

b. Neither contributions nor earnings are taxable to the employee, even if vested, while the assets remain in the qualified plan. Code Section 402(a).

c. The qualified plan pays no income tax on its earnings. Code Section 501(a).

d. Benefits are normally taxed as ordinary income when received but capital gains rules can apply to receipt of appreciated employer stock and income averaging may be available in some circumstances. Code Section 402

e. Tax-Deferral By Rollover. In the normal case, the benefit is taxed as ordinary income when paid. However, unless the benefit is paid as an annuity or in installments over 10 years or more, generally a participant's benefit can be **rolled over** to an IRA or another qualifying employer plan, within 60 days from its receipt. Code Section 402(c)(4). The amount required to be taxed under the MRD rules (see I.F., page 5 below) cannot be rolled over.

See V.B., page 15, below for the rules governing rollovers by death beneficiaries.

A benefit eligible for rollover by a participant or spouse is subject to a mandatory 20% withholding tax. Code Section 3405(c). The withholding tax can be only avoided by making a **direct rollover**, i.e., the benefit is transferred from the plan directly to an IRA or another qualifying employer plan.

f. Distributions to Hurricane Victims. Special rules apply until December 31, 2006, with regard to amounts withdrawn from qualified plans and IRAs by victims of the hurricanes of 2005: Katrina, Rita and Wilma. Katrina Emergency Tax Relief Act, §§101-103; IRS Notice 2005-92.

i. The distribution is included in taxable income "ratably over the 3-taxable year period" that begins with the year in which the distribution is received, unless the taxpayer elects to include in income 100% in the year of the distribution.

ii. The distribution is not subject to mandatory 20% withholding.

iii. The benefit can be rolled over to an eligible retirement plan at any time during the 3 year period beginning on the date on which the distribution was received. (Replaces the 60-day rule that normally applies to rollovers.) If the rollover occurs after the year in which the benefit is taken, and tax was paid on it, the rollover will allow recovery of the tax, plus interest.

iv. The distribution is not subject to the 10% excise tax on early distributions. (See I.F.1(e), page 6, below).

v. These rules apply only to the first $100,000 of such distributions.

3. Plan Design Caveat. Each qualified plan is controlled by the employer, who decides what benefit options the plan will provide, to a participant or a beneficiary. Review the plan document (or at least the "Summary Plan Description") carefully to determine what the benefit options are. Note particularly whether the plan requires payment of death benefits in a lump sum or otherwise limits the period for distribution to a beneficiary.

B. IRAs. Individual retirement accounts and individual retirement annuities ("IRAs") are accounts or annuities that meet the requirements of Code Section 408. IRAs are funded by rollovers from employer plans and by direct contributions.

1. There are three types of IRAs--

a. *Traditional IRA.* No tax on the money going in. No tax on the earnings. All distributions are subject to ordinary income tax unless rolled over to another IRA or to an employee plan. This outline will assume that an IRA in question is a traditional IRA, whether funded directly by the employee's deductible contribution or by rollover from a qualified plan.

b. *After-tax IRA.* No deduction of the amount contributed. Earnings not taxed. Benefits taxable except for return of the contributions.

c. *Roth IRA.* No deduction on contribution, and no tax on earnings or on qualifying benefits. A traditional IRA can be converted to a Roth IRA, but the full value of the IRA is taxed in the year of conversion. Conversion is allowed only if the account holder has adjusted gross income in the year of conversion of less than $100,000. This outline does not discuss Roth IRAs in any detail.

2. Plan Design Caveat. Unlike qualified plans, the account holder controls distributions from the IRA. Nevertheless, care has to be taken regarding the default provisions in the sponsor's form, especially regarding minimum required distributions and death benefits.

C. Other Tax-Favored Types of Plans. 403(b) annuities (for employees of schools and other tax-exempt organizations) and 457(b) plans (for governmental and 501(c)(3) entities) have similar tax benefits to qualified plans. They will not be specifically addressed in this outline.

D. Non-Qualified Plans. An employer may choose to promise a retirement-type benefit that is not "qualified" for tax benefits. The following are some special considerations for such plans.

1. Income-Tax Consequences. The employer's tax deduction and the employee's recognition of taxable income generally occur at the same time. The plan is normally designed to defer the tax events until the employee actually receives the benefit. If a benefit is "funded" (see below) and not subject to a substantial risk of forfeiture, the value of the benefit will be taxed to the employee and deductible by the employer. New rules apply under Code Section 409A as to when the benefit will be taxed. There is no possibility of tax-deferral by rollover from a non-qualified plan.

2. ERISA Considerations. ERISA sets out requirements that pension-benefit plans must meet, whether qualified or not. These include requirements that a plan be funded, that it provide benefits for spouses, that annual reports be filed with the DOL, etc. There is an important exception: if a non-qualified plan is for the benefit of a "top-hat group", the plan has to comply with almost none of ERISA's rules. (A very brief "top-hat notice" has to be filed with the IRS within 120 days of its adoption, under DOL Reg. Section 2520.104-23, in order to avoid the onerous requirement of filing annual reports.) Therefore, almost invariably a non-qualified plan is set up as a top-hat plan.

3. Top-Hat Plan. A top-hat plan is "unfunded" and maintained for a "select group of management or highly-compensated employees". ERISA Sections 201(2), 301(a)(3), 401(a)(1). How "select" must the plan be? No strict rules have been formulated. The Department of Labor has indicated that a plan limited to "highly-compensated employees", as defined by Code Section 414(q) for qualified plan purposes will not necessarily be exclusive enough to qualify as a top-hat plan. DOL Advisory Opinion 90-14A. Nevertheless, many employers do set up non-qualified plans that extend to all such "highly-compensated employees" (which means, for 2007, anyone earning more than $100,000 in 2006).

4. Funding. A non-qualified plan is deemed to be funded to the extent that contributions have been made to a trust or other depository and are not subject to the claims of the employer's creditors in the event of bankruptcy. Many non-qualified plans use "**rabbi trusts**", to which contributions are made for the sole benefit of the plan's participants, but which are exposed to claims of the employer's creditors in the event of insolvency. Rabbi trusts, even though "funded" in the normal sense of the word, are deemed to be "unfunded", thus accomplishing two goals: the plan avoids immediate income tax to the participating employees, and avoids the application of ERISA.

5. Policy Issue. Why does ERISA *require* employers to discriminate in favor of their most-highly-compensated employees in setting up non-qualified plans? The purpose of the top-hat rule evidently is to protect employees; only the highest paid or top management individuals are

deemed to be able to protect themselves without the protections of ERISA. There are obviously problems with this, and it is not surprising that DOL has not made any efforts to challenge the top-hat plan exemption of non–qualified plans that have broad coverage. But it is maddening that an employer that wants voluntarily to pay a pension to a retired low-paid worker cannot do it without having to set up a funded plan for that employee's benefit. For an example of the disaster that can hit an employer after it voluntarily provides post-retirement benefits see *Musmeci v. Schwegmann Giant Supermarkets*, 26 Employee Benefits Cases 2151 (DCED La. 2001).

6. Choosing the Form of Payment of the Non-Qualified Benefit. A participant in a qualified plan is taxed *when he receives his benefit*. A participant in a non-qualified plan is taxed either (a) *when he has the right to receive his benefit* or (b) *when his benefit is funded and non-forfeitable*. Thus, if a participant in a non-qualified plan can choose upon retirement to receive either a lump-sum benefit or an annuity, he will taxed on the lump-sum amount even if he elects the annuity. Therefore, if a non-qualified plan allows the benefit to be paid in a lump sum or an annuity, the employee must make the choice in advance of his retirement. Under Code Section 409A(a)(4)(C), furthermore, if penalties – in addition to regular income tax – are to be avoided, a non-qualified plan must require a participant who wants to change the form or time of payment of the benefit to make the election at least a year in advance *and* the new election must require the payment of the benefit to be postponed for 5 years! (The effective date of this rule has been postponed to January 1, 2008. IRS Notice 2006-79.)

