

MARTIN COUNTY ESTATE PLANNING COUNCIL, INC.

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***ESTATE PLANNING WITH RETIREMENT  
BENEFITS***

***WHAT, ME WORRY?***

by

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# ***ESTATE PLANNING WITH RETIREMENT BENEFITS***

## ***WHAT, ME WORRY?***

### **A. NON-TAX GOALS.**

Clients generally participate in qualified retirement plans ("QRPs") and individual retirement account (IRAs) to obtain tax-deferred retirement benefits and to save for retirement. Some individuals belong to plans where their employer contributes on their behalf, while others can and do make their own contributions. Some of these contributions may be tax-deductible, others may not. Some of the major tax benefits to the players are a tax-deduction at the time of the contribution for either the employer or the participant, with tax-deferred growth until funds are withdrawn. But besides the tax enticements, QRPs and IRAs offer several other advantages:

**1. Top Heavy Plans.** Qualified plans can be designed to allocate the annual employer contributions heavily in favor of the business owner(s) and key employees. This weighting oftentimes far outweighs the after-tax cost of staff coverage, and therefore encourages the use of these plans.

**2. Growth in Retirement Benefits.** Due to the growth in values of publicly-traded securities in particular, many individuals find themselves with very large qualified retirement plan or rollover IRA balances. They have been so successful in providing for their retirement that they have accumulated much more than they can spend in their retirement years. These individuals, especially, should pay close attention to all of the options available to them for distribution and further deferral, and plan accordingly.

**3. Creditor Protection.** One advantage of qualified retirement plan and IRA funds as an asset is creditor protection, but the level of creditor protection may vary from plan to plan and from state to state.

**4. Forced Savings.** Some individuals contribute to qualified retirement plans in order to "protect them from themselves." By placing their funds where they cannot be reached before certain distribution requirements are met, they find it easier to save for retirement. The temptation to use the funds for current needs or desires is greatly diminished by the plan's distribution restrictions and the early distribution tax penalty imposed by the tax law (Code § 724).

**5. Charitable Gifts,** Individuals may also want to explore the possibility of using some or all of their QRP benefits or IRAs funds to make charitable gifts.

**6. Economic Planning.** Other considerations include the client's intended purpose for the QRP benefits or IRAs, and the client's economic needs. The client will have to decide when he or she should begin receiving payments; what method of benefit payment should he or she select, e.g. lump sum, period certain, life annuity or joint and survivor annuity; and

whom to name as the beneficiary of death benefits. The client's decisions to questions like these may or may not conflict with his or her tax objectives, which often focus on deferring the receipt of benefits in order to postpone paying income tax, to defer the payment of transfer taxes and to avoid penalty taxes.

**7. ERISA Restrictions.** In advising clients with QRP and IRA account balances, remember that a participant's goals, both tax and non-tax, will be restricted by the provisions of the plan and by spousal rights under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and the Internal Revenue Code ("Code").

**8. Roth Accounts.** The new Roth IRA turns typical tax concepts and planning on its head: there is no deduction upon contribution, but the proceeds may be withdrawn income tax free once certain requirements are met. The ability for all account owners to convert existing IRAs and QRP accounts to Roth accounts poses one of the greatest wealth production opportunities in over a generation. This type of account provides significant opportunities for estate planners.

## **B. ERISA RULES.**

### **1. Qualified Retirement Plans.**

**(a) ERISA Title I.** In the context of the scope of this outline, the phrase "qualified employee benefit plan" (which I will refer to as a "QRP") embodies two elements. A non-governmental "pension plan," governed by Title I of ERISA, is any plan or program maintained by an employer or an employee organization (or both) that (1) provides retirement income to employees or (2) results in deferral of income by employees for periods extending generally to the end of employment or beyond, regardless of how plan contributions or benefits are calculated or how benefits are distributed. ERISA § 3(2). It encompasses both funded and unfunded plans or arrangements. A "funded" arrangement is required to comply with the requirements imposed under Title I of ERISA; unfunded plans are subject to only certain limited rules under Title I.

**(b) ERISA Title II - Tax Qualification.** The other element of this phrase is "qualified," which means that the employee benefit plan is afforded special tax treatment for meeting a host of requirements under the Code involving coverage, participation, vesting, funding, and distribution. These are found in Code §§ 401-417 and are sometimes referred to as the ERISA Title II requirements. Some (but not all) of these requirements have parallel provisions in ERISA Title I.

**2. General Categories.** Qualified retirements plans are broadly classified into two categories based on the nature of benefits provided: defined contribution plans and defined benefit plans.

**(a) Defined Contribution Plans.** Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts

maintained for each plan participant. There are several different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit sharing plans, stock bonus plans, and employee stock ownership plans ("ESOPs"). A profit sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (a "401(k) plan"). Under such an arrangement, an employee may elect to have the employer withhold amounts from his salary or wages and contribute them (pre-tax) to a qualified plan on behalf of the employee.

**(b) Defined Benefit Plans.** Under a defined benefit pension plan, retirement benefit levels are specified under a plan formula, phrased in terms of a benefit payable at a specified retirement age. Benefits are funded by the general assets of the trust established under the plan. Individual accounts are generally not maintained for employees participating in the plan (with the exception of theoretical accounts under "cash balance" plans).

**(c) 403(b) Plans.** Tax-sheltered annuities ("403(b) annuities," "TSAs" or "TDAs") are another form of employer-based retirement plans that provide similar tax-favored benefits as qualified plans and IRAs. Employers may contribute to such annuities (or custodial accounts) on behalf of their employees, and employees may contribute on a pre-tax basis through salary reduction. TSAs are subject to some (but not all) of the Code rules applicable to qualified plans, and are exempt from ERISA Title I if (i) either maintained by an agency or instrumentality of a governmental entity (*e.g.*, a public school district), or (ii) only salary reduction contributions may be made and the employer has very limited involvement. TSAs may be maintained only by certain types of organizations, in particular, tax-exempt charitable organizations and education institutions. They may be separate account-type or defined benefit-type plans.

**3. ERISA Generally Controls.** ERISA forms the basis for the current private pension system. The rules enacted in ERISA have been revised numerous times, with a variety of purposes, including ensuring broader pension plan coverage, providing greater benefit security for participants, modifying the rights of plan participants, and portability of benefits between plans for the benefit of an ever-more-mobile workforce.

**4. IRAs.** Despite the apparent all-encompassing reach of ERISA, some deferred compensation arrangements are not covered by ERISA Title I or II. Generally, IRAs are exempt from the provisions of Title I of ERISA. ERISA §§ 101(a), 201(6), 301(a)(7), 401(a). However, a payroll deduction program through an employer under which contributions to an IRA are made might be considered an "employee pension benefit plan" that would be governed by ERISA Title I, depending on the extent of the employer's involvement. *See*, Labor Regs. § 2510.3-2(l)(1).

**5. SEPs.** Simplified employee pension (SEP) plans are individual retirement accounts or annuities set up by an employer and designed to serve as a simplified form of pension plan. Although the funding vehicle for SEPs is required to be an IRA or IRA annuity, SEPs are considered employee benefit plans and are therefore subject to most of the requirements of Title I of ERISA. *See, Garratt v. Walker*, 121 F.3d 565, 570 (10<sup>th</sup> Cir. 1997).

**6. Plans Covering Only Owners.** Plans that cover only the sole proprietor or shareholder and/or spouse, or only partners, are not covered by ERISA. See, Labor Regs. § 2510.3-3(b); *Schwartz v. Gordon*, 761 F.2d 864 (2<sup>nd</sup> Cir. 1985); *Securities and Exchange Commission v. Johnston*, 143 F.3d 260 (6<sup>th</sup> Cir. 1998). After some confusion among the Circuits, the Supreme Court finally determined that a plan covering a sole proprietor or single shareholder will also be an ERISA-covered plan as long as there is at least one common-law employee also participating. *Yates v. Hendon*, 124 S. Ct. 1330 (2004).

**7. Governmental Plans.** Plans maintained by governments or other agencies or instrumentalities are exempt from ERISA Title I, but are required to comply with some of the tax-qualification rules under Code § 401(a).

**8. ERISA Preemption.** ERISA § 514(a) provides that "the provisions of this subchapter and subchapter III of this chapter [dealing with termination of defined benefit plans] shall supercede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan ...." This language leaves no doubt that Congress intended to establish employee benefit plan regulation as exclusively a federal concern, insofar as ERISA-covered plans are concerned.

**9. The Plan Document.** While QRPs and IRAs are governed by numerous provisions of the Code and ERISA, the primary source for determining the options available to a client with any such plan is the plan document. One of the fundamental requirements for a QRP is that the plan must be a definite written program for providing benefits. Code §§ 401(a)(1), 401(a)(2); Treas. Reg. §§ 1.401-1, 1.401-2; Notice 98-25, 1998-18 IRB 11. While plans are required to contain certain nondiscrimination and other provisions, plan sponsors also have wide latitude in selecting what distribution options will be made available to participants.

**(a) Optional Forms Available?** Many plans sponsored by larger employers restrict the method and timing for receiving benefits, especially defined benefit pension plans. A participant may not be entitled to receive his or her interest until retirement age, and then may not be entitled to a lump sum distribution. A life annuity, or if married, a joint and survivor annuity may be the only form of distribution allowed under the plan. Conversely, some profit sharing plans allow only a lump sum distribution. If a married participant dies while employed, this distribution might only be available to the surviving spouse.

**(b) Generally, the Plan Document Controls Over State Law.** In *Krishna v. Colgate Palmolive Co.*, 7 F.3d 11 (2d Cir. 1993), the court held that ERISA, rather than state law, should govern the determination of which claimant is the beneficiary of a life insurance policy because it is inappropriate, in light of uniform administration of ERISA plans, to require plan administrators to look beyond the terms of the plan controlling the designation of beneficiaries into varying state laws regarding wills, trusts, estates and domestic relations.

In *Krishna*, the deceased employee was covered by a group life insurance policy provided through his employer. The policy stated that the beneficiary shall

be the designated beneficiary on record. The deceased designated his cousin as the beneficiary of the policy. In his will, he designated his sister-in-law as the residual legatee. After his death, both his cousin and his sister-in-law claimed to be the beneficiary of the policy. The court first found that the insurance policy was governed by ERISA because it was issued under an employee welfare benefit plan. The court then concluded that New York State laws were preempted by ERISA to the extent that they were related to the designation of beneficiaries under the insurance policy. Since the insurance policy includes a clear provision requiring a written designation or change of beneficiary, the court concluded that it would be "counterproductive to compel the administrator to look beyond those designations into varying state laws regarding wills, trusts and estates, or domestic relations to determine the proper beneficiaries of policy distributions."

This issue will be addressed further below.

