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## THE TAXATION OF DISTRIBUTIONS FROM QUALIFIED EMPLOYEE BENEFIT PLANS

*Louis A. Mezzullo\**

### I. INTRODUCTION

One of the most confusing aspects of employee benefit plans is the federal tax treatment of distributions to the participants of these plans and to the beneficiaries of deceased participants. The issues frequently involve not only income taxation, but estate and gift taxation as well. While the average practitioner may never be called upon to draft a pension or profit-sharing plan, he may be asked by his client about the consequences of the various alternative methods of receiving a benefit from such a plan. Many employee benefit plans, particularly profit-sharing plans, offer a participant upon his retirement from the plan or upon his separation from employment a choice of a lump sum distribution, installment payments or some form of annuity. A participant's choice will affect his tax liability, and the wrong advice to the client may be costly. The attorney who does not specialize in the area of employee benefit plans may also discover that in drafting a will or establishing an estate plan some knowledge of the tax treatment of distributions from these plans is necessary. As more employees participate in employee benefit plans, and as more employees are faced with a choice as to the method of distribution at retirement, the attorney can expect more requests for advice in this matter.

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Many larger employers offer employees some guidance as to the tax consequences of the various methods of receiving their benefits. Notwithstanding that this guidance cannot and should not pass for legal advice, its value is questionable because each recipient will have a different tax situation. Most small employers will not give such guidance, especially since they may not wish to incur any liability if the "guidance" turns out to be wrong. Banks, savings institutions, insurance salesmen, accountants and others will be asked for and may offer advice as to the tax consequences of distributions from employee benefit plans. However, none of these individuals or institutions is in a position to render legal advice. Thus, the attorney should be the one who advises a person expecting to receive a benefit from a qualified plan as to the tax consequences of the various alternatives which may be available.

## II. LUMP SUM DISTRIBUTIONS

### A. *Definition*

Lump sum distributions are payments of the balance to the credit of an employee from a qualified plan.<sup>1</sup> The distribution or payment must take place within one taxable year of the receipt thereof. To

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1. INT. REV. CODE OF 1954, § 402(e)(4)(A). A qualified plan for purposes of lump sum distributions includes plans qualified under sections 401(a) and 501(a) of the Internal Revenue Code of 1954 and plans described under section 403(a). Section 401(a) of the Code relates to stock bonus, pension and profit-sharing plans. Section 403(a) of the Code relates to qualified employer annuity plans (other than plans purchased by charitable organizations and public schools).

Throughout this article, references will be made to "pension" plans and "profit-sharing" plans. A pension plan (a defined benefit plan) provides for a benefit at retirement age, usually a monthly payment based on some formula, for example, a percentage of earnings times years of service with the company. A profit-sharing plan (a form of defined contribution plan) provides for the payment of an account balance in a lump sum to the participant at some point in time or a series of payments to the participant beginning at some point in time. The account balance is the result of employer contributions, employee contributions, if any, forfeitures of those participants leaving the company before they had a 100% vested right to their account balance, and earnings, gains, expenses, and losses attributable to the account balances. Another form of defined contribution plan is a money purchase plan which requires contributions to the plan by the employer of a specified percentage of the participant's compensation each year, for example, ten percent.

It should be noted that the proposed regulations would deny lump sum treatment to the entire amount distributed from a trust not exempt under 501(a). Proposed Treas. Reg. § 1.402(b)-1(c). In *Greenwald v. Commissioner*, 366 F.2d 538, 541 (2d Cir. 1966), the court of appeals held that the portion of the distribution attributable to years during which the trust was qualified should be entitled to capital gain treatment.

qualify as a lump sum distribution, payment must occur (i) on account of the employee's death; (ii) after the employee attains age 59½; (iii) on account of the employee's separation from service<sup>2</sup> or (iv) after the employee has become disabled.<sup>3</sup> A self-employed person<sup>4</sup> cannot receive a lump sum distribution before he attains age 59½ unless he is disabled.<sup>5</sup> A common law employee<sup>6</sup> can receive a lump sum distribution after he becomes disabled only if the plan provides for separation from service because of such disability.<sup>7</sup> A distribution under an annuity contract<sup>8</sup> is a lump sum distribution, but only for purposes of computing the initial separate tax<sup>9</sup> imposed on lump sum distributions, and any tax attributable to an annuity is deducted from the separate tax.<sup>10</sup>

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2. INT. REV. CODE OF 1954, § 402(e)(4)(A)(iii). What constitutes a "separation from the service" has been the subject of frequent litigation in the courts.

3. *Id.* § 402(e)(4)(A)(iv). Disability is to be determined under section 72(m)(7) of the Code. That section states:

(7) MEANING OF DISABLED.—For purposes of this section, an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual should not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary or his delegate may require.

4. A self-employed person is defined in section 401(c)(1) of the Code as an individual who has earned income as defined in section 401(c)(2) of the Code. Earned income, generally speaking, is income from a trade or business in which the personal services of the individual are material income-producing factors. A sole proprietor and a partner in a partnership (with some exceptions) are self-employed persons.

5. In other words, a self-employed person is not entitled to lump sum distribution treatment on account of his separation from service (assuming he is not over 59½ or disabled). INT. REV. CODE OF 1954, § 402(e)(4)(A) (flush language).

6. A common law employee is any person who is employed by another, and would not include independent contractors or self-employed persons.

7. INT. REV. CODE OF 1954, § 402(e)(4)(A) (flush language). In other words, a common law employee is not entitled to lump sum treatment on account of disability, but, as stated above, can receive such treatment if he separates from service, regardless of his age. Most employee benefit plans do provide for separation from service (usually referred to as "retirement") when an employee becomes disabled.

8. An annuity contract is defined under section 1035 of the Code as a contract with a life insurance company which may be payable during the life of the annuitant only in installments. INT. REV. CODE OF 1954, § 1035(b)(2).

9. *Id.* § 402(e)(4)(A) (flush language). For an explanation of the separate tax see text accompanying notes 62-82 *infra*.

10. *Id.* § 402(e)(2)(B). The annuity payments will be taxed under section 72 of the Code. Generally, if the pension or profit-sharing plan did not provide for employee contributions, the entire amount paid each year to the recipient would be taxed as ordinary income. If the employee contributed to the plan, the exclusion ratio of section 72(b) would apply and a

The language of the Code permits a distribution to an employee who has attained age 59½ to be taxed as a lump sum distribution even though the employee continues to be employed by the employer maintaining the plan;<sup>11</sup> however, the Internal Revenue Service (IRS) has taken the position that in order to qualify as a lump sum distribution, the employee receiving such a distribution must be retired.<sup>12</sup> This position is based on a regulation adopted under section 401 of the Code prior to the enactment of the Employee Retirement Income Security Act of 1974 (ERISA).<sup>13</sup> The regulation and the statement of policy both refer to pension plans.<sup>14</sup> The IRS is advising taxpayers that distributions to employees who have attained age 59½ will not be considered as lump sum distributions regardless of the type of plan<sup>15</sup> if the employee continues to work for the company that maintained the plan.<sup>16</sup> The unambiguous language of the statute,<sup>17</sup> as well as the committee reports,<sup>18</sup> would seem to mandate a different result. There may be some strained logic to the concept that a "pension" plan only should provide "retirement"

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portion of the annuity payments would be considered a return of the employee's investment in the contract. A special provision applies when the part of the annuity contract considered as the employee's investment is recoverable in three years. In such a case, there is no taxable income until such amount has been recovered by the employee. *Id.* § 72(d).