E. The Importance of Tax-Deferral. Ultimately almost all distributions from qualified plans, IRAs (other than Roth accounts and Roth IRAs), and non-qualified plans are included in taxable income. The great attraction of these plans is not tax-avoidance but tax-deferral. The benefit of tax-deferral can be enormous because the investor can enjoy the growth and return on pre-tax dollars. For example, if $10,000 is invested pre-tax each year for 30 years, and the earnings rate is 8%, the nest egg at the end of 30 years will amount to about $1,223,000. But if income tax is paid currently, reducing the annual contribution to, say, $6,500, and taxes are paid currently on interest, dividends and capital gains, so the earnings rate nets to 6%, the nest egg at the end of 30 years amounts to only about $545,000. It is true that any payment out of the tax deferred account is taxable as ordinary income, but actual receipt of that nest egg can be delayed a long time, and in the meantime can produce a substantial annual income.

F. Minimum Required Distributions. A participant in a qualified plan or an IRA must begin to take his benefit by his **required beginning date**, and must continue to receive annually a **minimum required distribution**, under the following general rules:

1. When Distribution Must Begin. At some point in time a participant must begin to receive each year a **minimum required distribution** ("**MRD**") of the benefit he has accrued in the qualified plan or IRA. Code Sections 401(a)(9), 408(a)(6). Any undistributed MRD amount is taxed at 50%. Code Section 4974. Those wishing maximum deferrals will want to make sure that they comply with these rules. Some particulars:

    a. For IRAs, and for qualified plans when the participant is deemed to be a 5% or greater owner of the sponsoring employer, the first year for which an MRD must be taken is the year in which the IRA holder reaches **age 70½**. Code Section 401(a)(9)(C)(ii)(I); Treas. Reg. §1.401(a)(9)-2, A-2(c). The only exception is if a 5% owner prior to 1984 elected to defer receipt until retirement and elected the form of benefit. IRS Notice 83-23, 1983-2 CB 418.

    b. For qualified plans when the participant is not subject to the rule of the preceding paragraph, the first year for which an MRD must be taken is the year in which occurs the later of the participant's termination of employment with the plan's sponsor or the participant reaching age 70½.

    c. The MRD for the first year can be taken as late as April 1 of the following year. That date is called the **required beginning date** (or "**RBD**"). The MRD for each subsequent year has to be made during that year.

    d. Roth IRAs are not subject to these rules. Code Section 408A(c)(5).

    e. Besides *encouraging* receipt of benefits during a participant's retirement years, the Code also *discourages* taking benefits before retirement. A taxable distribution received before age 59½ may be subject to a 10% excise tax, in addition to regular income tax. Code Section 72(t).

2. How Much Must Be Paid Out Each Year?

    a. The MRD for the first year is determined by dividing the account balance at the beginning of the year by a number set out on a table published by the Treasury Department. The table (known as "the **Uniform Lifetime Table"**) is set out at Treas. Reg. §1.401(a)(9)-9, A-2, and is reproduced at the end of this outline. This table, which has been in effect since 2001, replaces the much more complicated rules that required participants to decide whether to recalculate life expectancies or not, and under which the identify of the participant's beneficiary affected his MRDs. The Uniform Lifetime Table is actually the joint and survivor life expectancy of a participant and a person 10 years younger than the participant. This allows benefits to be paid over a period that is at least as long as the period determined under the old regulations. If the participant is married to a person more than 10 years younger the actual joint life expectancy can be used in lieu of the uniform table, provided the participant names the spouse as the sole beneficiary. Treas. Reg. §1.401(a)(9)-5, A-4(b).

b. The MRD determined for each qualified plan must be paid from that plan. Treas. Reg. §1.401(a)(9)-8, A-1. If a participant has more than one IRA, the MRDs for his IRAs are calculated as if they were one plan, so that the MRD can be taken out of any one or more of them. Treas. Reg. §1.408-8, A-9. However, "inherited" IRAs cannot be aggregated with "owner" IRAs established by the participant.

3. Penalty for Not Distributing MRD Amounts. Any amount required to be distributed under the MRD rules that is not actually distributed is subject to a 50% excise tax. §4974. The IRS will normally waive the 50% excise tax, if the employee can show that reasonable error caused the failure to take the minimum required distribution and that steps have been taken to correct the situation. Code §4974(d); Treas. Reg. §54.4974-2, A-7(a). To apply for the waiver, the employee should file Form 5329 and attach a letter of explanation.

G. Terminology.

1. The term "**participant**" will be used to refer to both (a) a participant in a plan, and (b) the person in whose name an IRA is held.

2. The term "**non-participant spouse**" or "**NPS**" will be used to refer to the participant's spouse.

3. It will be assumed that the participant is male and the NPS is female.

II. APPLYING COMMUNITY PROPERTY PRINCIPLES TO EMPLOYEE BENEFIT PLANS

A. General Rule.

1. It is now fairly well settled that, as a matter of state law, community property principles apply to accumulations during the marriage in qualified plans, IRAs, and other employee benefit plans. T.L. James & Co. v. Montgomery, 332 So. 2d 834 (La. Sup. Ct. 1975). There are some difficulties, however, in determining how much of a benefit is community property when the community was not in place during the entire time the benefit was earned.

2. Rights under U.S. government plans may vary from these rules because the property rights derive from federal statutes that limit the application of community property principles. See, 10 U.S.C. §1408(c)(1) (military pensions); 5 U.S.C. §8345(j) (civil service pensions); Mansell v. Mansell, 109 S.Ct. 2023, (1989).

3. There is nothing in the Code or ERISA that prevents application of community property principles to accumulations in qualified plans or IRAs.

   a. As will be seen there is an important exception in the case of the death of the non-employed spouse.

   b. The statement in Code Section 408(g) (governing IRAs) that "This section shall be applied without regard to any community property laws", means only that the earnings of the accountholder will be counted 100% in determining the limits on his IRA contributions. See, e.g., PLR 9630034.

B. Defined-Contribution Plans.

1. Generally, the community share of an account balance is based on the contributions made during the marriage and the earnings on those contributions.

2. In the seminal case of *T.L. James v. Montgomery,* 332 So.2d 849 (1976), the Louisiana Supreme Court held that the contributions made to the plan during the community, divided by the total contributions made to the fund, is the community's share of the account balance.

3. *James* gives too much weight to the earlier contributions and too little to the later. In most defined-contribution plans, it is possible to determine how much of the earnings are attributable to contributions made during the community, and that will give a more precise picture of the community account balances. *See, e.g., Camp v. Camp,* 580 So.2d 553 (La. App. 1st Cir. 1991).

C. Defined-Benefit Plans.

1. Generally the community share of the defined-benefit plan is determined by the *Sims* formula, named for the lead Louisiana Supreme Court decision in *Sims v. Sims*, 358 So.2d 919 (La. 1978). The Supreme Court stated that generally the NPS is entitled to half of the portion of the benefit that is attributable to years while married that are taken into account by the plan in computing the benefit. The *Sims* formula looks like this:

$$\text{NPS's benefit} = \frac{\text{portion of pension attributable to creditable service during the existence of the community}}{\text{Pension attributable to total credited service}} \times 1/2 \times \text{annuity (or lump sum payment)}$$

Example. Plan pays a pension equal to 1-1/2% x years of credited service x average pay over the highest 5 years of pay. Participant has 30 years of credited service, 20 of which occurred while married. His average pay is $50,000. His total benefit is $22,500 a year (1-1/2% x 30 x 50,000). The NPS receives half of 2/3rds of the benefit, or $7,500 a year.