### **C. RETIREMENT EQUITY ACT (REA) ISSUES.**

**1. Introduction.** Although a participant's benefits are accumulated under an employer's retirement plan based upon the employee's service and (often) compensation, federal law requires protections for the non-participant spouse in the form of required annuity payments and required spousal consent to non-annuity payments. These rules are explored below and substantially complicate the estate planning process. Moreover, the practitioner must take into account the dichotomy between federal and state law and determine which law will govern over whatever plans and benefits are involved. The source of many of the rules is the Retirement Equity Act of 1984 ("REA"), as subsequently modified by the Tax Reform Act of 1986 ("TRA 1986"), the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), the Omnibus Budget Reconciliation Act of 1989 ("OBRA 1989"), and the Taxpayer Relief Act of 1997. The rules are generally found in Code §§ 401(a)(11), 401(a)(13), 414(b) and 417, §§ 1.401(a)-11, 1.401(a)-20 and 1.417(e)-1 of the Treasury Regulations ("Treas. Reg."), and ERISA §§ 205 and 206(d).

**2. Pre-REA Spousal Benefit Coverage.** Prior to passage of REA in 1984, there were no spousal benefit requirements with respect to defined contribution-type plans. With respect to defined benefit plans, a married participant's benefit was required to be paid in the form of a qualified joint and survivor annuity ("QJSA") unless the participant elected some other form of payment. There were no spousal consent rules, and no time period within which an optional election had to be made. Pre-retirement survivor annuity ("QPSA") benefits were required to be paid only to the spouse of a participant who died during employment after satisfying the requirements to retire early, and to the spouse of an early retiree who died before his/her pension began. In either case, the participant could elect out of QPSA coverage without the spouse's knowledge or consent. Optional forms of payment could be made by participant election, but no spousal consent was required.

**3. Changes Under REA.** With the passage of REA in 1984, the spousal benefit rules were strengthened in favor of non-participant spouses.

**(a) Defined Benefits Plans.**

**(i) Forms of Retirement Benefit.** REA continued the rule that a married participant's retirement benefit must be paid in the form of a QJSA, unless validly waived by the participant. Code §§ 401(a)(11)(A)(i), 417(a)(1)(A)(i). However, the waiver must include the spouse's written consent, and both the waiver and consent must be made within the 90-day period prior to the annuity commencement date. There were also added disclosure rules to adequately inform both the participant and the spouse of their rights with respect to QJSA and optional forms of benefits. In addition, with respect to non-married participants, REA mandated the normal form of benefit to be a straight life annuity, subject to the waiver rules described above. Treas. Reg. § 1.401(a)-20, Q&A 25(a).

**(ii) Pre-Retirement Survivor Annuity.** REA also expanded the QPSA rules. Generally, a survivor annuity must be payable to the surviving spouse of a vested participant if the participant dies before his/her retirement benefits begin (even if before his/her early retirement age and even if after termination of employment), regardless of the participant's age at the time of death. Code § 401(a)(11)(A)(ii). REA also imposed spousal consent requirements on a waiver of QPSA coverage. It also imposed restrictions on the time period during which QPSA waivers (and spousal consents) may be obtained (generally, beginning with the plan year in which the participant attains age 35). Code § 417(a)(6)(B). The amount payable under the QPSA in a defined benefit plan is the amount the spouse would have received if the participant had terminated employment and had begun receiving benefits immediately before death under a QJSA. However, if the participant dies on or before the earliest commencement date on which he/she could have begun receiving retirement benefits, the QPSA is based on the amount the spouse would have received had the participant survived to such earliest benefit commencement date, had begun receiving benefits under a QJSA immediately, and died the day after such benefit commencement. Code § 417(c)(2); Treas. Reg. § 1.401(a)-20, Q&A 20.

Where the participant dies on or before his/her earliest commencement date, the plan may prohibit commencement of the QPSA until the earliest date the participant could have begun receiving benefits. Code § 417(c)(1)(B); Treas. Reg. § 1.401(a)-20, Q&A 18. The spouse must consent to any payment that begins before the date the participant would have attained the latter of age 62 or the plan's normal retirement date. Treas. Reg. § 1.417(e)-1(b).

**(b) Defined Contribution Plans.**

**(i) Money Purchase Plans.** The above QJSA and QPSA rules also apply to defined contribution pension (money purchase) plans. With respect to QJSA benefits, the benefit payable to a married participant at retirement age or, if allowed under the plan, upon earlier termination of employment, must be a QJSA that may be purchased with 100% of the participant's vested account balance in the plan. With

respect to pre-retirement death benefits, the plan must provide a QPSA that is the actuarial equivalent of not less than 50% of the value of the participant's vested account balance in the plan, determined as of the date of his/her death. Code § 417(c)(2); Treas. Reg. § 1.401(a)-20, Q&A 20.

**(ii) Profit Sharing and Stock Bonus Plans.** The QJSA and QPSA rules do not apply to profit sharing or stock bonus plans, provided that the following requirements are met:

**(A)** The plan provides that a married participant's vested benefit is payable in full, on the participant's death, to the participant's surviving spouse or, if the spouse has consented, to a designated beneficiary.

**(B)** The participant does not elect to receive his/her benefits in a form involving a life annuity.

**(C)** The plan is not a transferee of a plan required to provide QJSA/QPSA benefits. Code § 401(a)(11)(B)(iii); Treas. Reg. 1.401(a)-20, Q&A 3.

Consequently, most profit sharing and stock bonus plans avoid these rules by not permitting an annuity-type form of payment to plan participants or beneficiaries, generally limiting distributions to lump sum and installment forms. Further, these plans must provide that upon a participant's death, the entire value of the participant's vested account will be payable to the surviving spouse unless a waiver with spousal consent is in effect. But note that lifetime distribution of a participant's benefit may be made in a lump sum without the spouse's consent. Consequently, this frees the participant to rollover the participant's benefit to an IRA and freely plan the distribution strategy for the entire account.

**(c) Waiver of Spousal Annuity Benefits and Spousal Consent.**

**(i) Right to Waive QJSA/QPSA.** A plan subject to the QJSA/QPSA rules must allow each participant to waive the QJSA or to revoke a prior waiver during the 90-day time period immediately preceding the annuity starting date, unless the plan prohibits selection of another form and selection of a non-spouse beneficiary. Code § 417(a)(1)(A). Waiver prior to then is not a valid waiver.

**(ii) Spousal Consent.** The waiver requires the spouse's written consent. Code § 417(a)(2). No consent is required if the optional form meets the requirements of a QJSA and is the actuarial equivalent of the plan's QJSA, provided the participant names his/her spouse as the survivor annuitant. Treas. Reg. § 1.401(a)-20, Q&A 16. The written consent must expressly acknowledge the effect of the waiver, must designate the beneficiary to whom any benefits will be paid and the optional form in which the benefits will be paid. The spouse's consent (but not the participant's waiver) must be witnessed by a plan representative or notary public. Code § 417(a)(2)(A); Treas. Reg. § 1.401(a)-20, Q&A 31. Therefore, any change in the form

of payment or designated beneficiary must generally be accomplished through a new waiver with spousal consent. However, a consenting spouse who executes a general consent may expressly permit the participant to make future changes in either the designated beneficiary or the form of payment without obtaining the spouse's subsequent consent, provided that the spouse acknowledges his/her rights to limit consent and that he/she is in effect relinquishing those rights. Treas. Reg. § 1.401(a)-20, Q&A 31. Normally, the spousal consents are made irrevocable as a matter of plan practice, and the regulations permit this. Treas. Reg. § 1.401(a)-20, Q&A 30.

**(iii) Consent Not Required.** No spousal consent is required under the following circumstances:

**(A)** If it is established to the satisfaction of a plan representative that there is no spouse or that the spouse cannot be located. Prudent plan administration requires the administrator to determine on its own that the spouse cannot be located. Locator services provided by either the Social Security Administration or the Internal Revenue Service should be utilized for this purpose.

**(B)** If the participant is legally separated or has been abandoned (within the meaning of local law), and the participant has a court order to such effect (Treas. Reg. § 1.401(a)-20, Q&A 27); however, a QDRO (described below) may provide otherwise. A consent obtained with respect to a particular spouse will not be effective with respect to any subsequent spouse. Treas. Reg. § 1.401(a)-20, Q&A 29. Moreover, a participant's waiver of QJSA or QPSA coverage or designation of a non-spouse beneficiary made while the participant is not married becomes ineffective immediately upon marriage. Treas. Reg. § 1.401(a)-20, Q&A 25.

**(iv) Effect of Administrator's Reasonable Actions.** ERISA § 205(c)(6) provides that if a plan administrator (or third party acting on the advice of an administrator) acts reasonably and relies on a spouse's consent or participant's revocation of a waiver, or in determining whether spousal consent is necessary, any resulting plan payments will discharge the plan's liability to the extent of the payments made. That is, the plan will not be liable for the same payments again to a disgruntled spouse.

**(v) Notice Requirements.**

**(A) QJSA Coverage.** Each participant (whether or not married) must be given notice within 30 to 90 days before the annuity starting date, as to the right to waive the QJSA or to revoke a prior waiver and the effect of such actions. Code § 417(a)(3). The notice must include sufficient information to adequately inform the participant and the participant's spouse of the terms and conditions of the QJSA, a description of the plan's optional forms and relative values of each and the spouse's rights to consent (or withhold consent) to a participant's

waiver. Code § 417(a)(3)(A); Treas. Reg. § 1.401(a)-20, Q&A 36. Alternatively, the plan may permit a participant to elect (with spousal consent) to waive any requirement that the explanation be provided at least 30 days before the annuity starting date if the distribution commences more than 7 days after the explanation is provided. Code § 417(a)(7). Many plans have experienced procedural difficulties with complying with the 30-day/90-day rule and have opted to allow participants to waive these rules. Considering the procedural difficulties the participants themselves face with these time restrictions, and the desire for more immediate payment, most participants will opt to waive the 30-day requirement.

**(B) QPSA Coverage.** A plan must provide notice of the right to waive QPSA coverage, unless a non-spouse beneficiary may not be selected, or the benefit is subsidized. Generally, the notice must be provided to the participant who does not terminate employment prior to age 35 within the period beginning on the first day of the plan year in which the participant reaches age 32, and ending at the close of the plan year in which the participant attains age 34. If an individual first becomes a participant after the plan year in which the participant attains age 34, the plan must provide the notice within a reasonable period after he/she becomes a participant. If the participant terminates employment before attaining age 34 and has not yet received the notice, the notice must be delivered within a reasonable period after the individual becomes a participant. Code § 417(a)(3)(B).

**(vi) One-Year Marriage Requirements.**

**(A) QJSA.** A plan may provide that the QJSA requirements will not apply unless the participant and his/her spouse are married during the entire one-year period immediately preceding the participant's annuity starting date. However, if a participant marries during the one-year period immediately preceding the annuity starting date and remains married to his/her spouse for at least one year prior to the date of the participant's death, the plan must begin paying benefits based upon a life annuity form (or other optional form) and then, after the one-year requirement is met, to recalculate the benefits and vest the participant and spouse in all remaining benefits. Code §§ 401(a)(11)(D), 417(d)(2); Treas. Reg. § 1.401(a)-20, Q&A 25(b)(2).

**(B) QPSA.** Plans are permitted to require a similar one-year marriage requirement for the payment of QPSA benefits to a surviving spouse. None of the complexities described in the previous paragraph come to play and, therefore, most plans have opted to include the one-year marriage requirement in their plans.