11. *Id.* § 402(e)(4)(A)(ii).

12. Technical Information Release 1403, September 17, 1975, question M-15.

13. Treas. Reg. § 1.401-1(b)(1)(i) (1976), which reads:

A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement.

*Id.* (emphasis added).

14. See notes 12-13 *supra*.

15. In conversations with the Richmond District Office, the writer has learned that the IRS will allow lump sum treatment for distributions made from profit-sharing plans to an employee over age 59½ even though the employee has not left the service of the company, provided the plan does permit such distributions.

16. There is no problem in having distributions qualify as lump sum distributions if they are made to a recipient who is currently employed by a company other than the company that maintained the plan with respect to which the distribution is being made.

17. INT. REV. CODE OF 1954, § 402(e)(4)(A)(ii).

18. The House conference report states:

The conference substitute also follows the House bill in permitting a distribution to an employee (common-law definition of an employee) after he attains age 59½ to be treated as a lump-sum distribution entitled to the special averaging and partial capital gain treatment, even though the recipient has not left his employment.

H.R. CONF. REP. No. 1280, 93d Cong., 2d Sess., 1974 U.S. CODE CONG. AND ADMIN. NEWS 5038, 5128.

benefits,<sup>19</sup> but any concern on the part of the IRS for the preservation of the public treasury should be eased by the restriction to one election with respect to a lump sum distribution after age 59½.<sup>20</sup>

A distribution to an employee will not qualify as a lump sum distribution unless the employee has been a participant in the plan for at least five full taxable years preceding the employee's taxable year in which the distribution or payment is made.<sup>21</sup> However, a distribution, otherwise qualifying as a lump sum distribution, made to the employee's beneficiary on account of the employee's death, will receive favorable treatment regardless of how long the deceased employee was a participant in the plan.<sup>22</sup> The five-year rule does not affect the capital gain treatment of the amount of distribution attributable to pre-1974 service,<sup>23</sup> though the rule may apply to some rollover transfers.<sup>24</sup> It is clear that a distribution on account of a termination of a plan or discontinuance of contributions may be transferred under the rollover provisions tax-free regardless of the length of time the employee participated in the plan from which the distribution is made.<sup>25</sup> Any other distribution, however, must qualify as a lump sum distribution to receive tax-free treatment if the amount is transferred to another qualified plan or Individual Retirement Account (IRA).<sup>26</sup> It should be noted that although one of the requirements for treatment as a lump sum distribution is the five-year participation rule,<sup>27</sup> it can be argued that the five-year rule should apply only to the ten-year forward averaging provision.<sup>28</sup>

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19. There may be other reasons for permitting distribution from profit-sharing plans (*i.e.*, financial hardship, educational needs, etc.).

20. INT. REV. CODE OF 1954, § 402(e)(4)(B).

21. *Id.* § 402(e)(4)(H).

22. *Id.* The Code refers to distributions to an employee.

23. *Id.*

24. For explanation of "rollovers" see Part III *infra*.

25. INT. REV. CODE OF 1954, § 402(a)(5)(A)(i). This provision does not require that the distribution to an employee qualify as a lump sum distribution in order to receive tax-free treatment if rolled over.

26. *Id.* § 402(a)(5)(A)(ii).

27. *Id.* § 402(e)(4)(H).

28. *Id.* § 402(e)(1). The basis of this argument would be that there is no purpose in hindering the portability provided by the rollover provision added by ERISA by requiring five years of participation. However, the language in section 402(e)(4)(H) of the Code clearly states that five years of participation in the plan are required for lump sum treatment, except for capital gain treatment, if the distribution is to an employee.

An additional requirement for lump sum treatment is that the distribution to the recipient must constitute the balance to the credit of the employee at the time the distribution commences.<sup>29</sup> However, if an employee begins receiving benefits (such as annuity payments) and dies before his entire interest has been distributed, the beneficiary receiving the deceased employee's remaining portion may be able to treat the amount received as a lump sum distribution.<sup>30</sup> If an employee receives the entire amount then credited to his account, and an additional amount is later credited to his account because of current or future service, the original distribution will still qualify as a lump sum distribution, as will a future distribution of the new amount.<sup>31</sup> A United States Retirement Bond retained by the trust will not disqualify an otherwise qualifying lump sum distribution.<sup>32</sup> The proceeds of a retirement bond plan will not be treated as a lump sum distribution.<sup>33</sup> Incidental amounts used to fund medical benefits may also be retained.<sup>34</sup> Finally, if a participant leaves the company and receives his vested interest in his account, any amount forfeited at the close of the plan year beginning with or within the taxable year of the recipient will not be considered part of the balance to the credit of his account.<sup>35</sup>

### B. *Elections*

The recipient of a lump sum distribution must elect to treat all amounts received during the taxable year of the receipt as a lump sum distribution.<sup>36</sup> Only one such election can be made after an individual attains age 59½,<sup>37</sup> and only individuals, estates and

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29. *Id.* § 402(e)(4)(A).

30. Proposed Treas. Reg. § 1.402(e)-2(d)(1)(ii)(B).

31. *Id.* The distribution must constitute the balance to the credit of the employee at the time the distribution or payment commences.

32. *Id.* § 1.402(e)-2(d)(1)(iv).

33. *Id.*

34. *Id.* § 1.402(e)-2(d)(1)(vi).

35. *Id.* § 1.402(e)-2(d)(1)(vii). Therefore, if the employee leaves the service of the company and receives a distribution of the amount of his vested (nonforfeitable) interest in his account, but does not incur a break in service under the plan (generally a break in service is a year in which an employee works less than 501 hours), and the forfeitable amount in his account is not forfeited at the end of his taxable year in which the distribution was made because he did not have a break in service, lump sum treatment will not be available for the distribution of his vested interest.

36. INT. REV. CODE OF 1954, § 402(e)(4)(B).

37. *Id.*

trusts may make such elections.<sup>38</sup> Therefore, a partnership or corporation is not entitled to lump sum distribution treatment. If the distribution is made to two or more trusts (*e.g.*, a marital and family trust), the election is to be made by the personal representative of the decedent employee.<sup>39</sup> The election must be made before the expiration of the period (including extensions of the period) for making a claim for credit or refund of the federal income tax for the taxable year in which the distribution was received (generally three years from the time the return for that year was filed, or two years from the time the tax for that year was paid, whichever is later). The election is made by filing Form 4972 (or Form 5544) as a part of the taxpayer's income tax return or amended return for the taxable year. The election is revocable within the period described above, and another election may be made during the same period.<sup>40</sup> Such an election will cause any annuity contract distributed after December 31, 1973, and during a look-back<sup>41</sup> period beginning after such date, to be treated as a lump sum distribution in the taxable year of the recipient when the contract was distributed.<sup>42</sup>

The decision whether or not to elect to receive lump sum distribution treatment is an important one. Unless the employee with respect to which the distribution or payment is made was self-employed at any time during his participation in the plan, the capital gain treatment will be applied automatically.<sup>43</sup> The employee may be covered under more than one plan and, if he has reached age 59½, he has only one opportunity to elect to have the ten-year forward averaging provision applied to a distribution from one of the plans.<sup>44</sup> Probably he would desire to have the ten-year forward averaging applied to the largest distribution which will be made. Because the recipient can revoke his election during the period described above, he may opt to have the first distribution or payment treated as a lump sum distribution for purposes of the ten-year forward averaging provision and later, after receiving a subsequent