2. *Sims* was substantially modified by *Hare v. Hodgins*, 586 So.2d 118 (La. 1991), where the Louisiana Supreme Court held that:

   a. The court may find a present value of a pension that will be determined and paid in the future. The participant can be credited with that present value and the NPS receive other assets in a community partition.

   b. But a fixed percentage of a future benefit is to be preferred if the benefit is hard to value, or the present value method would be inequitable. *See, e.g., Blanchard v. Blanchard*, 731 So.2d 175 (La. S.Ct. 1999).

   c. When the determination of the community portion is made years after the divorce, the *Sims* formula may be inappropriate if "a substantial post-community increase is due to personal effort or achievement after the termination of the community." The Court made it clear that mere longevity raises do not require modifying the *Sims* formula.

D. <u>Special Louisiana Considerations</u>.

1. Keep in mind that there is a presumption that all property owned by either spouse at death is community property, and that all income from a spouse's separate property falls into this community, unless the spouse has recorded a unilateral declaration to keep the income separate. La. Civil Code arts. 2339, 2340.

2. A marriage contract can change the rules that the law otherwise applies. If the contract is made during marriage and repudiates the community-property regime, it must be approved by a judge. La. Civil Code art. 2329.

3. Often property has both community and separate features. An agreement between the spouses as to what is separate and what is community is often helpful, especially if supplemented by declarations to keep separate the income from the declared separate property.

4. *T.L. James* and progeny ignore the possibility that a benefit earned during a period prior to the marriage may have a community element because of the reinvestment of income. Compare *Reynolds v. Reynolds*, 388 So.2d 1135 (La. S.Ct. 1980), where income paid on assets in a separate property trust was ruled to be community property if distributed but to remain separate (even in the absence of a declaration of separateness) until distributed. Does this extend to an IRA, held in a custodial account?

5. The fact that a person is not vested in the plan benefit at the time of the termination of the community is irrelevant. If there is subsequent vesting, the NPS's portion shares in its vested percentage. *See, e.g., Breaux v. Breaux*, 553 So.2d 1001 (La. App. 3rd Cir. 1990).

III. WHAT HAPPENS TO A COMMUNITY PROPERTY INTEREST UPON DIVORCE?

A. Qualified Plans.

1. In the Retirement Equity Act of 1984 ("**REA**") Congress created the qualified domestic relations order ("**QDRO**") as the exclusive means for enforcing the non-employed spouse's community property interest in a qualified plan. Code Section 414(p), ERISA Section 206(d)(3).

2. When a court order meets the requirements for a QDRO, the plan must pay a portion of the participant's benefit to the "alternate payee" (almost always the former spouse of the participant but could also be the participant's dependents). Code Section 414(p) and ERISA Section 206(d)(3). The consequences of a QDRO are as follows:

   a. Payments to the spouse or former spouse can be rolled over to the recipient's own IRA, thereby deferring the tax. Code Section 402(e)(1)(B).

   b. QDRO payments are not subject to the 10% tax on premature distributions. Code Section 72(t)(2)(C).

3. An alternate payee's rights may not be heritable. Such a rule can be inferred from Code Sections 414(p)(8) (defining "alternate payee") and 402(e)(1)(A) (tax treatment of alternate payee). Therefore, acceleration of the payment of the benefit to the alternate payee is desirable. Also *Boggs* says qualified plans are for the benefit of participant and spouse, not spouse's successors. But see *Eller v. Bolton* Md. Ct. Spec. App. 2006, reported at BNA Pension & Benefits Reporter, Vol. 33, No. 17 (April 25, 2006), holding that once an interest in a plan has been assigned to a former spouse as alternate payee it can be inherited.

4. Most QDROs are reached by agreement as part of the division of the community. If a partition fails to mention the plan, and if NPS waives all

rights, NPS can later apply to partition the pension. *See, e.g., Jennings v. Turner,* 803 So.2d 963 (La. S.Ct. 2001).

5. Some courts allow a QDRO to be issued after the Participant's death. *See, e.g., Marker v. Northrop Grumman Space & Missions Systems Corp. Salaried Pension Plan,* N.D. Ill., No. 4C-7933 (10/4/06).

B. IRAs. The rules for QDROs do not apply to IRAs. However, any amount paid from an IRA to a former spouse in connection with a divorce can be rolled over to the former spouse's IRA, thereby deferring income tax. Code Section 408(d)(6).

C. Non-Qualified Plans. There is no requirement in law that a non-qualified plan pay a community property interest to a former spouse upon divorce. Payment prior to the scheduled payment date could cause income-tax problems under Code Section 409A. Furthermore, the payment is likely to be taxed to the employee, even if paid over to the former spouse. ERISA §206(d)(3) (providing for QDROs) does not apply to top-hat plans.

IV. DISPOSITION OF THE NON-PARTICIPANT'S COMMUNITY INTEREST AT DEATH OF ONE OF THE SPOUSES.

A. How to Dispose of an Interest in a Qualified Plan or IRA

1. Participant's Death. The participant executes a beneficiary designation on a form provided by the plan administrator or IRA custodian. (In the absence of an effective designation the Plan may have a default rule, otherwise the benefit passes to the participant's estate.) If the plan is held as community property, when the participant dies first the beneficiary designation disposes of both halves of the community property, subject to a possible reimbursement claim by the NPS if not the designated beneficiary.

2. Spouse's Death. It is also well established that if the non-participant spouse dies owning a community property interest in a plan, to the extent that she can dispose of it at all her interest passes to her heirs as part of her probate estate, not by beneficiary designation. (The term "heirs" will refer hereafter to both intestate heirs and testate legatees.) But see discussion of *Boggs* case, next page.

B. What Happens to the Non-Participant Spouse's Interest in a *Qualified Plan* When the Non-Participant Spouse Dies First?

1. The Situation: The non-participant spouse dies first with an interest, as spouse in community, in the participant's qualified plan. This interest passes, as part of the spouse's probate estate. It often happens that the participant spouse is not NPS's sole heir of the interest, either because the NPS's Will says so, or because the laws of intestacy so provide.

2. ERISA Section 514 says that ERISA supersedes any state law that relates to an employee benefit plan that is governed by ERISA. (Almost all qualified plans are subject to ERISA.) ERISA 206(d) and Code Section 401(a)(13) both say that a participant's interest in a plan cannot be assigned or seized.

3. Although community property laws are not generally preempted (as illustrated by the QDRO rules), the United States Supreme Court, in *Boggs v. Boggs*, 117 S. Ct. 1754 (1997), held that ERISA preempts any state law that would cause a participant's interest in a plan to be paid to someone (other than the participant) by reason of inheriting the interest from the NPS. Thus, any interest the NPS may have had, as spouse in community, in the qualified plan terminates at her death.

4. Instead of claiming against the qualified plan, can the NPS's heirs assert a reimbursement claim against the employee? <u>Boggs</u> says no.

5. The same result is generally true for U.S. government pensions

C. <u>What Happens to the Non-Participant Spouse's Interest in an *IRA* When the Non-Participant Spouse Dies First</u>?

1. There is a remarkable lack of authority on this point. Paying the heirs of the non-participant spouse directly from the IRA is not expressly prohibited. And Code Section 408(d)(1) indicates that the person who is the "payee or distributee" is taxed on the benefit.