**(vii) Impact of Divorce.** If the participant and spouse divorce prior to the annuity starting date, the participant's valid waiver (with spousal consent) remains effective unless otherwise provided in a QDRO, or unless the participant changes the waiver (without a general consent) or is remarried prior to the annuity starting date. If, on the other hand, the participant and spouse are married on the annuity starting date, the QJSA protected benefit remains in effect (unless waived and

consented to by that spouse) even if the participant and spouse are not married on the date of the participant's death, except as otherwise provided in a QDRO.

(viii) **Cash Outs.** A plan may provide for a mandatory cash out of the present value of a QJSA or QPSA benefit if, in either case, the present value of the vested benefit payable at normal retirement date (or date of death, if later) does not exceed \$5,000 and the distribution is made prior to the annuity starting date. If the present value exceeds \$5,000 or the annuity starting date has already occurred, the plan may cash out the benefit only with the consent of the participant and his/her spouse (or the surviving spouse in the case of a QPSA). Code § 417(e). The present value is generally calculated by looking to statutorily mandated mortality tables and 30-year U.S. Treasury security rates.

## **D. PROTECTING QRP BENEFITS AND IRAs.**

### **1. Protection in Bankruptcy.**

(a) **Exclusion for ERISA-Covered Plans under Bankruptcy Code § 541(c)(2).** Since 1974, participants not in bankruptcy have been able to rely on ERISA § 206(d)(1) to ward off creditors who attempt to attach the participant's benefits in an ERISA-covered plan. ERISA § 206(d)(1) prevents the voluntary assignment or involuntary alienation by any creditor (other than the federal government with tax claims or claims for restitution, the plan itself in cases of financial wrongdoing to the plan, and spouses and dependents holding qualified domestic relations orders) of a participant's benefits within an ERISA-covered plan.

Prior to 1992, bankruptcy courts struggled with the question whether federal bankruptcy law (specifically, 11 U.S.C. § 541(c)(2), which excludes from the bankrupt's estate those assets in a trust that are subject to a restriction on transfer which is enforceable under non-bankruptcy law) implicated ERISA 206(d)(1) to exclude qualified plan assets from the bankrupt's estate. In 1992, the U.S. Supreme Court held in *Patterson v. Shumate*, 504 U.S. 753 (1992) that ERISA § 206(d)(1) was indeed non-bankruptcy law that restricted the transfer of benefits, thus enabling plan benefits to be excluded from the bankrupt's estate. But alas, *Patterson* did not finally resolve the issue. The Court did not grant protection to "ERISA-covered" plans, but instead to "ERISA-qualified" plans, a term not defined in ERISA and generally not used by employee benefits practitioners. Hence, courts were forced to determine to what plans does *Patterson* apply? Because "ERISA-qualified" specifically refers to ERISA, one must conclude that at the least, the debtor's retirement plan interest must be covered by

ERISA Title I.<sup>1</sup> Whether that phrase means something more has led to two distinct lines of cases.

The first requires only that the subject plan be covered by ERISA Title I and include the anti-alienation language required under ERISA § 206(d)(1), for example, interests in non-governmental, employer-contributory 403(b) plans should qualify for the exclusion. The second line, adhered to by courts in Florida since *Patterson*, requires the plan also meet all of the requirements for tax-qualification under Code § 401(a). *In re Fernandez*, 236 Bankr. 483 (Bankr. M.D. Fla. 1999); *In re Harris*, 188 B.R. 444 (Bankr. M.D. Fla. 1995). Under this reasoning, the 403(b) plan mentioned previously could not be excluded.

(b) **Exemption Under Florida Spendthrift Law.**

(i) **Retirement Plans.** Even if one cannot rely on *Patterson* to exclude the QRP interest from the estate, state spendthrift trust law may still apply to *exempt* the QRP benefits from the creditors' claims. That law in Florida is Fla. Stat. § 222.21, which exempts benefits in the following tax-exempt plans:

- Any Keogh (HR-10) plan, so long as it is tax-qualified, or is "almost" tax-qualified, under Code § 401(a);
- Any corporation-sponsored Code § 401(a) plan, so long as it remains tax-qualified or is "almost" tax-qualified;
- § 408 individual retirement accounts and § 408A Roth IRAs, as long as they are tax-exempt or "almost" tax exempt;
- § 403(b) annuities, both governmental and non-governmental;
- 457(b) governmental salary deferral plans; and
- governmental plans that are tax-qualified under Code § 401(a).

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<sup>1</sup> The following are not covered by ERISA Title I:

- (1) IRAs, unless (as with SEPs) they are sponsored by an employer and cover common-law employees (see ERISA § 201(b); Labor Regs. § 2510.3-2(d));
- (2) Plans covering only partners, or self-employed individuals, and/or their spouses, but no common-law employee (see, Labor Regs. §2510.3-3(b));
- (3) corporation-sponsored plans that have covered only the sole shareholder and/or spouse (see, *In re Witwer*, 148 Bankr. 920 (Bankr. C.D. Cal. 1992));
- (4) salary-deferral-only § 403(b) plans (see, Labor Regs. § 5210.3-3(f));
- (5) plans established or maintained by federal, state or local governments, agencies or instrumentalities;
- (6) church plans that do not elect to be covered by ERISA Title I.

Therefore, any such plan not covered by ERISA is exempt from creditors' claims against the estate. As described below, the focus of the express language of § 222.21 is on the (almost) tax-exempt status of the plan covered by the express Code section, and nothing more.

(c) **Florida Exemption of Plan Benefits Needed for Support.** Under Fla. Stat. § 222.201, bankrupt debtors may also rely on another bankruptcy section, 11 U.S.C. § 522(d)(10)(E), which exempts from claims any "payment under a stock bonus, pension, profit-sharing, annuity or similar plan or contract on account of...death, age or length of service, *to the extent reasonably necessary for the support of the debtor and any dependent of the debtor...*" (emphasis added). Considering the conditions to be met and its limited protection, this statute has been a secondary line of defense for the bankrupt debtor.

(d) **Exemptions for IRAs Needed for Support.** For owners (originators) of IRAs, in those states that permit a debtor to claim the federal exemption, 11 U.S.C. § 522(d)(10)(E) served as the primary defense to creditors' claims in bankruptcy. Yet, even 11 U.S.C. § 522(d)(10)(E) proved unavailable in many states because courts there have not viewed an IRA as providing payments "on account of...death, age, or length of service."

That inconsistency was resolved by the U.S. Supreme Court in *Rousey v. Jacoway*, 125 S.Ct.2d 1561 (2005), which held that the debtor's IRA qualified for the § 522(d)(10)(E) exemption as a plan payment from which is "on account of death, age, or length of service," noting that a debtor's IRA confers a right to receive payment **on account of** age and the IRA constitutes a plan or contract **similar** to pension and profit sharing plans that provide payments that are substituted for **wages**. The Supreme Court was unanimous in its characterization of an IRA as a "similar" plan that made payments because of the attainment of age (the 72(t) early distribution tax comprises a strong-enough impediment to early distribution that older age became the primary reason for distribution). However, as described below, the Court's focus on these factors, readily applicable to the originator of an IRA, do not lend well to beneficiaries.

(e) **Federal (Limited) Protection of IRAs.** Just a week after *Rousey* was decided, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), which supplements *Housey* (and avoids its limitations, notably the "necessary for support" requirement). BAPCPA amended Bankruptcy Code §§ 522(b) and (d) to provide a blanket \$1 million (now, \$1,095,000) federal exemption for contributory IRAs and Roth IRAs, and unlimited protection for rollover IRAs (creating the incentive to rollover large account balances to IRAs from non-"ERISA-qualified" plans that may not be protected under state law).

If a state (such as Florida) opts out of the listed federal exemptions under § 522(d) (see Fla. Stat. § 222.20), does the debtor lose BAPCPA's unlimited (and virtually unqualified) protection afforded rollover IRAs but gain possibly added state law protection afforded all IRAs, including contributory IRAs? (see Fla. Stat. § 222.21, described above).

While 11 U.S.C. § 522(b)(2) provides for state opt-out, thereby denying a debtor the IRA protection under 11 U.S.C. § 522(d)(12), the debtor's mandate (in some states, option) to use state law exemptions does not impact the debtor's right to claim BAPCPA's protection under 11 U.S.C. § 522(b)(3)(c). (see *Chilton v Moser*, 2011 WL 938310 (E.D.Tex.) fn 1).

**2. Non-Bankruptcy Protection.** For those plans covered by ERISA Title I, creditor protection is provided by ERISA § 206(d)(1). For all others, participants can look to Florida's protective statute, Fla. Stat. § 222.21, described above (and below).

### **3. Are Beneficiaries' Interests Protected?**

**(a) Bankruptcy.** Once the IRA interest passes to a beneficiary following the owner's death, the issue now becomes whether exemption carries over to the beneficiary. In the context of a beneficiary's bankruptcy, as noted above, BAPCPA appears to cover **any** debtor's interest in the IRA, whether created or inherited by the debtor. 11 U.S.C. § 522(b)(3); 11 U.S.C. § 522(d)(12)..

**(b) Non-Bankruptcy.** In non-bankruptcy situations, the debtor must rely on state law protection, and here is where the planner must take special note.

Starting with *In re Jarboe*, 365 B.R. 717 (2007), a case that was filed before BAPCPA in which the debtor (an IRA beneficiary) relied on Texas state law for protection, bankruptcy courts have looked beyond the precise statutory language that appears, in many cases, to grant full protection to beneficiaries. Despite the statutes (I dare say, in this climate of poor economic times), the courts have sympathized with creditors who claim that the protections given to "retirement accounts" should not pass on to beneficiaries whose benefits were derived strictly by inheritance.

In *Jarboe*, the Bankruptcy Court interpreted a broadly written Texas statute which exempts "assets...under any individual retirement account" and "retirement funds...in a[n] account...exempt under [Code] section 408...." A bankrupt beneficiary claimed his beneficial interest was exempt. The court noted that the debtor was merely a beneficiary whose rights under the IRA were decidedly different than the decedent's (he could not rollover nor contribute to the IRA, but could withdraw funds from the account at any time without the 10% premature distribution tax applying). Therefore, the IRA interest was no longer an interest in "retirement funds." In the court's view, the IRA had changed character sufficiently to be devoid of its original purpose as a source of *retirement* funds and, therefore, outside the umbrella of protection envisioned by the Texas Legislature.<sup>2</sup>

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<sup>2</sup> In April 2011, a Texas federal district court overturned a Bankruptcy Court decision and allowed the debtor's exemption claim for her inherited IRA under 11 U.S.C. § 522(d)(12) (Texas allows a choice between federal and state law exemption; here, the debtor opted for the federal exemption). The district court held that there were only two relevant questions under the federal exemption statute:

(i) Were the funds held in an account that was exempt from tax under Code § 408? The court

(c) **Florida Joins the Trend.** More recently, in *Robertson v. Deeb*, 16 So. 3<sup>rd</sup> 936 (2d DCA 2009), a case outside of bankruptcy, the Second District Court of Appeal interpreted Fla. Stat. § 222.21(2)(a) very narrowly. The pertinent statute reads:

"Any money or other assets payable to an owner, a participant, or a **beneficiary** from, or any interest of any owner, participant, **or beneficiary** in, a fund or account is exempt from all claims of creditors...of the **beneficiary**...if the fund or account is...[a tax exempt plan] under § 408 [or] § 408A of the Internal Revenue Code of 1986." Fla. Stat. § 221.21(2)(a) (*emphasis applied*).