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38. *Id.*

39. *Id.*

40. Proposed Treas. Reg. § 1.402(e)-3(c)(3).

41. See text accompanying notes 83-87 *infra* for an explanation of the "look-back" rule.

42. Proposed Treas. Reg. § 1.402(e)-3(c)(4).

43. INT. REV. CODE OF 1954, § 402(a)(2).

44. *Id.* § 402(e)(4)(B).



distribution from another trust or plan, decide to revoke his earlier election. Failure to make an election will cause the amount that represents the ordinary income portion of the distribution to be treated as ordinary income.<sup>45</sup> This may be a more advantageous choice in a year in which the employee has a substantial loss.<sup>46</sup> More frequently, however, the inclusion of the distribution as ordinary income in the gross income of the recipient will cause a "bunching of income." The recipient is always entitled to use the regular averaging provisions of sections 1301 and 1305.<sup>47</sup> This regular five-year averaging can be used even if the special ten-year forward averaging is used for the ordinary income portion of the distribution. Because it is not necessary to make an election to have the capital gains portion treated as such for income tax purposes (unless the recipient was a self-employed person),<sup>48</sup> capital gains treatment after age 59½ will apply regardless of whether or not an election has been made. Also, there is no limit to the number of elections which can be made prior to age 59½. However, the look-back rule will have a bearing on the decision to elect ten-year forward averaging.<sup>49</sup>

Section 1512<sup>50</sup> of the Tax Reform Act of 1976 gives the recipient-taxpayer the option to elect to have all calendar years of an employee's active participation in all plans in which such employee has been a participant treated as years of active participation after December 31, 1973. The total amount of any lump sum distribution made in conjunction with or subsequent to such an election would be treated as the ordinary income portion of a lump sum distribution and would be eligible for the ten-year forward averaging tax treatment. If such an election is made, all lump sum distributions from any plan will be treated in the same manner, and capital gain

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45. *Id.* § 402(e)(3) (by implication). That section allows a deduction equal to the ordinary income portion of a lump sum distribution in the taxable year to the extent such amount is included in the recipient's gross income. If the distribution is not a lump sum distribution, it would be taxed as ordinary income.

46. In order to benefit from a loss, the taxpayer must have offsetting income. Even if he carried over the loss to a subsequent year, it is usually advisable to obtain the lowest tax possible in the current taxable year.

47. INT. REV. CODE OF 1954, §§ 1301-05. Generally, the amount of taxable income in excess of 30% of the total taxable income for the past four years is taxed as if received ratably over the five-year period ending in the year of receipt.

48. INT. REV. CODE OF 1954, § 402(a)(2).

49. See text accompanying notes 83-87 *infra*.

50. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1512(a) [hereinafter cited as Act].

treatment will be unavailable. The election is irrevocable and cannot be exercised if the taxpayer has received a lump sum distribution after the effective date of this provision without utilizing the election.<sup>51</sup> The taxpayer is forced to make an irrevocable decision which will preclude capital gain treatment for all distributions from qualified plans in the future. Because the election only applies to distributions on behalf of an employee with respect to which the distribution is being made, a taxpayer who is receiving a distribution as a beneficiary of a deceased employee may still decide not to make the election for distributions from his own plan or plans even though he makes the election for the distribution from the deceased employee's plan. Once an individual reaches age 59½, he has only one election to have the ordinary income portion taxed under the ten-year forward averaging provision. If he also decides to use this new provision, all future distributions will be taxed as ordinary income without the benefit of the ten-year forward averaging treatment.<sup>52</sup>

### C. Capital Gains Treatment

A portion of a distribution which qualifies as a lump sum distribution may be entitled to long-term capital gain treatment.<sup>53</sup> The

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51. *Id.* § 1512(b). The provision is effective for payments and distributions after December 31, 1975, in taxable years beginning after that date.

52. Another provision of the Act relating to the taxation of lump sum distributions is contained in the amendment to section 1348 dealing with the maximum tax. Lump sum distributions do not qualify as personal service income under section 1348 of the Code, as amended by the Tax Reform Act of 1976. Act § 302(a); INT. REV. CODE OF 1954, § 1348(b)(1)(B)(i). Other payments from qualified employee benefit plans, such as pensions or annuities, will be treated as personal service income. Act § 302(a); CODE § 1348(b)(1)(A). These provisions are effective in taxable years beginning after December 31, 1976. Act § 302(d). Therefore, a lump sum distribution, even though it is not entitled to be taxed under the ten-year forward averaging provision, will not receive the favorable fifty percent maximum tax that other payments from employee benefit plans may receive that are otherwise included in the taxpayer's taxable income for the year.

53. INT. REV. CODE OF 1954, § 402(a)(2).

The advantages in receiving capital gain treatment have been substantially diminished by the Tax Reform Act of 1976, at least for many taxpayers. The change in the minimum tax provision will cause many taxpayers to fall under this tax. Whereas, prior to the tax years beginning after December 31, 1975 the minimum tax was a 10% tax on tax preference items that exceeded the sum of \$30,000 plus the regular tax liability and any carryovers from the previous 7 years; the new provision provides for a 15% tax on all tax preference items in excess of a greater of \$10,000 or ½ the regular tax liability with no carryovers from prior years. Tax

portion receiving capital gains treatment is determined by multiplying the total taxable amount of the distribution by the ratio of the number of calendar years of active participation by the employee in the plan before January 1, 1974, to the total number of calendar years of active participation by the employee in the plan.<sup>54</sup> Only individuals, estates or trusts are eligible for capital gain treatment.<sup>55</sup> The regulations provide that those calendar years of active participation will be calculated using the number of calendar months during the period beginning with the first month in which the employee becomes a participant under the plan and ending with the earliest month in which either the employee receives a lump sum distribution under the plan, separates from service, dies or receives a lump sum distribution on account of disability.<sup>56</sup>

In computing months of service of active participation, a part of a calendar year before January 1, 1974 is counted as twelve months, and part of a calendar month after December 31, 1973 is counted as one month.<sup>57</sup> Thus, service before 1974 is given greater weight, thereby increasing artificially the capital gain portion of the lump sum distribution. It should also be noted that the total taxable amount is divided between the capital gain portion and the ordinary income portion on the basis of service and not on the basis of contributions to the plan during the pre-1974 period as opposed to the post-1973 period. This fact also increases artificially the capital gain portion of the lump sum distribution because it is probable that the amount of contributions in post-1973 years apportionately will be higher than pre-1974 years because of inflation and regular salary advances.

No election is required to have the capital gain portion taxed as capital gains, except in the case of self-employed persons.<sup>58</sup> The Code refers to "an individual who is an employee without regard to sections 401(c)(1)," <sup>59</sup> whereas the regulations refer to "an individual

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preference items include ½ of capital gains, accelerated depreciation, excess amortization and other items described in section 57 of the Code. Act § 301, *amending* INT. REV. CODE OF 1954, §§ 56-58.

54. INT. REV. CODE OF 1954, § 402(a)(2).

55. *Id.*

56. Proposed Treas. Reg. § 1.402(a)-1(a)(9).

57. *Id.* § 1.402(e)-2(d)(3)(ii).