2. There is one known private letter ruling, over 25 years old, PLR 8040101. In that ruling the IRS held that payments could be made out of a participant's IRA to the legatees of the participant's deceased spouse. The wording of that ruling implies that the participant cooperated.

3. See also *Estate of MacDonald*, 794 P.2d 911 (Cal. 1990), in which the NPS was determined not to have conveyed her community interest in IRAs to the participant when she consented to his designation of a trust as the beneficiary upon his death, so that her interest in the IRA passed to her children under her Will when she died before the participant.

4. But what about income tax? Natalie Choate, the expert on qualified plans and IRAs, is of the option that the participant is taxed, and that the normal result is that the participant takes out the money and turns it over to its NPS's heirs. *Life and Death Planning for Retirement Benefits*, 6th ed. (hereafter *Choate*), at ¶2.1.05. However, PLR 8040101 said the legatee owed the tax.

5. And what about MRDs? Presumably the MRDs are determined by the Participant's age as long as he lives, even if payments are made to NPS's

heirs. After Participant's death would the MRDs depend on the ages of the Participant's beneficiaries, even if different from the NPS's heirs?

6. Would the 10% tax on premature distributions apply if the participant is still under the age of 59½ when payments are made from the IRA to the NPS's heirs?

D. What Happens to the Non-Participant Spouse's Interest in a *Non-Qualified Plan* when the Non-Participant Spouse Dies First?

1. Many non-qualified plans do not provide for payment upon the death of the non-participant spouse. Her heirs will presumably have to wait until a payment event under the plan to receive the benefit.

2. Non-qualified plans are almost always exempt from ERISA QDRO rules. See ERISA § 201(2).

3. A non-qualified plan can provide for payment of the NPS's community interest at death, without triggering taxes and penalties under Code Section 409A. *See* Code Section 409A(e)(2)(A)(iii).

E. Non-Participant Spouse's Gift Tax When Participant Dies.

1. The NPS will be considered to have made a taxable gift if her community interest in a benefit passes at the participant's death to someone other than the NPS. Compare Reg. §25.2511-1(h)(9), taxing the non-insured spouse when the proceeds of a community-owned life insurance policy pass at the direction of the insured to someone other than his spouse. Former Code Section 2517 excluded the NPS's community property interest in a qualified plan from gift tax in that case, but Section 2517 was repealed by TRA 1986 §1852(e)(2).

2. When an NPS waives a right to be the participant's beneficiary, under Code Section 401(a)(11) or Section 417, the waiver does not in itself constitute a taxable gift. Code Section 2503(f). However, the NPS would still be deemed to make a taxable gift if she allows her community interest to pass to someone else. Section 2503(f) is concerned only with the right to be a payee, whereas former Section 2517 was concerned with community ownership.

3. The gift-tax problem is aggravated in situations where the participant does not have to get the consent of the NPS, *e.g.*, if an IRA is involved, or after a divorce when the spouses have not produced a QDRO or otherwise disposed of the NPS's interest in a qualified plan.

4. A reimbursement claim, if available and exercised, could prevent the adverse gift tax result.

F. Estate Tax At Non-Participant Spouse's Death

1. Qualified Plans. Former Code Section 2039(d) (relettered Section 2039(c) in 1984) excluded from U.S. estate tax the non-participant spouse's community-property interest in a qualified plan when the non-participant spouse died first. This exclusion was repealed by TRA 1986 Section 1852(e)(1). However, because under Boggs, the non-participant spouse's interest in the qualified plan passes to the surviving participant by law, it will qualify for the marital deduction, so that there will be no estate tax at NPS's death.

2. IRAs. The non-participant spouse's community interest passes as part of the probate estate and the taxable estate. See VII.A below at page 26 for discussion of what the NPS's Will should say.

V. DISPOSITION AT PARTICIPANT'S DEATH.

A. Spousal Consent Rules.

1. In the case of a qualified plan the non-participant spouse normally has to consent if the participant wants to name someone else as a death beneficiary. Code Sections 401(a)(11)(B)(iii)(I), 417(a)(2). One important exception: In an annuity-based plan the surviving spouse is only entitled by law to the portion of the benefit that would fund the survivor portion of a joint and survivor annuity. Code Sections 401(a)(11)(A)(ii), 417(c).

2. Spousal consent is not required to name someone other than the surviving spouse as beneficiary of an IRA (although many custodians require consent anyway).

3. If a participant in a qualified plan is contemplating marriage and does not want to name the new spouse as his death beneficiary, the options are limited.

a. The IRS has interpreted the Code as allowing the spouse to sign a valid consent only **after** the marriage, which may not make the client completely comfortable. Code Section 417(a)(6); Treas. Reg. §1.401(a)-20, A-33.

b. The spouses may sign a prenuptial agreement requiring the non-participant spouse to sign a consent. If the spouse does not actually sign the consent, however, the agreement does not affect the spouse's right to receive the death benefit from the plan, but it might give rise to a claim by the participant's estate against the spouse. *See, e.g., Callahan v. Hutsell, Callahan & Buchino P.S.C. Revised Profit-Sharing Plan,* 1993 U.S. App. Lexis 34005 (6th Cir. 1993); *Greenbaum, Dell & McDonald v. Sandler,* W.D. Ky., No.

3:05 CV-754-H, October 24, 2006. Consider ensuring compliance by making other benefits conditioned on signing the consent.

c. As an alternative, consider rolling the benefit out of the plan and into an IRA, if that option is available. Such a rollover does not require spousal consent, unless it is an annuity-based plan. The participant can name any beneficiary of the IRA without spousal consent. Caveat: Some IRA custodians do require spousal consent, even though not required by law.

B. Maintaining Tax Deferral After Death. From an income tax perspective, normally the best estate plan for qualified plans and IRAs is one that allows continued deferral of receipt of the corpus of the account, and thus continued deferral of the income tax that eventually has to be paid on those amounts.

1. A surviving spouse as beneficiary of a qualified plan or IRA can be assured of continued deferral through a rollover. The NPS can roll over the benefit to her own IRA and she becomes the participant as to that IRA. The MRDs, therefore, are determined by the Uniform Lifetime Table (see Exhibit A), with the division redetermined annually. Thus at age 71 the MRD is the account balance divided by 26.5; at age 81, the MRD is the account balance divided by 17.9.

2. Prior to 2007, a non-spouse beneficiary could not make a rollover to defer the income tax. The ability of the beneficiary to defer the tax depended on whether the plan allowed payout over many years. Many plans do not. Thanks to Section 822 of the Pension Protection Act of 2006, effective for distributions made on or after January 1, 2007, a non-spouse death beneficiary of a benefit from a qualified plan can roll over the benefit to his or her own IRA. See Code § 402(c)(11). The IRA, however, remains a death benefit IRA, so MRD's are determined by the age of the beneficiary in the year following the year of the participant's death, under the Single Life Table (See Exhibit B), discussed below at page 17. For example, if the beneficiary is age 71 in the year after death, the MRD is the account balance divided by 16.3; and ten years later the MRD is the account balance divided by 6.3.

3. IRAs. If the benefit is being paid from an IRA, normally the beneficiary has complete control over the time of payment of the benefit. Thus the maximum deferral permitted by law should be available for an IRA. Furthermore, if the beneficiary is not happy with the way the IRA sponsor is managing the account, the beneficiary can make an IRA-to-IRA transfer and change the custodian, without accelerating the tax.