The creditor sought to garnish the debtor's interest in an IRA the debtor had inherited from his father, held now in an "f/b/o" IRA for the debtor's benefit.

Notwithstanding the plain language of the statute, the Second District held that the statute applied only to the original IRA account as owned by the originator (the decedent) and that the tax consequences to a beneficiary (the debtor) of that same IRA (no ability to rollover; no ability to add to his own IRA; no early distribution tax) rendered it a completely separate account not worthy of the state law protection as a retirement account. The amount was ordered paid over to the creditor.

After *Robertson*, one has to question the Legislature's intent when it included "beneficiary" as a protected class if the beneficiary ultimately is not protected. There is no possible scenario for an individual, not the owner of the account, to take a choate interest in the IRA except as a beneficiary. And retaining the account's tax-exempt status after the owner's death (indeed, subparagraph 2(a)3 doesn't even require the account retain its tax-exempt status under some circumstances) seems to be the most the statute requires. Unlike other states' statutes, Florida's makes no reference to "retirement" in its identification of the "fund" or account." Indeed, Code § 401(a) itself encompasses more than just retirement plans – profit sharing plans and 401(k) plans being prime examples. The *Robertson* court seems to have simply looked the other way.

(d) **Florida Bankrupt Beneficiaries Fare No Better.** And to further the horror show, a Florida Bankruptcy Court recently adopted the reasoning in *Robertson* to hold that a Florida bankrupt could not claim his inherited IRA as exempt under § 222.21. *In Re Ard*, WL 3400368 (Bankr. M.D. Fla.) (August 18, 2010).

(e) **Lessons for Planner:**

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simply referred to Code § 408(e), which states that "any IRA is exempt from taxation".

(ii) Did the direct transfer from the decedent's IRA to the debtor's inherited IRA change the character of the funds from "retirement funds" to something else? The court said it didn't, based on the express language of § 522(b)(4)(c) that furthers the § 522(d)(12) exemption following a direct rollover of tax-qualified funds. It noted in particular the absence of statutory language requiring the source of the funds to be the debtor.

(i) When advising clients whether to rollover their QRP accounts to an IRA, consider the ultimate beneficiaries' financial situations. Despite the limitations in the QRP, perhaps it's more advantageous to keep the benefits in the QRP and retain ERISA's federal protection (assuming the plan is covered by ERISA – *see*, footnote 6 for a listing of plans not covered by ERISA).

(ii) If an IRA rollover is preferred by the client, consider which states may come into play and decide which of those states' creditor protection laws are more favorable. (But also consider that the cases cited may be the wave of the future.)

(iii) And most important, consider naming a trust as the beneficiary of the IRA, not individuals outright. Of course, that triggers "trust as designated beneficiary" issues under Code § 401(a)(9) and IRD issues under Code § 691(a). More about that later.

## **E. ROTH ACCOUNTS IN THE ESTATE PLAN.**

**1. Observation.** The advent of Roth IRAs probably is one of the greatest opportunities for wealth transfer seen in at least a generation. The ability to accumulate dollars in a tax-free retirement account, with no obligation to receive MRDs during the owner's lifetime, gives a taxpayer the opportunity to accumulate wealth over a period of decades to be passed on to one or more generations below to be distributed over a period of possibility three or more generations. As with IRAs, there are two versions of Roth IRA's to consider (contributory and rollover), and even in retirement plans, the Roth account can be enhanced by virtue of the larger annual contribution limit (currently \$16,500, and possibly \$22,000).

**2. Avoidance of MRDs.** Unquestionably, the compelling reason for a Roth IRA is the avoidance of the MRD rules during the owner's lifetime. Furthermore, designating the surviving spouse as the beneficiary (as opposed to a trust, whether see-through or not) may enhance the deferral opportunity because the surviving spouse can roll the benefits into his or her own Roth IRA and avoid distributions for the rest of his or her lifetime.

**3. Payout Terms after Death.** Only after the participant (or spouse who elects a rollover) dies will the MRD rules kick in. In that case, there are only two possible outcomes:

(a) **Five-Year Rule.** If there is no designated beneficiary, full distribution of the Roth IRA must occur by December 31 of the calendar year that contains the fifth anniversary of the owner's death.

(b) **Life Expectancy Method.** If there is a designated beneficiary, distribution must commence based on the single life expectancy of that designated beneficiary, with the first payment due by December 31 of the year following the owner's death.

Designating beneficiaries who are two or more generations below the account owner may result in benefits that are in multiples of the account balance at the date of death. This arises because the life expectancy period for grandchildren, etc., of very young age, can extend 60 or more years. The advantages of compounding over that time period would be enormous. Most important, all of the benefits would be income tax-free. Of course, naming a "skip" person will implicate the generation skipping transfer ("GST") tax. Accordingly, consideration must be given to allocating GST exemption to the account.

## **F. USING RETIREMENT BENEFITS TO FUND BEQUESTS.**

**1. Example #1:** Vlad E. Vostock owns a \$2 million IRA. He has \$3 million of other assets which are highly volatile and might only be worth as little as \$1 million at any time. He wants to provide that \$1 million of his estate is to be payable to the Salvation Army and the balance to his four children. His financial advisor urges him to use the IRA to pay the charity's bequest because under Code § 408(d)(1), he'll shift the income taxes on the IRA distribution to the charity, and since the charity is tax-exempt, he'll end up transferring more of his estate to his other beneficiaries. Is he correct? Under all circumstances? Two possible income tax outcomes can arise: Either the IRA is taxable to the recipient (*i.e.*, the charity) or it is taxable to Vlad's trust or estate. How can that be?

**2. Background.** Code § 402(a) provides simply enough that any amount *actually* distributed to any distributee by any employee's trust described in § 401(a) which is exempt from tax under § 501(a) shall be taxable to the distributee in his or her tax year of distribution. With respect to IRAs, the rule is simply, "any amount paid or distributed out of an individual retirement plan shall be included in gross income by the payee or distributee" (Code § 408(d)(1)). But these rules may be overcome by other tax concepts which the planner must take into account in drafting the client's beneficiary designation.

**3. The § 691(a) Gateway.** The key Code Sections and IRS Guidance to consider are:

**(a)** Code § 402(a) (with respect to qualified plans), Code § 408(d)(1) (with respect to IRAs), and Code § 403(a)(1) (with respect to § 403(b) tax-deferred annuities), all of which direct the tax liability directly to the distributee of the benefits.

**(b)** Code § 691(a)(1), which states that with respect to items of income in respect of a decedent (IRD), the item is reportable as income by (i) the decedent's estate if it is the beneficiary of the account or (ii) the person who acquires the right to the account as the beneficiary, so long as that right is not taken through the decedent's estate or trust.

**(c)** Code § 691(a)(2), under which the IRD is recognized by the transferor (e.g., the decedent's estate or trust where the estate or trust takes as the designated beneficiary) at its fair market value at the date of transfer. However, there is no transfer if the account is assigned to a person pursuant to the right of that person to receive such an amount by reason of the decedent's death.

(d) IRS Chief Counsel Memorandum 2006-44020. The decedent had named his revocable trust as the beneficiary of his IRA. The trust provided that three charities would receive \$100,000 in cash or in kind from whatever trust funds were available, in the trustee's discretion. The balance was to be divided into separate shares for the decedent's issue per stirpes and either distributed outright or retained in trust. The trustee directed the IRA custodian to establish three separate IRAs, one for each charity, and to assign \$100,000 in equal shares to those charities. The Chief Counsel advised that although no distribution had yet occurred from the IRA account (thereby not yet implicating § 408(d)(1)), the assignment satisfied a pecuniary bequest and, therefore, triggered income to the trust under § 691(a)(2). Further, the trust was not entitled to a distribution deduction, thereby saddling the trust with the income tax liability on the IRA distribution to the charities.

The Chief Counsel's analysis relied on the notion that the assignment of the IRA constituted a "transfer," relying on *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940). That case did not deal with IRD items, but rather non-IRD appreciated property, and held that the executor's transfer to a pecuniary legatee of appreciated property triggered gain on the appreciation through a deemed sale, taxable to the estate. However, the analysis never addressed the exception described in the second sentence in § 691(a)(2), which states that a transfer is tax-neutral if the transferee is entitled to receive such amount "by bequest, devise, or inheritance from the decedent."

(e) Treas. Reg. § 1.691(a)-4(b)(2), which provides that the transfer of a right to receive IRD to a *specific* or *residuary* legatee is tax-neutral, in which case the legatee recognizes income as received. This regulation implies (but does not state) that fulfilling a pecuniary bequest with the right to receive IRD does not transfer the income tax burden to the distributee. Instead, under § 691(a)(2) (first sentence), the transferor must recognize income at the time of the transfer equal to the present value of the IRD item. Based on this regulation, estate planners have virtually adopted as sacrosanct the rule that funding a pecuniary bequest with items of IRD will trigger immediate taxation of the IRD item to the transferor.

**4. Lesson to Planners.** The lesson we can take from CCM 2006-44020 is that whether the assignment of the IRA interest triggers income to anyone other than the distributee will depend in large part on the wording of the bequest and the drafting of the pertinent documents, as described below.

**5. Possible Solutions.** Based on the above-described rules and guidance, what are the possible approaches to accomplish Vlad's goals?

(a) **Name Charity in Beneficiary Designation.** Within the beneficiary designation form, name the Salvation Army as the outright beneficiary of \$X million.

(i) **Death Before RBD – Result.** The income tax liability on the IRA distribution will fall on the Salvation Army, and since it is tax-exempt, no income tax will be due; and, a charitable estate tax deduction under Code § 2055 will reduce the taxable estate. The income tax result is obtained because the Code § 691(a)(1)

gateway is met. The IRD item is included in the gross income of the "person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent."

**(ii) Ancillary Result (Maybe).** If the charity's benefits are not distributed by September 30 of the year following the decedent's death, there is no "designated beneficiary" under Code § 401(a)(9). That means distribution will have to be made under rules that are much more restrictive than the client wants (or even knows of). If Vlad dies before his "required beginning date" (RBD) and there is no "designated beneficiary," distribution will have to be completed by the end of the fifth year following the owner's death. Treas. Reg. § 1.401(a)(9); *see*, IRS Form 5305 and 5305-RA, Article IV, ¶3(b). That obviously defeats the income tax and economic planning for the client and his or her family. Mostly clients will want, and expect, to "stretch" the payments out over the individual beneficiary's life expectancy. The solution to this dilemma is to pay out the Salvation Army's interest by September 30 of the year following the year of death. By doing so, you will negate the "no designated beneficiary" rule and get you back to the original intention of paying out the children's IRA benefits based on their life expectancies.