58. INT. REV. CODE OF 1954, § 402(a)(2).

59. *Id.*

who at no time during his participation under the plan is an employee within the meaning of section 401(c)(1)."<sup>60</sup> The regulations seem to controvert the meaning of the Code in stating that the status of the employee is to be determined at the time of distribution. Any participation as a self-employed individual in the plan with respect to which the lump sum distribution is made will mean that the participant must elect lump sum treatment for the entire distribution under section 402(e)(4)(B) in order to obtain capital gain treatment for the pre-1974 portion. This forced election can be a burdensome restriction because the self-employed person cannot receive a lump sum payment before age 59½ unless he is disabled, and he only has one election after age 59½.<sup>61</sup>

#### D. *Ten-Year Forward Averaging*

The recipient of a lump sum distribution may elect to have the ordinary income portion of the distribution taxed under section 402(e).<sup>62</sup> This tax is referred to as the "separate tax."<sup>63</sup> The ordinary income portion is allowable as a deduction from gross income to the extent that it is included in the gross income of the taxpayer for that year.<sup>64</sup> The separate tax is added to the tax otherwise imposed on the recipient with respect to his other income. The separate tax applies to distributions or payments made, or made available, to the recipient after December 31, 1973, in taxable years of the recipient beginning after that date.<sup>65</sup> The election to use the benefits of the separate tax does not preclude the recipient from using the five-year income averaging provisions on the other income he received during the year.<sup>66</sup>

The separate tax on a distribution which is not considered a multiple distribution<sup>67</sup> and does not include an annuity contract<sup>68</sup> is determined as follows. The taxpayer first determines the initial sep-

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60. Proposed Treas. Reg. § 1.402(a)-1(a)(9).

61. INT. REV. CODE OF 1954, § 402(e)(4)(A),(B).

62. *Id.* § 402(e).

63. *Id.* § 402(e)(1)(A).

64. *Id.* § 402(e)(3).

65. Proposed Treas. Reg. § 1.402(e)-2(a)(1).

66. *Id.*

67. See text accompanying notes 83-87 *infra* for treatment of multiple distributions.

68. See text accompanying notes 75-82 *infra* for treatment of annuity contracts.

arate tax.<sup>69</sup> This amount is equal to ten times the tax which would be imposed on one-tenth of the total taxable amount reduced by the minimum distribution allowance, using rates for single taxpayers. The minimum distribution allowance is the lesser of \$10,000 or one-half of the total taxable amount, reduced by twenty percent of the excess of this amount over \$20,000.<sup>70</sup> The amount of the minimum distribution allowance reduces the total taxable amount. The remainder is then divided by ten and is taxed at the single taxpayer rate. This amount, the tax on one-tenth, is then multiplied by ten. Finally, the initial separate tax is reduced by a fraction, the numerator of which is the ordinary income portion and the denominator of which is the total taxable amount.<sup>71</sup> The separate tax is added to the tax on the other income of the recipient for purposes of determining his total tax liability for that year. The income otherwise taxed would include one-half of the amount treated as a capital gain.<sup>72</sup> Also, the income otherwise taxed could be averaged under the averaging provisions.<sup>73</sup>

Several observations should be made concerning the separate tax. It is a separate tax in the sense that the recipient's tax rate on his other taxable income has no bearing upon the tax rate used in computing the separate tax. The minimum distribution allowance, a means by which a small distribution either escapes tax altogether

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69. INT. REV. CODE OF 1954, § 402(e)(1)(C).

70. *Id.* § 402(e)(1)(D).

71. For an example of how the separate tax is computed, assume a distribution to A on December 22, 1976, qualifying as a lump sum distribution for a profit-sharing plan in the amount of \$65,000. The plan provided for voluntary contributions, and A is considered to have contributed \$15,000 of the total amount. A was an active participant in the plan since February 20, 1966. A has not previously received a distribution of an annuity contract from a qualified plan nor a lump sum distribution since January 1, 1974.

The total taxable amount would be equal to \$50,000 (\$65,000 less the \$15,000 considered contributed by A). The capital gain portion would be equal to 4/5 of the total amount (96 months/120 months) or \$40,000, and only one-half of this would be added to A's other income for the year.

The minimum distribution allowance with regard to A's distribution would be \$4,000 [\$10,000—\$6,000 (\$50,000—\$20,000 = \$30,000; \$30,000 x 20% = \$6,000)]. The initial separate tax in A's distribution is ten times the tax imposed on one-tenth of \$46,000 (\$50,000—\$4,000) and would be \$8,160 (\$816 x 10). This amount is multiplied by the ordinary income portion, 1/5 (24 months/120 months), to determine the separate tax which would be \$1,632. [Note, the single taxpayer tax on \$4,600 (1/10 of \$46,000) is \$816.]

72. INT. REV. CODE OF 1954, § 1202.

73. *Id.* §§ 1301-05.

or is subject to a reduced tax, completely disappears after the total taxable amount reaches \$70,000.<sup>74</sup>

The computation becomes more complicated when the recipient receives an annuity contract as part of the lump sum distribution.<sup>75</sup> In such a case, the so-called adjusted separate tax<sup>76</sup> is further reduced by the tax that is attributable to the annuity contract.<sup>77</sup> The method of calculating the adjusted total taxable amount differs for taxable years beginning before January 1, 1975, and those beginning after December 31, 1975. In post-1974 years, the current actuarial value of the annuity distributed is reduced by the excess, if any, of the net amount contributed by the employee over the cash and other property which is distributed.<sup>78</sup> Once the current actuarial value of the contract has been reduced, this amount is added to the total taxable amount of the lump sum distribution for the taxable year to arrive at the adjusted total taxable amount.<sup>79</sup> The adjusted initial

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74.  $\$70,000 - \$20,000 = \$50,000$ ;  $20\% \times \$50,000 = \$10,000$ ;  $\$10,000 - \$10,000 = 0$ . See note 73 *supra*.

75. INT. REV. CODE OF 1954, § 402(e)(2).

76. The adjusted separate tax is an amount equal to the adjusted initial separate tax multiplied by the ordinary income portion fraction (see note 71 *supra* and accompanying text). Proposed Treas. Reg. § 1.402(e)-2(c)(1)(ii)(A).

77. Proposed Treas. Reg. § 1.402(e)-2(c)(1)(i).

78. *Id.* § 1.402(e)-2(c)(1)(ii)(C)(2)(i). For example, if A is deemed to have contributed \$20,000 to a qualified plan, and receives a lump sum distribution of \$10,000 in cash and an annuity contract with a current actuarial value (determined under the regulations) of \$20,000, the current actuarial value of the contract would be equal to \$10,000. Practically speaking, the difference between the total taxable amount and the actuarial value of the annuity, where the amount contributed by the employee exceeds the cash and other property distributed, would be zero. In our example, the total taxable amount would be \$10,000 (*i.e.*,  $\$30,000 - \$20,000$ ). The net amount contributed by the employee is defined in proposed regulations section 1.402(e)-2(d)(2)(ii)(A) for taxable years beginning after December 31, 1974, as the amount actually contributed by the employee plus any amounts considered to be contributed by the employee under the rules of section 72(f) and 101(b), and paragraph b of treasury regulation section 1.72-16, reduced by any amounts theretofore distributed to him which were excluded from gross income as a return of employee contributions. Section 72(f) deals with amounts includible in the employee's gross income at the time of contribution to the trust, or amounts that would have been excluded from the gross income of the employee if paid to him instead of to the trust. Section 101(b) refers to the \$5,000 death benefit excludible from gross income of a beneficiary. Paragraph b of Treasury Regulation section 1.72-16 refers to life insurance contracts, and to amounts includible in the gross income of the employee because of the protection of such insurance. For taxable years beginning before January 1, 1975, there is a different rule. Proposed Treas. Reg. § 1.402(e)-2(d)(2)(ii)(B).