4. What if the trust terminates (or the estate is the beneficiary and the administration ends)? Plan or IRA custodians should recognize the new owner without change of MRD rules. For example, if a trust for the

benefit of Jane Doe is the beneficiary of John Doe's IRA, and the trust terminates before all payments are made from the IRA, the IRA would undergo two changes: (1) at John Doe's death it converts from being simply in John Doe's name to being in the name of John Doe, deceased, IRA fbo John Doe Trust; and at the termination of the trust the name changes to John Doe, deceased, IRA fbo Jane Doe. See, e.g., PLR 200234019.

5. Estate Tax Apportionment. Long deferral is frustrated if estate tax has to be paid out of the benefit itself.

   a. If the benefit triggers an estate tax, the estate tax is normally apportioned to the benefit. La. R.S. 9:2432.

   b. Consider requiring in the Will that the estate tax be paid out of other assets.

   c. Using Life Insurance. A participant might fund the estate tax on the benefit by making annual gifts to children, or to an irrevocable trust for children, which amounts the participant's children or the trustee can use to pay premiums for a policy of insurance on the participant's life that will provide estate tax liquidity.

C. Special IRD Rules.

1. Benefits due under qualified plans, IRAs and non-qualified plans do not get a new tax basis at death. They are "**income in respect of a decedent**" ("**IRD**") under Code Section 691, and as such are includible in taxable income when received by a beneficiary to the same extent as they would have been taxable if received by the employee. (As a reminder, we are not discussing Roth IRAs or Roth accounts.)

2. A death benefit, therefore, may be subject to both estate and income taxes. To reduce the tax burden, a deduction is allowed on the income-tax return for any estate tax paid on the benefit. Code Section 691(c).

3. The combination of a 46% estate tax and 40% federal and state income tax, even after taking into account the 691(c) deduction, could result in a tax grab of over 65% of the benefit.

4. An executor's election to fund a pecuniary legacy with IRD may trigger full recognition of the IRD and the estate's taxable income. Code Section 691(a)(2); Reg. §1.661(a)-2(f)(1). Thus, retirement benefits generally should never be used to fund a legacy that is expressed as an amount (but a stated allocation in the Will is ok). For example, an executor should not elect to fund with qualified plan benefits or IRAs a legacy to a QTIP trust of "the smallest amount necessary to reduce the estate tax to zero." See discussion at Choate, ¶6.4.08.

D. How Quickly Must the Death Benefit Be Paid? The MRD rules (and the 50% excise tax on undistributed minimum amounts) apply after death, too. The following is a summary of these rules:

1. The "normal rule", if a participant dies *before* his "RBD" (defined on page 6), is that the death benefit from a qualified plan or IRA has to be completely paid out by the end of the 5th year after the participant's death. Code Section 401(a)(9)(B)(ii). The benefit can be paid at any time or times during that period of years.

2. The new "normal rule", if a participant dies *after* his RBD, is that the death benefit has to be paid out annually over the life expectancy of a person who is the age reached by the participant in the year of his death. Reg. §1.401(a)(9)-5, A-5(a)(2). (The 5-year rule does not apply.) Life expectancy is determined under the "**Single Life Table**", set out at Treas. Reg. §1.401(a)(9)-9, A-1, and reproduced at the end of this outline.

3. But if there is a "**designated beneficiary**", the benefit can be instead taken out in annual installments over a period as long as the beneficiary's life expectancy, based on the beneficiary's age attained in the year following the year of death. Code Section 401(a)(9)(B)(iii). Treas. Reg. §1.401(a)(9)-5, A-5(c). If the beneficiary is the spouse, life expectancy is redetermined each year. In all other cases, life expectancy is determined once, and in each subsequent year is reduced by one. Life expectancy is determined under the Single Life Table.

4. When payout is made over a life expectancy, the first payment must be made by the end of the year following the year of death. For additional options available when the surviving spouse is the beneficiary, see VI.A, below, page 20.

5. Note that if a participant dies after his RBD, and has not received the minimum required distribution for the year of death, that amount must be distributed by the end of that year. Treas. Reg. §1.401(a)(9)-5, A-4(a).

6. A "designated beneficiary" must be an individual. If any beneficiary is the owner's estate or a charity the regulations state that there is no designated beneficiary, and the rules set out in paragraphs 1 and 2, above, apply. Code Section 401(a)(9)(E); Treas. Reg. §1.401(a)(9)-4, A-1, A-3. If a Participant intended to designate an individual but the custodian failed to give effect to that intent, and a court order corrects the mistake, the individual will be a designated beneficiary. PLR 200616039.

7. The MRDs are computed separately for each account entitled to a share of the benefit. Separate accounts can be established after the participant's death, as late as the end of the year following the year of death, in order

for the MRDs to be computed separately for each account. Each separate account must be a percentage of the initial benefit, not a fixed dollar amount. Treas. Reg. §1.401(a)(9)-5, A-7; §1.401(a)(9)-8, A-2, A-3. Separate accounts are best evidenced by transferring to separate IRAs, or establishing separate named accounts in a qualified plan.

8. If established after death, the separate accounts are effective only for years *after* the year in which the accounts are established. Thus, the MRD for the first year after death may be determined differently from the MRDs for subsequent years.

9. If there is more than one individual beneficiary of the benefit (or of the separate account) the oldest beneficiary within that group is the "designated beneficiary" whose age determines the MRDs for the account.

10. The determination of whether there is a "designated beneficiary" is made as of September 30 of the year following the year of your death. If the designation includes one or more individuals plus a disqualifying entity, the entity's share should be distributed before that September 30 in order to allow the individuals' MRDs to determined based on a life expectancy. Note: according to the IRS, if the participant's estate is the beneficiary, placing his heirs or legatees into possession of the IRA by the September 30 date does *not* make them designated beneficiaries. Treas. Regs. §1.401(a)(9)-4, A-3; PLR 2001-26041.

11. Example. Participant dies in year 1, at the age of 75. His IRA designates as beneficiary 20% to each of three nieces who are 45, 40 and 35 years old, 20% to Tulane, and 20% to participant's estate (perhaps because of the predecease of a nephew). Before September 30 of year 2 (the year following the year of death), Tulane receives its 20%. Also in year 2, the participant's estate's share is put into an account separate from the account holding the nieces' share. In year 3 the three nieces each establish separate accounts. The following results apply:

    a. Since Participant had reached his RBD, his MRD for year 1 - if not distributed before death - must be distributed, to his beneficiaries, 20% to each.

    b. In determining the MRD for years 2 and thereafter, Tulane is ignored, because its share was fully distributed by September 30 of year 2.

    c. The MRD for the separate account holding the estate's share is based on the life expectancy of someone who reached age 75 in year 1. That life expectancy is 13.4. In year two the divisor is 12.4, which is 1 less than 13.4. In year 3, the divisor is 11.4 (13.4 minus 2), in year 4 is 10.4, etc.

d. For the separate account holding the nieces' shares, the MRD for year 2 is determined in the same way as for the estate, *i.e.*, using the divisor 12.4, since their separate accounts were not established until year 2. However, the MRD in year 3 is based on the age of the oldest niece, who has her 46th birthday in year 2. The life expectancy of a 46-year old is 37.9 years. Thus in year 3 the MRD is determined by dividing the nieces' account balance at the end of year 2 by 36.9 (37.9 minus 1). In year 4 the divisor is 35.9, etc. The divisor thus determined applies to each niece's account because their separate accounts were not established by the end of year 2.

E. Paying Death Benefits to a Trust.

1. Qualified plan or IRA death benefits can be made payable to a trust. The trust can be one set up during life or at death.