**(iii) Death After RBD – Result.** Another dilemma is that each child was expecting to be paid out over his life expectancy. This can only happen if the single IRA is subdivided into separate accounts, one for each child, by December 31 of the year after Vlad's death. Otherwise, all the children must use the oldest child's life expectancy for the distribution calculation.

**(iv) Result.** If Vlad dies after his RBD and the Salvation Army isn't paid by the September 30 deadline, the outcome probably won't be as bad, but it's still not great. The distribution to the children can still be made over a life expectancy period, but that period will be the remaining life expectancy of *Vlad*, not the children. To correct this and get the results back in line with Vlad's desires and the children's expectations, the person in charge has to be sure to get the Salvation Army its \$1 million IRA distribution by the September 30 deadline and subdivide the accounts by the following December 31.

**(b) Name the Charity in the EP Document.** Many planners prefer to centralize and simplify the estate plan by running all bequests through the decedent's estate or revocable trust and simply name the estate or trust as the IRA beneficiary. Then, neither the owner nor the planner have to monitor the IRA account with the idea of changing the IRA beneficiary designation as the owner's planning thoughts change or his IRA account value changes. So, in Vlad's case, he could simply name the Salvation Army as a specific legatee under his revocable trust in the amount of \$1 million and then name as his IRA beneficiary his Revocable Trust. Upon Vlad's death, the trustee will not receive a distribution of \$1 million in IRA funds to then transfer to the charity (thereby triggering tax to the trust under Code § 408(d)(1)), but, instead, assigns the right to \$1 million to the Salvation Army.

(i) Assume first that the planner didn't specify in the Revocable Trust that the IRA funds are to be specifically used to fund the Salvation Army's benefit.

**Result:** Vlad's trust will be liable for the income tax on the Salvation Army's \$1 million IRA distribution and cannot offset it with a distribution deduction, thereby trapping the income tax liability within the trust. CCM 2006-44020 holds that funding a pecuniary bequest by the trustee triggers income recognition to the trust by reason of § 691(a)(2). The trustee might argue that the charity is acquiring the IRA by right under the terms of the revocable trust, and the trust gives the fiduciary the right to use the IRA to fulfill the bequest. The trustee's argument is based on the second sentence in § 691(a)(2) (" 'transfer' does not include...a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent"). IRS counters that where the fiduciary has an available choice of assets to use, the beneficiary has acquired an **amount**, not a **specific asset**, and the amount is coming from the trust through exercise of the trustee's discretionary powers, not by bequest from the decedent. Under the facts presented, that will be a winning argument. And to add further injury to the outcome, no charitable deduction is allowed to the trust. Code §§ 651(a)(2) and 663(a)(2) deny a distribution deduction for any distribution to a charity. This outcome reduces the amount payable to the residuary beneficiaries.

**Lesson to Planners:** If you fall into this approach, consider a special income tax clause to allocate the income tax liability back to the charity (but which in turn reduces the estate tax charitable deduction).

(ii) Now, assume that under the terms of Vlad's trust, his IRA must be used first to fund whatever charitable bequests are included in the trust. For example, "I give to the Salvation Army \$1 million and, if I have named the trustee of this trust as beneficiary of any IRA that I may own at my death, I direct my trustee to first utilize amounts in any such IRA to satisfy this bequest." Treas. Reg. § 1.691(a)-4(b)(2) says that if the right to receive IRD is transferred by an estate or a trust to a specific legatee, only the specific legatee includes the IRD item in gross income. The language in the trust requires the IRA to be used to fund the bequest, making the bequest a specific bequest that implicates the regulation and pushes the income tax liability on the IRA distribution back to the (tax-exempt) charity where it belongs, to the advantage of all of the estate beneficiaries.

(iii) What if the only asset available in the trust was the trust's right to the IRA? In this case, a stronger argument can be made that the beneficiary is receiving the IRA "by bequest, devise or inheritance from the decedent." (Code § 691(a)(2), second sentence). With no other asset available, it appears that decedent knew at the time of his death that there were no other assets, and he was looking specifically to the IRA to fund the bequest. Therefore, there would be no taxable event to the trust, and the Salvation Army would be liable for the income tax.

(iv) If Vlad's attorney did not use a revocable trust as the keystone to the estate plan but was using a will for that purpose and named the estate as beneficiary, the same rules as described in (a) above (the 5-year rule for death before Vlad's RBD; the decedent's life expectancy to apply if death occurs after RBD) and in the (i)-(iii) would apply. But unlike the result in (a), paying out the Salvation Army by September 30 of the next year will not eliminate the "non-individual" as the designated beneficiary. Naming an estate as the beneficiary will trigger for the Salvation Army and Vlad's children the 5-year rule where death occurs before Vlad's RBD, or the fixed payout rule (based on Vlad's life expectancy in the year of his death if death occurs after his RBD).

(v) Vlad has come to believe his children don't need a significant chunk of money from his estate and now prefers to give them only a fixed amount (\$1 million each). The trouble is that his investments swing high and low in value and he won't know how much he might have at the time of his death. So he's going to give them each \$1 million and the rest he'll give to the Salvation Army. As it turns out, at his death his trust has enough non-IRA assets to pay the children their bequests, and the Salvation Army receives the IRA. Result: The § 691(a)(1) gateway is met, and the Salvation Army, as the residuary beneficiary, will shoulder the income tax burden on the IRA distribution. Treas. Reg. § 1.691(a)-4(b)(2).

**6. Example #2.** Ben Misbehaven owns a \$3 million IRA and other assets totaling \$4 million. His revocable trust uses a pecuniary marital formula that benefits his wife, attempting to minimize the estate tax burden to his family, but providing a limited right to benefits under his estate plan to his wife. He does not want to provide his wife with unlimited access to his IRA benefits, but, rather, wishes to set up a QTIP arrangement that utilizes all of his assets. His wife has significant property of her own. Ben's lawyer drafts the IRA beneficiary designation to name the trustee of the revocable trust as the beneficiary because of the centralized management of the entire trust account. Doesn't this pose the same problems as Vlad faces with his pecuniary charitable bequest, leaving the revocable trust as taxable on the IRA benefits used to fund the marital trust?

(a) Based on CCM 2006-44020, that would appear to be the case. Ben's attorney is using an IRD item to fund a pecuniary bequest and the trustee has the discretion to use the IRD item to fund that bequest. Therefore, the trust should be taxed on the IRA immediately upon the transfer of its interest to the marital trust under § 691(a)(2). Of course, this could be avoided by changing the marital bequest to a fractional formula bequest. Or as was done in Vlad's case, Ben's lawyer could draft the trust to say that the IRA must be used first to fund the marital share.

(b) Even if Ben's lawyer is not so careful with his drafting, numerous Private Letter Rulings have been issued that allowed an estate or trust to transfer IRAs and qualified plan benefits, intact, to a spouse or marital trust under a pecuniary funding formula without triggering tax to the estate or trust under § 691(a)(2). In many of those rulings, the spouse was allowed to roll over the benefits to an IRA, even though payable to the estate or trust and

divisible under a pecuniary marital formula, without recognition of income by the transferor. [Note: In every case, the spouse was acting as the sole personal representative or sole trustee with significant discretionary authority to select the assets to fund the trust.] *E.g.*, PLR 200705032.

## **G. NAMING TRUSTS AS BENEFICIARIES.**

**1. Outright Beneficiary.** Certainly if the IRA owner's goals are to achieve convenience and simplicity, naming a beneficiary outright under the IRA beneficiary designation will work. And the vast majority of IRA owners will do just that. Yet many issues arise (even with the smallest of estates) when the beneficiary is selected outright.

(a) Pre-printed, IRA custodian's forms offer little, if any, opportunity to vary the disposition scheme dictated by the terms of the form. Very few forms allow the designation of a specific dollar amount, requiring the owner to designate by percentage or fraction instead.

(b) Typically, no provision can be made for a named beneficiary who predeceases the owner but who is survived by children, leaving the children to inherit no portion of the IRA.

(c) No provision can be tailored to cover income tax liabilities that will arise from the distribution.

**2. Leaving Benefits in Trust.** For as many reasons as there are for establishing trusts to hold non-retirement account assets, IRA and QRP benefits can be, and should be, controlled by the owner's designated trustees of his or her inter vivos or testamentary trust.

(a) **Revocable Trust as the Keystone Document.** Revocable trusts are frequently the main document within the client's estate plan, and often the client wishes to funnel all assets through the revocable trust for ease of administration, for ease of lifestyle and ease of understanding. Accordingly, the planner needs to take into account the various complexities that are created by naming a trust as IRA beneficiary, including the distinction between principal and income, the fiduciary duty rules, and the minimum required distribution ("MRD") rules that apply to retirement benefits.

(b) **Funding the Credit Shelter Trust.** If the estate is large enough to be concerned with federal estate taxes, but the estate has insufficient non-retirement account assets to fund the trust, the planner may have to resort to using the IRA to fill up the shelter. The recent estate tax legislation increases the individual federal exemption to \$5 million and \$10 million per married couple. More important, portability of the unused exemption in the first estate means that the traditional bypass trust strategy will not be as prevalent in the estate plans, where the strategy is driven primarily by tax considerations. Nevertheless, non-tax considerations for the use of trusts are not imparted by the 2010 legislation.

(c) **Marital Trusts.** Marital trusts offer the same non-tax advantages over outright dispositions (except the bypass benefit) and, therefore, should be considered as IRA beneficiaries. However, if you are expecting to qualify the IRA benefits for the unlimited marital deduction (maybe less of a concern now), simply naming the marital trust as the beneficiary of the IRA will not suffice. You may have to specially draft the marital trust to be sure that all income of both the non-retirement assets and the IRA are distributed (or distributable) to the spouse each year, and that the other marital deduction qualification rules are also met by the IRA. Typically, a well-drafted marital trust will ensure this. *See*, Rev. Rul. 2006-26 and Rev. Rule 2000-2. You might pay particular attention to Rev. Rul. 2002, where IRS stated that these requirements are satisfied with respect to a retirement benefit payable to a marital trust if (i) the marital trust document contains language giving the spouse the right to all of the income both from the trust and the retirement plan and (ii) the retirement plan document does not prevent the marital trust trustee from complying with the trust's provisions with respect to the retirement plan.

At the same time, the planner must take into account the definition of "income" for purposes of the marital deduction. Under the Florida Principal and Income Act (which adopted much of the 1997 Uniform Act), 10% of any MRD is treated as income and 90% is treated as principal. This arbitrary characterization was rejected by the IRS in Rev. Rul. 2006-26, basically because the 10% rule had no direct correlation to the actual income of any IRA account (except for possibly an IRA owned by a 95-year-old). Rather, the marital trust will qualify if it contains a specific direction that the trustee must pay the surviving spouse the income of any retirement plan payable to the trust. If it fails to do so, the trust may have to be modified unless it contains an acceptable definition of income that would supercede the 10% rule under Florida's UPIA.