79. For example, if the current actuarial value of the annuity contract is \$20,000, and \$50,000 in cash is distributed along with the annuity (assuming no employee contributions), the adjusted total taxable amount would be \$70,000.

separate tax is calculated by multiplying by ten the tax, using the single taxpayer rate, on one-tenth of the adjusted total taxable amount minus the adjusted minimum allowance.<sup>80</sup> Once the adjusted initial separate tax is determined, it is multiplied by a fraction, the numerator of which is the ordinary income portion of the distribution and the denominator of which is the total taxable amount of the lump sum distribution.<sup>81</sup> The tax attributable to the annuity contract is then deducted from the adjusted separate tax to determine the separate tax.<sup>82</sup>

### E. Lookback Rule

If the payment or distribution is classified as a multiple distribution,<sup>83</sup> the total amount of payments or distributions in the "lookback period" are aggregated to calculate the modified separate tax.<sup>84</sup> The lookback period with respect to any recipient is a period of six consecutive taxable years ending on the last day of the taxable year of the recipient in which a payment or distribution is made which is considered a multiple distribution.<sup>85</sup> The separate tax imposed on

80. The adjusted minimum distribution allowance would be zero in the example in note 78 *supra*. It is determined in the same manner as the minimum distribution allowance, but using the adjusted total taxable amount rather than the total taxable amount.

81. See note 71 *supra*.

82. The tax attributable to the annuity contract is the product of (1) the quotient of the adjusted ordinary income portion of the lump sum distribution divided by the adjusted total taxable amount and (2) ten times the tax, at the single taxpayer rate, imposed on the excess of the current actuarial value of the annuity contract reduced by the adjusted minimum distribution allowance, multiplied by a fraction, the numerator of which is the current actuarial value of the annuity contract and the denominator of which is the adjusted total taxable amount. Proposed Treas. Reg. § 1.402(e)-2(c)(1)(iii).

For example, assume A receives a lump sum distribution on December 29, 1975, consisting of \$44,000 in cash and an annuity contract with a current actuarial value of \$6,000. The adjusted total taxable amount would be \$50,000. Assume that the ordinary income portion is 1/5. The adjusted maximum distribution allowance would be \$4,000 [ $\$50,000 - \$20,000 = \$30,000$ ;  $\$30,000 \times 20\% = \$6,000$ ;  $\$10,000 - \$6,000 = \$4,000$ ].<sup>1</sup> Therefore, the tax attributable to the contract would be computed as follows:  $\$6,000 - \$480$  ( $\$4,000 \times \$6,000/\$50,000$ ) =  $\$5,520$ ;  $\$5,520 \div 10 = \$552$ ; single taxpayer rate tax on  $\$552 = \$77.80$ ;  $\$77.80 \times 10 = \$778$ ;  $1/5 \times \$778 = \$156$ . This amount would be subtracted from the initial separate tax to compute the separate tax.

83. INT. REV. CODE OF 1954, § 402(e)(2). A multiple distribution simply means a distribution in more than one taxable year during the lookback period.

84. The modified separate tax is the tax computed as in note 71 *supra* but aggregating all previous distributions and annuity contracts distributed during the lookback period.

85. Proposed Treas. Reg. § 1.402(e)-2(c)(2)(ii)(F).

the latest payment or distribution in the lookback period is equal to the modified separate tax minus the sum of the aggregate amount of the separate tax imposed and paid during the lookback period and the modified tax attributable to any annuity contract distribution.<sup>86</sup> This rule has the effect of increasing the tax rate applied to all of the payments or distributions made during the lookback period and of decreasing the minimum distribution allowance.<sup>87</sup> Therefore, even if an annuity contract is the only property distributed in a taxable year of the recipient, and if there has been one or more previous payments or distributions during the lookback period, there will be a tax imposed on the distribution of the annuity. The tax would represent the increased rate applicable to all prior distributions plus the decrease in the minimum distribution allowance.

#### F. *Aggregation Rules*

In determining the balance to the credit of an employee which must be distributed to the recipient within one taxable year of the receipt to qualify as a lump sum distribution, special aggregation rules are applied. All trusts qualified under section 401(a), exempt under section 501(a) and part of a single plan, are treated as a single trust.<sup>88</sup> Therefore, distributions from plans having more than one trust must include all amounts in each trust credited to the distributee's account. Also, all pension plans maintained by an employer are treated as a single plan, all profit-sharing plans are treated as a single plan and all stock bonus plans are treated as a single plan.<sup>89</sup> Annuity contracts are considered as trusts for purposes of special aggregation rules.<sup>90</sup> Trusts not qualified under section 401(a) or exempted under section 501(a), and annuity contracts not satisfying the requirements of section 403(a) are not aggregated.<sup>91</sup>

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86. See note 82 *supra*.

87. The rate is increased because of the progressive increase in the tax rate applied to one-tenth of the modified total taxable amount. The modified minimum distribution allowance is decreased because of the fact that 20% of the excess over \$20,000 reduces the \$10,000 maximum allowance. As the excess approaches \$50,000, the modified minimum distribution allowance approaches zero.

88. *Id.* § 1.402(3)-2(e)(1)(i)(A).

89. *Id.*

90. *Id.*

91. *Id.* § 1.402(e)-2(e)(1)(i)(B).



Amounts distributed under such nonqualified plans are not treated as lump sum distributions in any event.<sup>92</sup> For purposes of aggregation, a money purchase plan is treated as a defined benefit pension plan.<sup>93</sup> Where a distribution consists of amounts from two or more plans and are aggregated under the above rules, the ordinary income portion is to be computed by aggregating all of the amounts that would constitute the ordinary income portion of a lump sum distribution if each plan were treated separately.<sup>94</sup>

### G. *Multiple Recipients*

Often the distribution from an employee benefit plan will be made to more than one individual or to one or more trusts upon the employee's death. The proposed regulations denied lump sum treatment to a distribution to more than one individual, except where the employee himself was treated as the recipient because of some other tax theory, such as assignment of income.<sup>95</sup> The conference committee reports supported the IRS in this regard.<sup>96</sup> However, the IRS retreated from this position in a subsequent decision.<sup>97</sup> The Service indicated that the final regulations would permit a distribution made to more than one recipient to be treated as a lump sum distribution (under certain circumstances).<sup>98</sup> The entire amount paid or distributed will be aggregated for purposes of determining the separate tax due on the ordinary income portion of the distribution.<sup>99</sup> Each recipient will then be liable for the portion of the total separate tax allocated to him according to the percentage of the total payment or distribution that he received.<sup>100</sup> Each recipient may make the election to obtain the ten-year averaging benefit, even though one or more of the other recipients do not so elect.<sup>101</sup>

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92. These plans are not "qualified" in the sense that they do not receive favorable tax treatment under the Code.

93. Proposed Treas. Reg. § 1.402(e)-2(e)(1)(iii), *Example (2)*.

94. *Id.* § 1.402(e)-2(e)(1)(ii).

95. *Id.* § 1.402(e)-2(d)(1)(iii).