2. Income-Tax Considerations. Since distributions from traditional IRAs and from qualified plans are normally subject to ordinary income tax in their entirety, tax consequences to the recipient should be kept in mind. Trusts are taxed under a much more accelerated table than the table that applies to individuals. In 2006, the highest U. S. income tax rate (35%) is reached (by married individuals filing a joint return) when their taxable income reaches $326,450; that rate is reached for a trust when its taxable income (after deduction of the amounts paid to the beneficiaries) reaches just $9,750.

3. Deciding Whether to Accumulate Benefits in the Trust:

a. A "**conduit trust**" passes out all the income to the beneficiary. In that event there is no tax to the trust. Conduit trusts of IRAs may be desirable when the trust is for one individual, as a temporary vehicle while that person is too young to manage the IRA himself.

b. An "**accumulation trust**" will retain at least part of each distribution from the plan or IRA. If the trustee is given discretion on how much to distribute the decision should be influenced in part by the income tax consequences of distributing versus retaining.

4. If a trust receives the benefit, the following rules affect the determination of the MRDs:

a. Normally the "designated beneficiary" is the oldest individual who has a current interest in the trust. That includes both the current income beneficiaries and (if the trust is an accumulation trust) the current principal beneficiaries. Reg. Section 1.401(a)(9)-5, A-7.

b. This rule applies even if there are separate shares within the trust. Reg. Section 1.401(a)(9)-4, A-5(c); PLR 9809059. Thus, in order to determine life expectancies separately for different individual beneficiaries, each beneficiary's interest should be held in a separate trust.

c. If there is a beneficiary of the trust that would prevent its having a designated beneficiary (*e.g.*, a charity), the "normal rule" can still be avoided if the trust can be terminated as to that beneficiary by September 30 of the year following the year of death.

d. In order for a beneficiary of a trust to be a "designated beneficiary" and avoid the "normal rule", the trust must also meet the following criteria under Reg. Section 1.401(a)(9)-4, A-5(b):

   i. the trust must be valid under state law;

   ii. the beneficiaries must be identifiable under Treas. Reg. §1.401(a)(9)-4, A-1; and

   iii. by October 31 of the year following the year of death, the trustee must either (1) deliver to the plan administrator a list of all beneficiaries of the trust as of the just-completed September 30, certify that the list is correct, and certify that the trust is valid under state law, and that the trust became irrevocable no later than the employee's death, and offer to provide a copy of the trust, or (2) deliver a copy of the trust instrument. Trustees holding inherited IRAs must give this notice to the IRA custodian. Treas. Reg. §408-8, A-1(b).

e. Many commentators question whether there is a "designated beneficiary" if the IRA could pass to the estate of a beneficiary; therefore, they contend that every trust should operate as a conduit trust. Although passing through all payments to a beneficiary may be desirable to avoid a trust's high income-tax rates, it is not necessary to have a conduit trust to have a "designated beneficiary" for RMD purposes. See Reg. §1.401(a)(9)-5, Q&A 7(c). Although no IRS statements clearly support that proposition (PLR 200537049 comes close to saying it), none have denied it. See also PLR 200620025.

VI. WHO SHOULD BE THE DESIGNATED BENEFICIARY?

A. <u>The Spouse Outright</u>? Naming the non-participant spouse (NPS) as the outright beneficiary makes good sense in many cases:

1. The NPS is the only death beneficiary who can roll over the benefit to his or her own IRA, or to an account in a qualified plan. Code Section 402(c)(9).

   a. Benefits to rollover: By converting the account into his or her own, the NPS gets to determine the MRDs based on the Uniform Lifetime Table, not the Single Life Table. Also, the NPS gets to defer taxable receipt of the benefit until his or her own RBD.

   b. Drawback to rollover: If under 59½, the NPS cannot make withdrawals prior to age 59½ without paying the 10% penalty; if instead the funds remain in the participant's name, an under-59½ NPS can take distributions without incurring a penalty.

   c. A rollover can be made by the NPS even if the NPS has passed her own RBD.

   d. The IRS has been extraordinarily generous in allowing rollovers by surviving spouses even when they are not named as the beneficiary. If a trust or the estate is named as the beneficiary and the trustee is required to deliver the benefit to the NPS, or the NPS is able, through the exercise of powers vested in her as executrix and/or trustee, to require the benefit to be paid out to her in full ownership, she can make a rollover. See, e.g., PLRs 2003-04038, 2001-29036, 9515042, 9502042. It should even be possible in those circumstances to have a direct transfer made from the plan to the rollover IRA to avoid withholding tax. See, e.g., PLR 9509028.

   e. If under 59½, the NPS might want to elect to roll over *most* of the benefit, retaining in the existing IRA only those funds that the NPS expects to withdraw prior to age 59½.

   f. Or the NPS could keep the inherited IRA until age 59-1/2 and then make a rollover.

   g. Instead of rolling over an IRA to the surviving spouse's own IRA, she can elect to treat the existing IRA as her own, by directing the custodian to change it into her name. The result is the same as a rollover.

2. The NPS is the only beneficiary who can, if she does not make a rollover, elect to defer commencement of the benefit until the participant would have reached age 70½. Code Section 401(a)(9)(B)(iv). Thus, not rolling over may be beneficial when the participant was younger than the NPS.

3. The NPS can elect to transfer the participant's interest in a qualified plan to the participant's IRA and not elect to treat the IRA as the spouse's own. See, e.g., PLR 9608042.

4. Payment outright to the non-participant spouse is the easiest way to qualify for the marital deduction.

5. In the case of a qualified plan, the participant avoids having to get the NPS's consent to the designation of another beneficiary.

6. If the benefit is community property, a designation of the NPS as beneficiary avoids the possibility of the NPS being deemed to have made a taxable gift. See V.E, above, page 13.

7. In many defined-benefit plans, the *only* death benefit is an annuity for the life of the surviving spouse. In that case no planning is possible. Many of the planning tactics discussed in this outline do not apply to defined-benefit plans.

B. <u>...Or Trust for Spouse</u>? Perhaps client wants his spouse to be only the income beneficiary, to assure that the benefit is wisely invested, or to make sure that something is left for his children or other persons after the death of the NPS.

1. How to Qualify for the Marital Deduction.

a. If the NPS is the sole beneficiary of the trust, the trust should qualify for the marital deduction regardless of the trust's provisions on distributions to the NPS. Reg. §20.2056(c)-2(b), Example (1)(i).

b. Difficulties arise when the desired beneficiary is a trust of which the NPS is only the income beneficiary. The marital deduction is generally available only if the requirements for qualified terminable interest property ("**QTIP**"), under Code Section 2056(b)(7), are met. How is the "all the income" requirement of Section 2056(b)(7)(B)(ii)(I) to be met?

i. A lump sum payment of the entire benefit to the trust would allow it to qualify, since the income would be determinable at the trust level, but such a payment would accelerate the income tax.

ii. An installment payment also qualifies, provided that the IRA or plan distributes to the trust each year at least the greater of (i) the account's income under general trust accounting principles or (ii) the minimum distribution required under Code Section 401(a)(9), and the trust distributes to the spouse the income portion of what the trust receives. See Rev. Rul. 2006-26. The trust should also have the usual language allowing the spouse to compel investment in productive assets, in case the account is invested in assets unproductive of income.

iii. Thus, when payments are made periodically from a qualified plan or IRA, it is necessary to identify trust accounting income. This is usually not a problem but could be a problem with a qualified plan if the periodic statements show only total investment return and do not distinguish between trust accounting income and capital gains and losses.

c. It may be possible to qualify for the marital deduction under Code Section 2056(b)(5), by giving the spouse as income beneficiary an unlimited power to compel the trustee to withdraw any or all of the plan or IRA assets and to distribute them to her. See Reg. Section 20.2056(b)-5(f)(8), Rev. Rul. 2000-2. Such a power is authorized by La. R.S. 9:2068A. This method avoids having to distinguish between income and principal.