(d) **Initial Thoughts Crafting the Beneficiary Designation.** Because QRP and IRA accounts are for many clients the most single valuable asset in the estate, it may be necessary to utilize all or a portion of the retirement benefits to fund the bypass trust where estate taxes are still a concern. Naming the revocable trust that includes a pecuniary marital formula may pose income tax problems to the trust. Instead, the planner should consider using either a fractional marital formula if, indeed, using a bypass trust is important within the estate plan, or name the bypass trust directly as the beneficiary of the retirement account. Another approach is to postpone that decision until the first spouse's death by providing in the beneficiary designation that the bypass trust is to take if the surviving spouse executes a qualified disclaimer. The problem with funding the bypass, of course, is that none of the retirement assets can be rolled over to an IRA, and the distribution term period will be limited to the oldest beneficiary's life expectancy (most often, the spouse).

(e) **Another Concern – the MRD Rules.** If you are considering any trust as the named beneficiary of retirement benefits, you must ask whether the trust as drafted will be considered a "designated beneficiary" under the MRD rules and, if not, over how long a time period can distribution be made following the participant's death. If retirement benefits are left to a "see-through" trust, then the trust will be disregarded and the beneficiaries of the trust will be looked to for the distribution term and installments made over the life expectancy of the

oldest trust beneficiary. If the trust does not qualify as a see-through trust, then the "no designated beneficiary" rules kick in, limiting the distributions to either a five-year period or the rest of the client's life expectancy.

**(f) What Does it Take to Qualify as a "See-Through Trust?"**

- (1)** The trust must be valid under state law.
- (2)** The trust must be irrevocable or will, by its terms, become irrevocable upon death.
- (3)** The beneficiaries must be identifiable from the trust instrument.
- (4)** Certain documentation must be provided to the plan administrator by October 31 of the year following death.
- (5)** All trust beneficiaries must be individuals (by September 30 of the year following death).

**(g) The More Troubling Issues with Trusts as Named Beneficiaries.** All of the beneficiaries must be identifiable by September 30 of the year following the year of death. However, it may be impossible to identify certain beneficiaries by that date. For example, powers of appointment that, if exercised, may include older beneficiaries and may be exercisable years in the future. A typical tax allocation clause may allocate estate taxes and/or income taxes to the retirement benefits, making the estate a beneficiary. The beneficiary determination date of September 30 of the year following death may save the trust, as long as the retirement benefit's share of taxes are paid by that date. Of course, this can be avoided by carefully drafting a clause prohibiting the distribution of retirement benefits to the estate or to any non-individual beneficiary. Note also that IRS favorably held that where there were no other assets available to pay estate taxes, the trust would still qualify as a see-through trust (PLR 2004-32027).

**(h) Planning for Disabled Beneficiaries.** Trusts may be useful when planning for disabled beneficiaries, especially those who rely on governmental assistance for their basic needs. If an IRA owner names his disabled child as the outright beneficiary, those benefits will be taken into account and may disqualify the child from receiving Medicaid or other governmental assistance. However, by designating a supplemental needs trust as the beneficiary, it may be possible to avoid that loss of governmental assistance. Under a recent Private Letter Ruling (PLR 2006-20025), IRS ruled that the disabled beneficiary's assignment of his inherited IRA to a 100% grantor trust that the child (through his guardian) created for the child's benefit, was not considered a transfer under § 691(a)(2) nor was it a sale or disposition of the IRA. Rather, because the trust was considered a "grantor trust" because the child created the trust and retained the right to income or principal without the consent of any adverse party (though the right to distribution was restricted in order to qualify the trust as a § (d)(4)(A) supplemental needs trust). The significance of this ruling is the fact that the

assignment to the grantor trust for the benefit of the designated beneficiary was a tax-neutral event. Such an assignment can be utilized when the IRA owner fails to designate a trust for the child's benefit as the beneficiary but, instead, names the child outright. Other trusts that should be considered in the case of a disabled beneficiary, where the objective is to qualify for need-based government benefit programs, are accumulation trusts, whereby immediately following the disabled beneficiary's death, the benefits are distributed immediately to living individuals (not a charity), or a trust accumulates IRA distributions but which gives the beneficiary (through the guardian) the right to withdraw all of the trusts principal at anytime.

## H. NON-SPOUSAL ROLLOVER RULES.

**1. Summary.** Prior to the Pension Protection Act of 2006 (PPA 2006), the Code permitted no one other than the participant and his or her surviving spouse to "roll over" his qualified plan account ("QPA") tax-free from one retirement plan to another. With enactment of PPA 2006 and new Code § 402(c)(11), a "designated beneficiary" other than the surviving spouse is permitted to transfer an inherited qualified retirement plan benefit (including 403(b) and 457(b)) *by direct rollover only*, into an "inherited" IRA newly created for that purpose.<sup>3</sup>

### 2. Basic Rules.

**(a) Generally, No Time Limit After Death - But . . . ?** Any nonspouse designated beneficiary can transfer his or her inherited benefits to an inherited IRA after 2006 regardless of how long ago his or her benefactor dies, subject to a special rule (described later) if the inherited benefits are subject to the 5-year rule for purposes of calculating MRD.

**(b) Transferee "Inherited IRA."** The inherited plan account (or, at least, the designated beneficiary's share of that account) must be rolled into an "inherited" IRA that is created for the purposes of receiving the rollover. § 401(c)(11)(A); Notice 2007-7, Part V (first paragraph). The inherited IRA must have the same (deceased) "owner" and beneficiary as the originally inherited plan, and must be titled to indicate it is an inherited IRA, *e.g.*, "Tom Smith as beneficiary of John Smith" or "John Smith, owner, f/b/o Tom Smith." Notice 2007-7, A-13. Whether this newly-created inherited IRA can then later be merged with another inherited IRA in the name of the same participant and beneficiary is an open question for now.

**(c) Only "Designated Beneficiary(ies)" May Effect Rollover (and See-Through Trust Qualifies).** The rollover-to-an-inherited-IRA option is available *only* for nonspouse "designated beneficiaries," which is defined in the same manner as for the minimum distribution rules of Code § 401(a)(9). A "designated beneficiary" is an *individual* who inherited the benefits on the participant's death under the terms of the participant's beneficiary designation form or under the terms of the plan. The law also specifies that the IRS is to provide rules whereby a trust maintained for the benefit of one or more designated beneficiaries

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<sup>3</sup> See § 402(c)(11), added to the Code by § 8290(a)(1) of PPA 2006. The new rule applies to 403(b) plans and 457 plans as well as qualified plans. PPA 2006 § 829(a)(2)-(4).

is treated as a designated beneficiary for this purpose. Code § 402(c)(11)(B). Notice 2007-7, A-16, confirms that for now "see-through trusts" (only) will qualify for this purpose (*see*, Reg. § 1.401(a)(9)-4, A-5(b)).

**(d) Only Eligible Rollover Distributions After Death?** The new rule applies only to *post-death* distributions. If the participant took a distribution *prior* to death, then died before rolling it over, the executor may complete the rollover. Section 402(c)(11) has no effect on that situation. As in all other rollover situations, MRDs are not eligible for rollover.

**(e) Direct Rollover Only.** Section 402(c)(11) allows the nonspouse beneficiary rollover to occur **only** by means of a trustee-to-trustee transfer (what the IRS calls a "direct rollover") from the plan to the "inherited" IRA. Code § 402(c)(11)(A). If the plan makes the distribution check *payable to the beneficiary*, instead of *to the IRA*, then the distribution is taxable and rollover of the distributed funds cannot take place. Notice 2007-7, A-11.

### **3. Minimum Distribution Rules Applying to Nonspouse Rollovers.**

**(a) Purpose of the New Rule.** Deferral of tax-favored retirement accumulations cannot last forever; the MRD rules of § 401(a)(9) set the outer limits of deferral. When the original owner of the plan dies, the MRD rules general require that the benefits must be paid out in annual installments over the life expectancy of the designated individual beneficiary. Under the Code, that is the *slowest* rate at which the benefits can be paid out after the owner's death; nothing in § 401(a)(9) prevents a plan from paying out or requiring payment of the benefits more rapidly. In short, plans are not required to offer the beneficiary the option of a life expectancy payout, and many qualified retirement plans do *not* offer the life expectancy payout for death benefits. Rather, they offer a single lump sum distribution as the only form of death benefit. This is obviously for the convenience of the plan administrator, since plans do not want the expense and trouble of administering an employee's retirement plan account after the employee has dies.

However, this common plan policy created an unfortunate situation for many nonspouse beneficiaries. The Code says the beneficiary can take the benefits out gradually over his or her life expectancy, but the plan won't allow him or her to do that. Prior to PPA 2006, there was nothing the beneficiary could do about this situation, other than take a fully taxable immediate lump sum and pay the tax (at a high or the highest marginal rate), because the law did not allow a nonspouse beneficiary to rollover inherited plan benefits into another retirement plan. The purpose of added § 402(c)(11) was to allow beneficiaries who were entitled under the law to a life expectancy payout to actually *get* that life expectancy payout, even if the inherited plan offered only a lump sum payout, by transferring the inherited plan to an "inherited" IRA. We'll see if IRS actually views it that way.

**(b) What MRD Rules Apply After the Rollover?** Section 402(c)(11)(A) provides that the transferee plan "shall be treated as an inherited individual retirement

account... for purposes of this title" and that "section 401(a)(9)(B) (other than clause (iv) thereof) shall apply to such plan." Section 401(a)(9)(B) contains all the post-death MRD rules; the excluded clause (iv) deals with benefits payable to a surviving spouse. It would thus appear under the new Code provision that the minimum distribution rules are to be applied *ab initio* to the transferee "inherited" IRA. The report of the Joint Committee on Taxation supports this interpretation.

However, the IRS, in Notice 2007-7, A-19, provides exactly the opposite of what Congress provided: "The rules for determining the required minimum distributions *under the [originally inherited] plan* with respect to the nonspouse beneficiary also apply *under the [transferee "inherited"] IRA*. Thus, if the employee dies *before* his or her required beginning date and the 5-year rule in § 401(a)(9)(B)(ii) applied to the nonspouse designated beneficiary...the 5-year rule applies for purposes of determining required minimum distributions under the IRA." [Emphasis added.] If this rule is applied literally, the benefits of PPA 2006 will be denied to many of the people it was intended to help.

(c) **The Applicable MRD Rules.** The MRD rules that apply to a nonspouse designated beneficiary are different depending on whether the participant died before or after his required beginning date (RBD).

(i) **Death After the RBD: No Problem.** If the participant died *on or after* the RBD, the Distribution Period ("DP") is the life expectancy term of the beneficiary, or, if longer, what would have been the life expectancy term of the deceased participant. Reg. § 1.401(a)(9)-5, A-5(a)(1). A beneficiary who inherits a plan from someone who died on or after his RBD can transfer the inherited plan benefits (other than that year's RMD) to an inherited IRA. MRDs from the inherited IRA will continue to be based on the life expectancy of the designated beneficiary (or the life expectancy of the participant if longer). The inherited plan might require a lump sum distribution of the benefits, and is perfectly entitled to do so; but the *minimum required distribution* under the law (as opposed to the distribution options under the plan document) is based on the life expectancy of the beneficiary (or of the participant, if longer).