96. H.R. CONF. REP. No. 1280, 93d Cong., 2d Sess., 1974 U.S. CODE CONG. AND ADMIN. NEWS 5038, 5128.

97. Technical Information Release No. 1426, December 15, 1975. This release can be found in CCH TAX CT. REP. ¶ 6277.

98. *Id.*

99. *Id.*

100. *Id.* Form 5544 (Multiple Recipient Special Ten-Year Average Method) is the form used for computing the tax on a lump sum distribution to more than one recipient.

101. *Id.*

## H. *Liability for Tax*

If the payment or distribution is made to two or more trusts and the beneficiary of any one of the trusts is not treated as the sole recipient, the separate tax on the ordinary income portion is computed as if the distribution were made to a single recipient.<sup>102</sup> The liability for the tax thus computed is prorated.<sup>103</sup> For purposes of the look-back rule, separate taxes imposed in each of the prior years on each trust receiving a portion of the distribution are aggregated.<sup>104</sup> This total will then be deducted from the modified separate tax in arriving at the separate tax liability for the current lump sum distribution.<sup>105</sup>

Generally the recipient is liable for the separate tax imposed on ordinary income portions of the lump sum distribution. In cases in which the recipient of the lump sum distribution is a trust and the beneficiary of that trust is either an employee with respect to the plan under which the distribution is made,<sup>106</sup> or is treated as the beneficiary of that trust (a grantor-trust under sections 671-78),<sup>107</sup> the beneficiary is treated as the sole recipient of the lump sum distribution.<sup>108</sup> An employee with respect to the plan under which the distribution is made means an individual who, immediately before the distribution, is a participant in the plan under which the distribution is made.

## I. *Community Property Laws*

Community property laws are disregarded in determining the tax liability in a lump sum distribution<sup>109</sup> except in applying the deduction from gross income from the ordinary income portion of the lump sum distribution.<sup>110</sup> For example, if H and W live in a community property state, and H receives a lump sum distribution in which the ordinary income portion is \$10,000, they would report

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102. Proposed Treas. Reg. § 1.402(e)-2(e)(6)(ii)(B)(1).

103. *Id.*

104. *Id.* § 1.402(e)-2(e)(6)(ii)(B)(2).

105. *Id.*

106. *Id.* § 1.402(e)-2(e)(6)(ii)(A)(1).

107. *Id.* § 1.402(e)-2(e)(6)(ii)(A)(2).

108. *Id.* § 1.402(e)-2(e)(6)(ii)(A).

109. *Id.* § 1.402(e)-2(e)(2)(i).

110. *Id.* § 1.402(e)-2(e)(2)(ii).

\$5,000 on their respective returns as gross income assuming that they were filing separate returns. They would also be entitled to deduct \$5,000 pursuant to section 402(e)(3) from each of their gross incomes. H would be liable for the separate tax imposed on the \$10,000 ordinary income portion of the lump sum distribution pursuant to section 403(e)(1)(A).

### J. *Securities and Other Property*

The net unrealized appreciation of securities<sup>111</sup> of the employer corporation<sup>112</sup> which is part of a distribution may be entitled to tax deferral. For any distributions in taxable years ending before January 1, 1970, or distributions qualifying as lump sum distributions under section 402(e)(4)(A) after January 1, 1970,<sup>113</sup> the net unrealized appreciation will not be taxed at the time of distribution.<sup>114</sup> In all other cases, that is, for distributions in taxable years ending on or after January 1, 1970 that do not qualify as lump sum distributions, only the amount attributable to the amount considered to be contributed by the employee will be excused from taxation at that time.<sup>115</sup> The five-year participation rule is not applied in determining whether a distribution qualifies as a lump sum distribution for purposes of deferring tax on net unrealized appreciation of securities of the employer corporation.<sup>116</sup> The amount of gain excluded from income in the taxable year of the distribution or payment will be taxed as long-term capital gain at the time that the securities are sold by the recipient.<sup>117</sup> Under prior law, if the recipient died while he owned the securities, the securities would take a stepped-up basis under section 1014.<sup>118</sup> The step-up in basis at death was eliminated

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111. Securities are defined as only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form. INT. REV. CODE OF 1954, § 402(a)(3)(A).

112. Securities of the employer corporation include securities of a parent or subsidiary corporation of the employer corporation. INT. REV. CODE OF 1954, § 402(a)(3)(B). Net unrealized appreciation is the increase in value of securities after they are purchased by the trust. Such amount would normally be taxed as a capital gain at the time the securities were sold or exchanged (either short- or long-term, depending upon the holding period).

113. See Part II. A. *supra*.

114. Proposed Treas. Reg. § 1.402(a)-1(b)(1)(i)(A).

115. *Id.* § 1.402(a)-1(b)(1)(i)(B).

116. *Id.*

117. *Id.* § 1.402(b)(1)(i).

118. INT. REV. CODE OF 1954, § 1014. But see Revenue Ruling 75-125, which holds that the

by the Tax Reform Act of 1976.<sup>119</sup> If the securities should increase in value after the distribution to the recipient, the increase in value will be treated as a capital asset,<sup>120</sup> but the holding period for determining whether or not it will be a short- or long-term capital gain will date from the time of distribution.<sup>121</sup>

Except with respect to the security of the employer corporation, a distribution of property (other than an annuity contract) by a trust described in section 401(a) and exempt under section 501(a) will be treated as ordinary income at its fair market value.<sup>122</sup>

### III. ROLLOVERS

One of the unique features of ERISA is the concept of "rollover amounts." Congress provided for so-called rollovers from one qualified plan to another, or from a qualified plan to an IRA in order to give employees portability with respect to their benefits. Recognizing the high incidence of employee turnover in the American economy, it was felt that, under certain circumstances, distributions from employee benefit plans should be given continued favorable treatment so long as the amount was being retained for retirement purposes. Under prior law, it was possible to transfer the vested interest of an employee directly from one qualified trust to another, if properly done, without activating the constructive receipt doctrine.<sup>123</sup> This direct "rollover" was not always possible because many plans did not allow the trust to accept such rollovers, either by expressed terms, or more often by implication. Furthermore, many employees separating from service did not immediately become participants in another plan.

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appreciation represents income in respect of a decedent under section 691(a)(1) of the Code and, therefore, the securities would not receive a step-up in basis because of section 1014(c) of the Code. Rev. Rul. 125, 1975-2 CUM. BULL. 254. This analysis appears to be incorrect.

119. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2605(a).

120. Proposed Treas. Reg. § 1.402(a)-1(b)(1)(i).

121. *Id.* There will be no tacking on of the holding period of the trust that originally purchased the securities for purposes of determining whether the gain qualifies as a short- or long-term capital gain.

122. *Id.* § 1.402(a)-1(a)(1)(iii).

123. The constructive receipt doctrine holds that a taxpayer will be considered in receipt of income for tax purposes when the income is made available to him, whether he actually receives the income, unless some special exemption exists under the Code to defer taxation. Income is made available when there are no restrictions to the receipt of such income.