2. Provision for a trust is more likely to be desired when the trust is *not* expected to be elected for QTIP. It may be that the participant's unified credit against U. S. estate tax cannot be fully used without leaving the participant's interest in the qualified plan or IRA in a way that does not qualify for the marital deduction.

3. If the benefit is community property, NPS's community share should not be placed in a trust of which she is not the sole beneficiary. She will be deemed to have made a taxable gift of the interest passing to others.

4. Keep in mind, too, that in the case of a qualified plan (and some IRAs), NPS's consent is required if she is not named as the sole primary beneficiary.

5. And keep in mind that benefits paid to a trust and not distributed may be subject to income tax at high rates.

C. <u>...Or Spouse as Usufructuary</u>? This can have benefits similar to a trust.

1. The surviving spouse receives benefits while rights are protected for children or other naked owners.

2. A usufruct for life can be elected for the marital deduction just like an income interest in trust.

3. The taxable income is likely to be reportable entirely on the NPS's income tax return, which may result in a lower tax than if the income is taxed to a trust.

4. Can the usufruct be of non-consumables? This could allow increases in value (when the usufruct is not elected for the marital deduction) to be excluded from the NPS's taxable estate, but the accounting problems could be enormous. See VII.A.4, below, page 27.

5. How about a usufruct of consumables? As usufructuary of a consumable the surviving spouse is full owner of the benefit with only an obligation to deliver an amount equal to the starting value of the account to the naked owners on termination of the usufruct. This is a simpler type of usufruct. However, this approach does give up the possibility of protecting appreciation in value from estate tax.

6. Can an IRA or plan benefit payable to the non-participant spouse as usufructuary of a consumable be rolled over to the NPS's own IRA? This should be allowed since under Louisiana law the NPS is the owner of the benefit, but we have no authority one way or the other.

D. <u>...Or as Spouse Decides</u>? It may be that the participant's exemption from estate tax will not be fully used unless some of the qualified plan or IRA benefits go other than to the NPS. But you can't be sure until death how much of those benefits (if any) will be needed.

1. One solution is to name the NPS as the primary beneficiary, and name as the contingent beneficiary, in case of the NPS's predecease or disclaimer, either (a) a trust of which the NPS is income beneficiary, or (b) a usufruct. If the NPS survives, the NPS decides which way the benefit will go, for the best possible tax result.

2. IRS has recognized that disclaimers qualified under Code Section 2518 for gift and estate tax purposes are also effective to avoid any adverse income tax consequence. GCM 39858, September 9, 1991.

3. Furthermore, a disclaimer can be qualified even after the disclaimant withdraws a portion of the benefit. Rev. Rul. 2005-36, 2005-26 IRB 1368. This is especially helpful if an MRD has to be taken before the disclaimer decision is made.

E. <u>...Or Charity</u>?

1. If participant intends to leave a portion of his estate to a charity, designating the charity as the beneficiary of some or all of the interest in the qualified plan or IRA has an extra tax kicker. The charity (even a private foundation) does not have to pay income tax upon receipt of the

benefits. See, e.g., PLR 9341008. Leaving the plan benefit to the charity and other assets to other legatees maximizes the amount all parties receive.

2. Be careful of naming a charity as a co-beneficiary with one or more individuals – a charity is not a "designated beneficiary" and a failure to carve out and/or pay out a charity's share by September 30 of the year following the year of the participant's death can risk losing deferral benefits for non-charitable beneficiaries. Treas. Reg. §1.401(a)(9)-4, A-3, A-4(a); §1.401(a)(9)-8, A-2, A-3. See V.D., above, page 17.

F. <u>...Or Descendants, Outright or in Trust</u>? An unmarried participant, or one who plans to provide for his spouse in other ways (and is able to get consent, if needed), may wish to name children or grandchildren as beneficiaries. The following are some considerations in naming descendants as beneficiaries.

1. An IRA may be a wonderful way to provide a lifetime benefit for a grandchild or other very young person. A 5-year old child, for example, has a life expectancy under the Single Life Table of 77.7 years. He can enjoy tax-deferred earnings in the IRA until well into his own retirement! The distributions that he has to take each year begin at less than 2% of the IRA account balance, and don't reach even 6% until he is 67 years old. Thus, enormous growth is possible.

2. Especially when the descendant is young, a trust may be desirable as the recipient of the benefit. The trust could serve as a conduit trust, paying out the small MRDs for educational or other purposes. As the child matures the trust could terminate.

3. If the trust is not a conduit trust, the income tax rate on the undistributed receipts could be a substantial negative. See V.E.2, above, page 19.

4. The transfer will not qualify for the marital deduction, and could be a generation-skipping transfer. It would be wise to plan so that neither an estate tax nor a generation-skipping transfer tax has to be paid. If possible, arrange to allocate the GST exemption to the transfer if is a generation-skipping transfer. And arrange for any estate tax to be paid from other sources, such as life insurance.

5. The trust must meet the requirements of Treas. Reg. §1.401(a)(9)-4, A5(b); see V.E.4.d, above, page 20.

6. Forced Heirship Considerations. Although the IRA or qualified plan is not included in determining the amount of the forced portion, amounts payable to the child or in trust for the child are credited against the forced portion. La. Civil Code article 1505D. If an IRA or qualified plan is used to satisfy the forced portion, the participant is free to leave his probate assets to the surviving spouse. And in the usual case the surviving spouse

can still benefit from the plan or IRA by receiving a usufruct over the forced portion or an income interest in a trust of the forced portion.

7. Many beneficiary designation forms require a listing of the descendants by name, or provide that if any child dies the deceased child's share passes to the other named beneficiaries rather than to the descendants of the predeceased child. With some perseverance, the participant should be able to dictate otherwise. As always when an IRA is involved, consider transferring to a different custodian if the current custodian refuses to cooperate with the employee's wishes, assuming that the wishes are valid under law.

G. ...Or Charitable Remainder Unitrust? A charitable remainder unitrust ("CRUT") pays to one or more individual annuitants each year a designated percentage of the value of the assets at the beginning of the year, and complies with the requirements of Code Section 664.

1. Like payments directly to a charity, payments to a CRUT are protected from income tax. See, e.g., PLR 9237020.

2. Naming a CRUT as beneficiary under a qualified plan or IRA could be useful in at least two circumstances:

   a. When your client plans to establish a CRUT anyway, e.g., to pay an annuity for the life of an aged relative; or

   b. When your client's aim is to allow a child to receive a lifetime benefit from a qualified plan but the plan does not allow long payouts. Since no income tax is due when the CRUT receives the plan benefit, this arrangement may allow the child, as life annuitant, to receive greater life-time benefits than if he were the outright beneficiary. This motive is less important than it was, thanks to the ability starting in 2007 of a non-spouse beneficiary to make a rollover. *See* V.B.2, above, page 15.

3. The estate-tax charitable deduction is not likely to be a significant reason for using this technique. For example, if the child is age 45 at the parent's death, and the unitrust rate is 7%, the charitable deduction is less than 14%.

VII. ESTATE PLANNING WHEN THE BENEFIT IS COMMUNITY PROPERTY.

A. Non-Participant Spouse's Will.

1. Each NPS's Will usually should leave his or her entire community interest in the participant's IRAs and non-qualified plans to the participant spouse. (*Boggs* actually mandates this result as to qualified plans.) Only if the

marital deduction is not wanted (for example, if the unified credit can not otherwise be used), should other dispositions be made.