(ii) **Death Before the RBD: A Problem.** As noted above, when death occurs on or after the RBD, there is only one possible DP for benefits payable to a designated beneficiary. The same is true *under the Internal Revenue Code* when the participant dies *before* the RBD – there is only one possible DP, namely, the life expectancy of the designated beneficiary. Code § 401(a)(9)(B)(iii).

However, the IRS regulations do not follow the Code. The IRS's regulations substantially modify the Code's MRD rules in several ways and this is one of them. Under the IRS regulations, there are *two* possible MRD schemes for benefits payable to a designated beneficiary when death occurs before the RBD. One calls for annual distributions over the designated beneficiary's life expectancy term. The other

calls for complete distribution by the end of the calendar year that contains the fifth anniversary of the date of death. Reg. § 1.401(a)(9)-3, A-1.

Taxpayers usually want to avoid the 5-year rule. But Notice 2007-7 says if the 5-year rule applied under the transferor plan, it will apply under the transferee IRA as well, even if the beneficiary qualifies as a "designated beneficiary." Thus, you generally cannot "shed" the 5-year rule and switch to a life expectancy payout under the transferee/inherited IRA.

Under the Code, the 5-year rule applies *only* when there is no designated beneficiary. Under the regulations, the 5-year rule can apply even when benefits are left to a designated beneficiary. This can happen in one of three ways:

(A) The plan can provide that the 5-year rule always applies in cases of death before the RBD, regardless of whether there is a designated beneficiary. Reg. § 1.401(a)(9)-3, A-4(b).

(B) The plan can give the beneficiary the right to choose between the 5-year rule and the life expectancy payout, and the beneficiary chooses the 5-year rule. Reg. § 1.401(a)(9)-3, A-4(c), first sentence.

(C) The plan gives the beneficiary the right to choose between the 5-year rule and the life expectancy payout, and provides that the default rule (if the beneficiary fails to elect otherwise by a certain deadline) is the 5-year rule. Reg. § 1.401(a)(9)-3, A-4(c), fourth sentence.

If the 5-year rule is triggered in any one of those three ways, then the plan's MRDs for that benefit are determined under the 5-year rule, and (according to A-19 of Notice 2007-7) the 5-year rule carries over to the inherited IRA.

**(d) Limited Circumstances to Avoid 5-Year Rule.** According to IRS's informal clarification issued in early 2008, Notice 2007-7 does allow *some* beneficiaries who are subject to the 5-year rule to change the life expectancy payout. In those cases, the beneficiary may determine the MRD using the life expectancy rule in the case of a rollover distribution that is made prior to the end of the year following the year of death. In order to use this rule, the MRD under the transferee IRA must also be determined under the life expectancy rule using the same designated beneficiary. Notice 2007-7, A-17(c)(2) ("Special Rule").

If the only other requirement for using the Special Rule is that the MRD for the year after the year of death be determined using the life expectancy method, then we are left with at least three possible situations, each of which will have its problems:

(i) **Rollover in the Year of Death – Issue Remains.** If the rollover is accomplished in the year of death itself, how does the beneficiary fulfill the condition of determining the distribution under the plan for the *final year* using the life

expectancy method? There won't be any MRD under the plan in the following year if the entire plan is distributed in the year of death! One commentator suggests delaying the distribution until the year after the year of death so as to be able to fulfill the requirement, if it is a requirement, that the beneficiary compute the plan MRD for the year after the year of death using the life expectancy method.

**(ii) Rollover in Year After Year of Death – No Problem.** The most nearly clear situation for the Special Rule arises when the rollover occurs in the year after the year of the participant's death. In that year, it appears that the IRS's intent is that the beneficiary would (1) take a distribution from the plan equal to or greater than the amount of the MRD for such year, computed as if MRDs under the plan were based on the beneficiary's life expectancy, then (2) instruct the plan to send the rest of the benefit, by plan-to-plan transfer, to the inherited IRA in the same year. In subsequent years, MRDs from the IRA will be determined using the life expectancy of that beneficiary.

**(iii) Rollover in Later Years – Ineffective.** A beneficiary will be subject to the 5-year rule if he does not effect the rollover by the end of the year after the year of the employee's death – regardless of whether he or she took life expectancy-based "MRDS" from the plan every year before then.

#### **4. When the Beneficiary Rollover Helps (Or Doesn't).**

**(a) Helpful.** Despite the defects of Notice 2007-7, the following beneficiaries can use a nonspouse beneficiary rollover under § 402(c)(11) to transfer inherited plan benefits to an "inherited IRA," and can use the life expectancy payout method for the "inherited IRA":

**(i)** Any designated beneficiary (including see-through trust) that inherits from a participant who died on or after his RBD; and

**(ii)** Any designated beneficiary (including see-through trust) that inherits from a participant who died before his RBD, where *either* MRDs under the plan are determined under the life expectancy payout method *or* the benefits under the plan are subject to the 5-year rule but the rollover occurs in the year after the year of the participant's death or (presumably) in the same year as the participant's death.

#### **(b) No Help.**

**(i) An Estate or Non-See-Through Trust Cannot Use § 402(c)(11).** Section 402(c)(11) does not allow an estate or non-see-through trust to transfer plan benefits left to such estate or trust into an "inherited" IRA payable to the estate or trust.

(ii) **An Estate Cannot Use § 402(c)(11) to "Fix" a Defective Beneficiary Designation.** Section 402(c)(11) cannot be used by the personal representative of the decedent's estate to "create" a designated beneficiary when there is no designated beneficiary.

(iii) **A Nonspouse Beneficiary Still Cannot Roll Over Benefits to His or Her Own Plan.** A nonspouse beneficiary still is not allowed to roll over inherited benefits to the beneficiary's *own* plan. Code § 402(c)(9), Code § 408(d)(3)(C).

(iv) **The Spouse Is Left Out.** Section 402(c)(11) applies only to nonspouse beneficiaries. That doesn't hurt because the surviving spouse as beneficiary has even more options under other provisions of the Code, so § 402(c)(11) would add nothing to the spouse's arsenal of options. The Code and regulations clearly establish the surviving spouse's right to roll over inherited plan benefits to his or her own IRA. The IRS (in private letter rulings) has also long recognized the surviving spouse's right to transfer inherited plan benefits to an IRA *in the name of the decedent*. See, e.g., PLRs 9418034, 9842058, 2004-50057, and 2006-08029. Interestingly, in none of these PLRs did the IRS specify that the same MRD rules that applied to the inherited plan also applied to the "beneficiary IRA" into which the spouse transferred the benefits. In fact, it appears probable that in some of these rulings the spouse was doing the transfer just to escape the 5-year rule that might otherwise have applied to the plan benefit.

## 6. Implications for Planners.

(a) Rollover option is now expanded to include nonspouse beneficiaries. Planners need to take this into account when developing the estate plan.

(b) Practitioner should compare ERISA protection against state law creditor protections. The only available transferee plan is an IRA. That brings into play the erosion of creditor protection described earlier in this outline, and a focus on the various states' laws.

(c) The planner must also account for the client's desire for each of administration and enhanced investment options through an IRA that might not be available to the QPA.

## I. SPECIAL CONSIDERATIONS FOR SPOUSES.

### 1. Spouse's Rights in Separation or Divorce.

(a) **Marital Property.** Florida Statute § 61.075(b)(a) provides that pension rights are "marital property" to the extent they were acquired during the marriage, even if unmatured or even non-vested at the time the matrimonial action began. Therefore, those benefits are subject to equitable distribution between the spouses in any matrimonial action

between the two. Prior to 1984, judicial determinations awarding the non-participant spouse a portion of the participant's benefits posed a serious dilemma to plan fiduciaries. Generally, ERISA prohibits the assignment or alienation of a participant's benefits during his/her lifetime, other than in limited situations.<sup>4</sup> On the other hand, the plan administrator's failure to abide by the parallel tax-qualification rule of Code § 401(a)(13) (the anti-assignment, anti-alienation rule) disqualifies the plan and transfers immediate income tax to all participants on their vested benefits.

**(b) QDRO Exception.** Recognizing the need to remove the Catch 22 facing plan fiduciaries who were thrust in the middle of participant matrimonial actions, Congress in 1984 provided an explicit statutory exception for payments under a domestic relations order that meets several "qualification" rules ("QDRO"). Under this exception, the plan must make payment of the benefits pursuant to the QDRO, and any such payment will not violate ERISA's general anti-alienation rule.<sup>5</sup>

**(c) Qualified DROs.** Code § 414(p) defines a QDRO as any domestic relations order that creates or recognizes the right of an alternate payee (a spouse, former spouse, child or other dependent of the participant) to a portion of a participant's benefits and that meets certain other requirements. The order, to be qualified, must clearly specify:

**(i)** the name and last known mailing address (if any) of the participant and each alternate payee;

**(ii)** the amount or percentage of the participant's benefit to be paid to each alternate payee, or the manner in which such amount or percentage is to be determined;

**(iii)** the number of payments or period to which the order applies;<sup>6</sup>  
and

**(iv)** each plan to which the order applies.

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<sup>4</sup> ERISA § 206(d)(1). Involuntary transfer resulting from enforcement of federal levies, fines and tax judgments do not violate the anti-alienation rule. *Treas. Reg. § 1.401(a)-13(b)*; *U.S. v. Sawaf*, 74 F.3d 119 (6<sup>th</sup> Cir. 1996); *U.S. v. Tyson*, 242 F. Supp.2d 469; (E.D. Mich. 2003); *U.S. v Garcia*; 2003 U.S. Dist. LEXIS 20151 (D.C. Kan. 2003). Involuntary assignment to repay a plan for fiduciary breach or other liability arising from a fiduciary's criminal behavior affecting the plan is permissible (ERISA § 206(d)(4)).

<sup>5</sup> Code §414(p); ERISA §206(d)(1). Judgments related to the marital action allowing an award for payment of related attorneys' fees).

<sup>6</sup> See *Belfer v. Zee*, 166 F.3d 1204 (3rd Cir. 1998); There, a property settlement incorporated in a divorce decree required the participant to designate his children as beneficiaries but did not specify if payment would be made to them if he retired and began receiving his benefits. The court held the decree did not adequately specify the timing of payments and therefore did not qualify as a QDRO.

(d) **Other Rules.** A domestic relations order is not qualified if:

(i) it requires a plan to provide a type or form of benefit, or any option, not provided under the plan;

(ii) it requires the plan to provide increased benefits (determined on the basis of actuarial value); or

(iii) it requires payments to an alternate payee which are required to be paid to a different alternate payee under a previous QDRO.