Sections 402(a)(5) and 402(a)(6) and the parallel sections 403(a)(4) and 403(a)(5)<sup>124</sup> are designed to facilitate portability. As amended by a 1976 act designed to correct an apparent oversight by the draftsmen of ERISA,<sup>125</sup> these sections do allow employees to carry their benefits from one qualified plan to another. An employee who receives the balance of his account in one of his taxable years from an employee's trust qualified under sections 401(a) and 501(a), or from an employee annuity qualified under section 403(a), under certain circumstances may roll over the amount into another qualified plan or an IRA. The distribution must either qualify as a lump sum distribution,<sup>126</sup> or result from the termination of the plan or a discontinuance of contributions to a profit-sharing or stock bonus plan. Because an election is not required under section 402(e)(4)(B), there is no limitation on the number of times an employee may utilize the rollover provisions.<sup>127</sup> The employee must transfer all of the property he received in the distribution to the IRA or the qualified plan before the 60th day after the day he received the distribution,<sup>128</sup> but only to the extent that the property distributed exceeds the amount considered to have been contributed by the employee.<sup>129</sup> The transfer must be made to either (i) an individual retirement account,<sup>130</sup> (ii) an individual annuity account (other than an endowment contract),<sup>131</sup> (iii) a retirement bond,<sup>132</sup> (iv) another employees' trust described in section 401(a) which is exempt from tax under 501(a)<sup>133</sup> or (v) an annuity plan described in section 403(a).<sup>134</sup> The amount transferred must consist of the same property distributed to the employee, except for cash and the amount considered contrib-

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124. Section 403(a) deals with qualified annuity plans.

125. There was no provision in the rollover sections that allowed for a tax-free rollover when the plan terminated but the employee continued to work for the company that had maintained the plan.

126. See Part II. A. *supra*.

127. INT. REV. CODE OF 1954, § 402(a)(5)(A)(ii). Recall that only one election under the special ten-year forward averaging provision can be made by a recipient of a lump sum distribution after he attains age 59 ½. See note 37 *supra* and accompanying text.

128. INT. REV. CODE OF 1954, § 402(a)(5)(B).

129. *Id.*

130. *Id.* § 408(a).

131. *Id.* § 408(b).

132. *Id.* § 409.

133. See note 1 *supra* and accompanying text.

134. See note 1 *supra*.

uted by the employee.<sup>135</sup> A rollover to an IRA is treated as a rollover contribution described in section 408(d)(3).<sup>136</sup> An employee who was self-employed within the meaning of section 401(c)(1) when contributions were made on his behalf under the plan may not utilize the rollover provision to transfer distributions to another qualified plan or employee annuity.<sup>137</sup> Such an employee may use the rollover provision for tax-free transfers into an IRA.

It should be noted that the five-year participation rule of section 402(e)(4)(H) applies to lump sum distributions,<sup>138</sup> but not to the balance of an employee's account distributed on account of termination of a plan (or a complete discontinuance of contributions under a profit-sharing or stock bonus plan).<sup>139</sup> Therefore, if a distribution is made for any purpose other than a termination of a plan or discontinuance of contributions, the rollover provision is not available unless the employee has been an active participant for at least five full taxable years of the employee before the taxable year in which the distribution is made.<sup>140</sup>

Before the 1976 Act,<sup>141</sup> a distribution on account of a termination of a plan or a discontinuance of contributions was not eligible for rollover treatment because the distribution was not a lump sum distribution.<sup>142</sup> Therefore, in the many cases when plans were terminated, frequently as a result of ERISA, the recipients were faced with unfavorable tax consequences. There are several other means of preventing the immediate imposition of income tax on the benefits of employees of terminated plans. The employer may leave the amounts in a wasting trust,<sup>143</sup> or insurance contracts may be distributed that qualify for deferred taxation.<sup>144</sup>

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135. INT. REV. CODE OF 1954, § 402(a)(5)(C).

136. *Id.* § 402(a)(5) (flush language).

137. *Id.*

138. See notes 21-28 *supra* and accompanying text.

139. INT. REV. CODE OF 1954, § 402(a)(5)(A)(i).

140. There is some indication that the Internal Revenue Service may not be enforcing the five-year participation rule for tax-free rollovers.

141. Pub. L. No. 94-267, *amending* INT. REV. CODE OF 1954, §§ 402(a), 403(a).

142. INT. REV. CODE OF 1954, § 402(e)(4)(A).

143. The plan would be "frozen" and no further benefits would accrue. Each participant would have a nonforfeitable right to his accrued benefit at the time of termination. The trust would retain its tax-exempt status and benefits would be paid to the participants according to the plan. A disadvantage would be the fact that the reporting requirements of ERISA would apply to such a trust. The trustees would still be under a fiduciary duty.

144. Treas. Reg. § 1.402(a)-1(a)(2) (1976).

The new law allowing rollovers in the case of terminated and discontinued plans provide certain transitional rules. The effective date of the law was set at July 4, 1974, sixty days before the enactment of ERISA.<sup>145</sup> Any recipient of a payment on account of a termination of a plan or discontinuance of contributions, from July 4, 1974, until November 2, 1976, may utilize the rollover provisions without regard to the sixty-day requirement for making the transfer.<sup>146</sup> After November 2, 1976, the sixty day period will apply to all types of distributions for which a rollover is to be effected.<sup>147</sup> Instead of transferring the entire amount of the distribution required to be transferred, (the part attributable to the employee's contribution cannot be rolled over), the employee may elect to transfer the net amount received after deducting the amount of tax imposed on the distribution.<sup>148</sup> The balance, representing the tax attributable to the distribution, must be transferred no later than thirty days after the date a credit or refund is allowed because of the amended return filed to take advantage of the tax deferment.<sup>149</sup> If property other than cash was received pursuant to a distribution on account of termination of the plan or discontinuance of contributions, and if the property so distributed was sold before the enactment of the Act (April 15, 1976), the transfer of an amount of cash equal to the proceeds from the sale or exchange of the property will qualify for rollover treatment.<sup>150</sup> No gain or loss will be recognized with respect to the sale or exchange of the property if the proceeds are transferred in accordance with sections 402(a)(5) or 403(a)(4).<sup>151</sup>

The new law also adds some clarity to the concept of the "time of termination" and expands the meaning of termination for purposes of the rollover provisions.<sup>152</sup> A complete discontinuance of contributions under a profit-sharing or stock bonus plan is deemed to occur on the day the plan administrator notifies the IRS that all contributions to the plan have been completely discontinued.<sup>153</sup> Dis-

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145. Pub. L. No. 94-267, ¶ (e).

146. *Id.* ¶ (d)(1)(A).

147. INT. REV. CODE OF 1954, § 402(a)(5)(B).

148. Pub. L. No. 94-267, ¶ (d)(1)(B)(ii).

149. *Id.*

150. *Id.* ¶ (d)(2).

151. *Id.* ¶ (d)(3).

152. INT. REV. CODE OF 1954, § 402(a)(6).

153. *Id.* § 402(a)(6)(A).

tributions in connection with the liquidation, sale or other means of terminating a parent-subsi-dary or controlled group of corporations' relationship, or in connection with the sale or other transfer of assets may be rolled over to an IRA or qualified plan if certain conditions are met.<sup>154</sup> An employee of the subsidiary or affiliate which is liquidated, sold or otherwise ceases to be a member of the controlled group of corporations<sup>155</sup> or an employee of a corporation that sells or transfers all of the assets used by the corporation in its trade or business<sup>156</sup> may rollover the distribution if the employees of the corporation sold or the corporation acquiring the assets are not active in the plan at the time of the distribution.<sup>157</sup> The distribution must take place no later than the end of the second calendar year after the calendar year in which occurs the sale or other transfer of assets, or the liquidation, sale or other means of terminating the parent-subsi-dary or controlled group relationship.<sup>158</sup>

Rollovers are also permitted from one IRA into another IRA<sup>159</sup> (other than an endowment contract), or into a retirement bond.<sup>160</sup> A rollover into a qualified trust or annuity plan from an IRA is permitted if the entire balance in the account consists of a previous rollover from a qualified plan or annuity plan and earnings of the initial amount rolled over, and no other amounts have been contributed to the account.<sup>161</sup> An employee who was self-employed within the meaning of section 401(c)(1) at the time the contributions were made on his behalf under the plan will not be able to use an IRA as a conduit into a qualified pension or annuity plan.<sup>162</sup> This is consistent with the prohibition on direct rollovers under sections 402(a)(5) and 403(a)(4) that applies to self-employed individuals.<sup>163</sup> Rollovers from one IRA into another are limited to one every three years, measured from the day of the receipt of the first distribution from

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154. *Id.* § 402(a)(6)(B).