2. Consider planning for disclaimer: leave the community interest in the IRA or plan outright to the participant spouse, and if he disclaims (in order to use up the NPS's unified credit, or otherwise) leave him a usufruct or an income interest in trust.

3. It is better to leave the participant a usufruct than an income interest in trust. The participant spouse retains possession. If a trustee were to carry out his duty to gain possession of an IRA he would trigger income tax, and possibly the 10% tax on premature distributions. For the same reason, leaving the IRA interest outright to an individual other than the participant could create adverse income tax results.

4. It is probably wise to specifically provide that the participant's usufruct of the NPS's share of the IRA or plan is a usufruct of a consumable, in order to avoid complex accounting obligations that might apply if it were a usufruct of nonconsumables—

   a. How much of the account at any future time is income owned by the usufructuary and how much is principal ultimately belonging to the naked owners?

   b. How does the payment of income tax on a distribution affect the usufructuary's obligation to the naked owners?

   c. If assets are sold, does that convert the usufruct into a usufruct of consumables?

   When the account is handled as a usufruct of consumables, the usufructuary owes the naked owner an amount equal to the starting value of the account. No future events affect that obligation. Much simpler. But the price one pays is that any appreciation in value of the account is taxable in the participant's estate.

B. <u>Participant's Designation of Beneficiary</u>.

1. The Participant, unlike the NPS, has the authority to determine the beneficiary of both halves of the community benefit, and effects this by completing the plan's designation of beneficiary form. The participant's Will becomes important only if the designation of beneficiary refers to the Will.

2. The designation of the non-participant spouse as outright beneficiary, beneficial in the normal case anyway, has the further benefit of assuring that the NPS is not deemed to make a taxable gift of her community

interest, and is not obliged to make a reimbursement claim to avoid the gift tax result.

3. If leaving an income interest in the NPS may be beneficial for estate-tax reasons, the NPS can be given the option of receiving the full benefit outright or receiving only an income interest in the participant's share of the benefit, by making NPS the primary beneficiary, and a trust the contingent beneficiary.

4. If the designation of beneficiary disposes of 100% of the benefit, and the participant wants the NPS to receive only an income interest from his share, but full ownership of her share, how does he accomplish that?

    a. One way to do that would be to designate NPS as the beneficiary of her half, and to provide that the NPS receives an income interest (usufruct or trust income interest) in participant's half. Is such a partition of the community feasible? Two problems:

        i. There is no provision in Louisiana law for such a partition.

        ii. The plan administrator or custodian may not accept a beneficiary designation that requires determining how much of a benefit is community property.

    b. A workable alternative is the conduit trust: designate a trust under participant's will as the primary or contingent (in event of disclaimer) beneficiary, and have the trustee divide the proceeds as follows:

        i. The NPS receives only an income interest in the participant's share; and

        ii. The NPS receives in full ownership (or as sole trust beneficiary) any community interest owned by the NPS (as determined by the trustee, not the plan).

        iii. The NPS will be able to roll over to her own IRA the portion payable directly to her. If NPS is left the other half as usufructuary of a consumable, she may also be able to roll over that portion, since as usufructuary of a consumable she owns the asset, subject only to an obligation to pay the naked owners the initial value upon termination of the usufruct.

        iv. A partition by trust is permitted by La. R.S. 9:1955.

5. The conduit trust concept also works in tandem with disclaimer planning. NPS can be named as sole primary beneficiary, and the testamentary trust can be named as the contingent beneficiary.

Example: IRA is worth $2,000,000 and is 100% community property. NPS is primary beneficiary. The executor of participant's estate determines that $800,000 of the IRA is needed to use up the rest of the participant's estate's unified credit. NPS can renounce 80% of the outright designation, causing $1,600,000 of the community property to pass through the testamentary conduit trust. That trust pays NPS's half of the $1,600,000, *i.e.*, $800,000, outright to NPS, and participant's half, also $800,000, passes to NPS as usufructuary. The unified credit is fully used, but NPS gets full use of the benefit.

C. Lifetime Partition of IRA. In the case of an IRA, consider separating the two spouses' shares during marriage. See, e.g., PLR 90439020. Both IRAs must remain in the name of the participant, but there can be separate beneficiary designations, and the non-participant spouse's Will will dispose of her separate IRA. If the community and separate interests are not easy to determine, this may be especially helpful in order to clarify ownership. Do whatever is needed (including Declarations of Separateness under Civil Code article 2339) to assure that the earnings on each share do not fall into the community.

EXHIBIT A
UNIFORM LIFETIME TABLE

Age of the Participant	Distribution Period	Applicable Percentage
70	27.4	3.65%
71	26.5	3.77%
72	25.6	3.91%
73	24.7	4.05%
74	23.8	4.20%
75	22.9	4.37%
76	22.0	4.54%
77	21.2	4.72%
78	20.3	4.93%
79	195	5.13%
80	18.7	5.35%
81	17.9	5.59%
82	17.1	5.85%
83	16.3	6.13%
84	15.5	6.45%
85	14.8	6.76%
86	14.1	7.09%
87	13.4	7.46%
88	12.7	7.87%
89	12.0	8.33%
90	11.4	8.77%
91	10.8	9.26%
92	10.2	9.80%

Age of the Participant	Distribution Period	Applicable Percentage
93	9.6	10.42%
94	9.1	10.99%
95	8.6	11.63%
96	8.1	12.35%
97	7.6	13.16%
98	7.1	14.08%
99	6.7	14.93%
100	6.3	15.87%
101	5.9	16.95%
102	5.5	18.18%
103	5.2	19.23%
104	4.9	20.41%
105	4.5	22.22%
106	4.2	23.81%
107	3.9	25.64%
108	3.7	27.03%
109	3.4	29.41%
110	3.1	32.26%
111	2.9	34.48%
112	2.6	38.46%
113	2.4	41.67%
114	2.1	47.62%
115 & older	1.9	52.63%

EXHIBIT B
SINGLE LIFE TABLE

Age	Multiple
0	82.4
1	81.6
2	80.6
3	79.7
4	78.7
5	77.7
6	76.7
7	75.8
8	74.8
9	73.8
10	72.8
11	71.8
12	70.8
13	69.9
14	68.9
15	67.9
16	66.9
17	66.0
18	65.0
19	64.0
20	63.0
21	62.1
22	61.1
23	60.1
24	59.1
25	58.2
26	57.2
27	56.2
28	55.3
29	54.3
30	53.3
31	52.4
32	51.4
33	50.4
34	49.4
35	48.5
36	47.5
37	46.5

Age	Multiple
38	45.6
39	44.6
40	43.6
41	42.7
42	41.7
43	40.7
44	39.8
45	38.8
46	37.9
47	37.0
48	36.0
49	35.1
50	34.2
51	33.3
52	32.3
53	31.4
54	30.5
55	29.6
56	28.7
57	27.9
58	27.0
59	26.1
60	25.2
61	24.4
62	23.5
63	22.7
64	21.8
65	21.0
66	20.2
67	19.4
68	18.6
69	17.8
70	17.0
71	16.3
72	15.5
73	14.8
74	14.1
75	13.4

Age	Multiple
76	12.7
77	12.1
78	11.4
79	10.8
80	10.2
81	9.7
82	9.1
83	8.6
84	8.1
85	7.6
86	7.1
87	6.7
88	6.3
89	5.9
90	5.5
91	5.2
92	4.9
93	4.6
94	4.3
95	4.1
96	3.8
97	3.6
98	3.4
99	3.1
100	2.9
101	2.7
102	2.5
103	2.3
104	2.1
105	1.9
106	1.7
107	1.5
108	1.4
109	1.2
110	1.1
111 & older	1.0