(e) **Some Options to Consider.** A QDRO may provide that a former spouse shall be treated as the participant's surviving spouse for purposes of the QJSA and/or QPSA rules. In addition, a QDRO may provide that payments to the alternate payee begin on the date on which the participant attains the "earliest retirement age" under the plan, even if the participant has not yet retired. Earliest retirement age is defined as the earlier of (i) the date the participant is entitled to a distribution, or (ii) the later of the date the participant attains age 50 or the earliest date he could begin to receive benefits if he separated from service. Distribution may be made to an alternate payee before the participant's earliest retirement age if the plan allows it.<sup>7</sup>

In any such case, payments are to be computed as if the participant had retired on the date on which the payments are to begin, but the calculation of the benefits shall only take into the account the present value of the benefits actually accrued at that time, without regard to the value of any actuarial subsidy provided for early retirement benefits. The discounted present value is to be calculated using the interest rates specified in the plan, or if no rate is specified, 5%.

(f) **Notice and Procedural Requirements.** Once a domestic relations order has been issued and received by the plan, the plan administrator is required to notify any alternate payee of the plan's procedures for determining the qualified status of the domestic relations order. The plan administrator must then determine whether the order is in fact qualified and notify the participant and each alternate payee of that determination.

(g) **Separate Accounting.** During the pendency of a domestic relations order's review, the plan administrator must separately account for but need not segregate all amounts that would be payable to the alternate payee during such period if the order had been determined to be a QDRO. If within 18 months following the first date on which payments would be made the order is determined to be QDRO, the separately accounted for amounts, plus interest, are to be paid to the persons entitled under the QDRO. If it is determined not to

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<sup>7</sup> Staff, Joint Committee on Taxation, Explanation of Technical Correction to the Tax Reform Act of 1984 and Other Recent Tax Legislation 228 (1987); see also U.S. Department of Labor, "The Division of Pensions Through Qualified Domestic Relations Orders" (1997), Q&A 3-10.

be qualified, or the issue is not resolved, within that 18-month period, the segregated amounts are to be paid to the persons who would be entitled to it under the terms of the plan.

**(h) Income Tax Effects.**

**(i) Transfer to (Former) Spouses.** QDROs have become a very convenient device for the transfer of plan benefits to a spouse without the participant incurring the income tax effects of a normal distribution. Code § 402(e)(1)(A) provides that a spouse or former spouse who receives amounts pursuant to a QDRO will incur the income tax liability attributable to those benefits paid. Distributions pursuant to a QDRO may be eligible for rollover to an IRA. Code § 402(3)(1)(B). The early distribution tax will not apply to distributions to a spouse pursuant to a QDRO. Code § 72(4)(2)(C).

**(ii) Transfer to Others.** Payments to a non-spouse alternate payee are taxed as if received by the participant. However, the interest of any alternate payee in the plan is not taken into account in determining whether a distribution to the participant is a lump sum distribution. Code § 402(1)(4)(4).

**(i) Discharge of QDRO in Bankruptcy.** Under the theory that a QDRO is a "debt" subject to discharge under Chapter 7 of the Bankruptcy Code, participants have attempted to avoid the QDRO obligation by filing for bankruptcy, but to no avail. The QDRO, once accepted by the plan administrator, becomes the obligation of the *plan*, not the participant, and therefore is not dischargeable in the participant's bankruptcy. *Adkins v. Adkins*, 675 So.2d 199 (Fla. 1<sup>st</sup> DCA 1996).

**(j) Division of IRAs.** In contrast to § 401(a) tax-qualified plans and non-governmental § 403(b) annuities, neither ERISA Title I nor Code § 414(p) apply to IRAs. Consequently, IRAs are not divisible under the QDRO rules described above. Instead, Code § 408(d)(6) provides that an individual may avoid income taxes on the transfer of his/her interest in an IRA, provided the transfer is to a spouse or former spouse (only) under the terms of a court decree of divorce or separate maintenance, or under a written instrument incident to the court's decree. Once made, the transferred interest is considered owned by the transferee spouse. According to the IRS, only one of four acceptable methods may be used to effect the transfer:

**(i)** change the name on the account to the spouse's name (if all of the account is being transferred);

**(ii)** direct the IRA trustee/custodian to transfer the affected assets to the trustee/custodian of the recipient spouse's IRA;

**(iii)** split the IRA account into two portions, one holding assets to be retained and the other for assets to be transferred, and change the name on the second account to the spouse's name; or

(iv) distribute the assets to be transferred to the IRA owner, who rolls the assets within 60 days to a new IRA established in the spouse's name (subject to the "one rollover per year" rule) under Code § 408(d)(3)(B). *See*, IRS Publication 590.

## 2. Competing Beneficiaries.

### (a) In Marital Action: Effect of Pre-Nuptial Agreements.

(i) The statutory consent rules that apply to ERISA-covered plans described above are particular in their requirements – consent is given by a spouse; the consent is to a particular beneficiary being named by the participant (with an exception for a clear and express general waiver); the spouse's consent acknowledges its effect on the spouse's rights; and it is witnessed by a notary public or a plan representative. The courts have almost universally denied enforcement of antenuptial agreements that deprive the surviving spouse of survivor's benefits, finding that one or more of the waiver/consent requirements was lacking – principally, the requirement that the consent must be by the participant's spouse. (By definition, the signatories are not yet spouses.) *See*, Reg. § 1.401(a)-20, Q&A 28, which expressly states the agreement cannot act as a waiver; *Zinn v. Donaldson Co. Employees Retirement Savings Plan*, 799 F. Supp. 69 (D. Minn. 1992).

(ii) In the context of divorce, however, the courts have been willing to enforce the terms of a prenuptial agreement because the rights addressed in divorce are "ex-spouse's" rights, not "spousal" rights. *In Re Marriage of Rahn*, 1995 WL 478464 (Colo. App. 1995).

**(b) In Marital Action: Does Waiver of Benefits in Divorce Control Over ERISA Rights?** A common scenario is this: The divorce is finalized, and either the divorce decree or separation agreement states that the non-participant spouse (in a qualified plan context) waives all rights to the participant's benefits, except for what the parties agreed to (or the court allocates). After the divorce, the participant fails to change the beneficiary designation on his QRP. Will the beneficiary designation control over the ex-spouse's waiver of benefits under the divorce decree/property settlement agreement? A split exists among the Circuit Courts. In some courts, a divorce decree or settlement agreement the subject of a court decree that does not qualify as a QDRO will not operate as a waiver of pension benefits. *Krishna v. Colgate Palmolive Co.*, 7 F.3d 11 (2<sup>nd</sup> Cir. 1993). *See, also, McMillan v. Parrott*, 913 F.2d 310 (6<sup>th</sup> Cir. 1990); *Reardon v. E.T. Dupont De Nemours and Co.*, 1998 U.S. App. LEXIS 7573 (6<sup>th</sup> Cir. 1998). In those cases, ERISA's requirement that the plan be operated in accordance with the documents and instruments governing the plan (including the honoring of valid beneficiary designations) controls. Other Circuits hold that a spouse may effectively waive benefits through specific language in a divorce decree, regardless of its compliance with QDRO rules. *See, Estate of Altobelli v. IBM*, 77 F.3d 78 (4<sup>th</sup> Cir. 1996); *Fox Valley & Vicinity Const. Workers Pension Fund v. Brown*, 897 F.2d 275 (7<sup>th</sup> Cir. 1990); *Lyman Lumber Co. v. Bill*, 877 F.2d 692 (8<sup>th</sup> Cir. 1991).

(c) **In Marital Actions: Does a Waiver of Benefits in a Divorce Decree or Separation Agreement Control With Respect to IRAs?** What is different here is that IRAs are governed by state law, not ERISA. Florida courts have had difficulty in coming to a uniform position, reflecting the competing and equally compelling arguments. In its first ruling on the issue, the Second District Court of Appeal held that an ex-wife, who remained the designated beneficiary of her ex-husband's IRA after a divorce decree had been entered, retained no rights in her ex-husband's IRA. The settlement agreement between the two included her release of all claims against her ex-husband and his estate and an acknowledgment that the settlement agreement superceded any prior understanding or agreement between the parties. The court found this determinative of the issue. *Vaughan v. Vaughan*, 741 So.2d 1221 (Fla. 2<sup>nd</sup> DCA 1999).

Two years later, that same court, in an *en banc* opinion, retreated from that position and held that the IRA constitutes a contract with choate rights held by the designated beneficiary that attach upon the owner's death and that do not arise through the owner's estate. According to that opinion, the existence of general releases and waivers of benefits under a separation agreement or divorce decree will not alter the beneficiary designation "unless the IRA owner was required to designate a particular beneficiary as a condition of a dissolution of marriage." *Luszczy v. Lovoie*, 787 So.2d 245 (Fla. 2<sup>nd</sup> DCA 2001).

Yet, while that may appear straight-forward enough, the Fourth District Court of Appeal implied (though did not hold expressly) that where a separation agreement or divorce decree specifically references IRA proceeds, the designated beneficiary's general waiver of rights and releases of claims in a separation agreement may be sufficient to deny the designated beneficiary the IRA benefits. *In re Estate of Bellinger*, 760 So.2d 1016 (Fla. 4<sup>th</sup> DCA 2000).

(d) **Marital Action: Can an Ex-Spouse's Rights to a Participant's Pension Benefit be Negated by a Subsequent Marriage?** Generally, QDROs may provide that a second spouse will have no spousal QPSA or QJSA rights, or it may limit those rights to benefits accrued after the first divorce, or to benefits other than those payable to the ex-spouse. However, if the ex-spouse fails to obtain an effective QDRO by the time the working spouse remarries and retires, those rights may be lost to the second spouse. *See, Hopkins v. AT&T Global Information Solutions Co.*, 105 F.3d 153 (4<sup>th</sup> Cir. 1997).

Lesson for Practitioners: During the negotiations toward a separate agreement, or in the course of the proceeding toward a divorce decree, determine between the parties who will prepare the QDRO, prepare it, obtain the order, and file it with the plan administrator immediately. Do not linger.

(e) **Will a State Nullification Law Alter the Result?** Absolutely not with respect to ERISA-covered plans. *Egelhoff v. Egelhoff*, 53 U.S. 141 (2001). As to IRAs and other non-ERISA covered plans, each state's courts will have to determine its validity. Florida's nullification statute only applies to wills and trusts, but not to retirement accounts or

life insurance policies (as pointed out by the 4<sup>th</sup> District Court of Appeal in *Luszczy v. Lovoie*, *supra*).

**(f) Death Benefits: Will A Pre-Nuptial Agreement Control Over Spousal Rights to Deny the Spouse Death Benefits Under an ERISA-Covered Plan?**  
Absolutely not. See ¶2(a)(i) above.

Suggestion to Planner: Nevertheless, to get around the negative impact to the estate plan, the attorney should consider including in the pre-nuptial agreement the spouse's agreement to execute the necessary consent after the marriage. Although courts will generally not enforce the spouse's undertaking (based on ERISA pre-emption of state law and state law actions for breach of contract, fraud, etc.), perhaps a set-off mechanism within the agreement will suffice, to take effect if the spouse fails to execute the consent after the marriage. *See, Burch v. George*, 866 P.2d 92 (1994).

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