155. *Id.* § 402(a)(6)(B)(i).

156. *Id.* § 402(a)(6)(B)(ii).

157. *Id.* § 402(a)(6)(B) (flush language).

158. *Id.*

159. *Id.* § 402(a)(5)(B)(i).

160. *Id.*

161. *Id.* § 408(d)(3)(A)(ii).

162. *Id.* See note 4 *supra* for the meaning of self-employed.

163. *Id.* §§ 402(a)(5)(B) (flush language), 403(a)(4)(B) (flush language).



an IRA.<sup>164</sup> This limitation does not apply to rollovers into qualified trusts or annuity plans.<sup>165</sup>

There are some disadvantages to rollovers into IRA's. Because distributions from IRA's cannot qualify as lump sum distributions, they are excluded from capital gain treatment and the ten-year forward averaging provision.<sup>166</sup> A distribution from an IRA will be treated as ordinary income.<sup>167</sup> If the distribution occurs before age 59½, and not because of the taxpayer's disability, a penalty tax is imposed equal to ten percent of the amount of the distribution.<sup>168</sup> Nevertheless, IRA's can serve as a useful tool in cases where a future rollover into a qualified pension or annuity plan is anticipated. The amounts so transferred may again receive favorable lump sum treatment when they are distributed from the pension or annuity plan.

#### IV. ESTATE AND GIFT TAX CONSEQUENCES

Section 2039(c),<sup>169</sup> as amended by the Tax Reform Act of 1976,<sup>170</sup> excludes from the gross estate (as defined in section 2031)<sup>171</sup> the value of an annuity received by any beneficiary, other than the executor, as a result of the decedent's participation in the following types of plans: (i) an employees' trust qualified under section 401(a);<sup>172</sup> (ii) a retirement annuity contract purchased by an employer and qualified under section 403(a);<sup>173</sup> (iii) a retirement annuity contract purchased for an employee by an organization described in section 170(b)(1)(A)(ii) or (vi), or a religious organization exempted from tax under section 501(a);<sup>174</sup> (iv) an annuity under the Retired Serviceman's Family Protection Plan<sup>175</sup> or (v) an individual

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164. *Id.* § 408(d)(3)(B).

165. *Id.*

166. *Id.* § 402(a)(2).

167. *Id.* § 408(d)(1).

168. *Id.* § 408(b).

169. *Id.* § 2039(c).

170. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009(c).

171. INT. REV. CODE OF 1954, § 2031(a):

The value of the gross estate of the decedent shall be determined by including to the extent provided in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.

172. See note 1 *supra*.

173. See note 1 *supra*.

174. Such annuities are described in section 403(b) of the Code.

175. 10 U.S.C. § 1431 *et seq.* (1970).

retirement account, an individual retirement annuity account or a retirement bond.<sup>176</sup> A lump sum distribution, as defined in section 402(e)(4),<sup>177</sup> but not including an annuity contract,<sup>178</sup> will no longer be excluded from the gross estate in the case of decedents dying after December 31, 1976.<sup>179</sup> Before an annuity payable from an individual retirement account, an individual retirement annuity or a retirement bond can qualify for the exclusion from the gross estate, the contract must provide for a series of substantially equal periodic payments made to a beneficiary other than an executor for the life of the beneficiary or over a period extending for at least 36 months after the date of the decedent's death.<sup>180</sup> In the case of decedents dying after December 31, 1976, the exclusions from the gross estate provided under section 2039(c) and (e) are extended to self-employed persons.<sup>181</sup> Section 2517(a), as amended by the Tax Reform Act of 1976, provides that the exercise or non-exercise of an election or option to have an annuity payable under one of these plans to any beneficiary at or after the employee's death will not be a taxable transfer for gift tax purposes.<sup>182</sup> Again, this treatment will be accorded to self-employed after December 31, 1976.<sup>183</sup>

Section 101(b)<sup>184</sup> relates to lump sum distributions on the death of a participant in a qualified plan. Although not an estate or gift tax exclusion, section 101(b) and regulations issued thereunder ex-

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176. INT. REV. CODE OF 1954, §§ 408(a),(b) and 409(a).

177. See Part II. A. *supra*.

178. As described in the text accompanying note 8 *supra*, an annuity contract is treated as a lump sum distribution, but only for purposes of computing the initial separate tax imposed on a lump sum distribution. For purposes of the estate tax exclusion, an annuity contract will not be considered as a lump sum distribution. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009(c)(3), amending INT. REV. CODE OF 1954, § 2039.

179. INT. REV. CODE OF 1954, § 2039.

180. *Id.* § 2009(c)(1).

181. *Id.* § 2009(c)(2).

182. INT. REV. CODE OF 1954, § 2517(a), as amended by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009(c)(4)(A).

183. INT. REV. CODE OF 1954, § 2517(a), as amended by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009(c)(4)(B). It should be noted that amounts attributable to payments for contributions made by an employee are not entitled to the exclusions under sections 2039(c) and 2517(a). INT. REV. CODE OF 1954, §§ 2039(c), 2517(b). Also, the amounts contributed on behalf of a shareholder employee of a subchapter "S" corporation will not be excluded to the extent that they exceeded the limitations of section 1379 relating to contributions to qualified plans. Proposed Treas. Reg. §§ 20.2039-2(c)(1), 20.2517-1(c)(1).

184. INT. REV. CODE OF 1954, § 101(b).

empt from income tax up to \$5,000 of a lump sum distribution to a beneficiary of an employee.<sup>185</sup> Absent this provision, under section 101(b) an amount which an employee had a nonforfeitable right to receive while living immediately before his death (which would include the vested portion of the employee's accrued benefit under a qualified plan), would not qualify for the \$5,000 exclusion.<sup>186</sup>

## V. CONCLUSION

It should be apparent from the foregoing discussion that understanding the tax consequences of distributions from qualified employee benefit plans is not a simple matter. There are various issues involved concerning not only income taxation, but also estate and gift taxation. It will be difficult, at times, for the practitioner to determine whether or not the distribution to his client qualifies as a lump sum distribution. The practitioner will need to know the type of plan involved and the reason for the distribution of benefits to his client. He will need to discuss with his client the possibility of future distributions from other plans and the future financial and employment plans of the client. Finally, it will be necessary for the practitioner to check for any later changes in federal law. In the last few years, the changes and interpretations of the law have been significant both in scope and number.

Provisions relating to the taxation of distributions from employee benefit plans seek to provide the participant in such plans with favorable tax treatment to encourage the participant to save for his retirement. Such provisions also encourage employers to adopt pension, profit-sharing and stock bonus plans to provide for their employees' retirement. In all, the statutory provisions do provide the employee with an opportunity to have investments build up earnings tax free on his behalf that will be distributed to him at a later date when he is in a lower tax bracket.

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185. *Id.* § 101(b)(2)(B).

186. *Id.*