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Qualified Plan Distributions: Tax Deferral, ERISA and the IRA

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QUALIFIED PLAN DISTRIBUTIONS:
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I. INTRODUCTION

A 1975 study showed that 17 percent of corporate payroll expenditures were in the form of pension plan contributions.¹ Under the protections provided by the Employee Retirement Income Security Act of 1974 (ERISA),² a typical corporate employee faced with retirement or other separation from service after a long period of employment may expect to have accrued a considerable amount of benefits through participation in such plans. If the plan is qualified under the Internal Revenue Code of 1954,³ the employee is not taxed⁴ on his employer’s contributions under the plan until they are distributed in the form of benefits.⁵ It may be assumed that he will try to arrange this distribution so as to minimize this tax liability. The purpose of this Note is to consider and compare some of the options for distribution of qualified plan benefits that may be available to such an employee. Particular attention will be given to the possible deferral of tax consequences through a rollover⁶ of the distribution into an Individual Retirement Account (IRA).⁷

A. Deferral and Taxation

The value of a tax deferral is perhaps not as intuitively obvious as an explicit exemption from taxation. It has been argued that as long as a tax is eventually paid the deferral is not a significant advantage.⁸ However, deferral of taxation on the earnings of invested tax deferred income is at least equal to a partial exemption.⁹ Other factors which may enhance the value of a tax deferral are favorable changes in tax rates,¹⁰ eligibility for certain tax credits¹¹ and exemptions¹² available only to older taxpayers, a lower tax bracket due to

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¹. Pensions & Investments, May 24, 1976, at 1, col. 4.
³. § 401(a).
⁴. Except where otherwise indicated, the tax referred to will be the federal income tax.
⁶. This is the nontaxable transfer of funds from a qualified plan trust. See id. § 402(a)(5).
⁷. IRA includes the individual retirement account, id § 408(a), the individual retirement annuity, id. § 408(b), and the qualified retirement bond, id. § 409.
⁹. "[W]here rates are constant, deferring the tax is the equivalent of imposing the tax initially, but exempting any subsequent profit due to continued investment of what is left after payment of the tax." Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113, 1126 (1974) [hereinafter cited as Andrews].
¹⁰. There is a tendency for the statutory tax rates applicable to given income levels to decrease over time in response to inflation. See Von Furstenberg, Individual Income Taxation and Inflation, 28 Nat’l Tax J. 117 (1975).
¹¹. There are additional inclusions of pensions in the computation of a tax credit for individuals who have attained the age of 65. Int. Rev. Code of 1954, § 37(c)(1).
¹². There is an additional personal exemption for a taxpayer or spouse aged 65 or more. Id. § 151(c).
B. Deferral and Qualified Plan Distributions

A basic purpose and effect of a qualified plan is to defer taxation of benefits accrued during a taxpayer's employment with a corporation. The period of deferral possible in such a plan is not indefinite, as the employee's ability to avoid current taxation for an accrued benefit will be limited by requirements that plan benefits be distributed in certain ways or by certain times.

There are three general categories of qualified plans that an employer may establish for his employees: pension plans, profit-sharing plans, and stock bonus plans. In order to qualify under the standards set by the Internal Revenue Service (IRS), a plan must provide for distribution of benefits within certain broad guidelines established for its category. These guidelines have

13. This is, in effect, what happens under the capital gains tax when a taxpayer dies without having sold or exchanged his appreciated property. "There has been no attempt by the Commissioner of Internal Revenue to assert that the transfer of property at death falls within the meaning of 'exchange' as used in Section 1222 of the Code (which defines capital gains) so that such transfer would constitute a taxable realization of capital gains." Castruccio, Becoming More Inevitable? Death and Taxes . . . and Taxes, 17 U.C.L.A.L. Rev. 459, 460 (1970). See also Katsoris, In Defense of Capital Gains, 42 Fordham L. Rev. 1, 17-23 (1973).

Similarly, an accrued benefit in a qualified plan will not be taxed to a participant if it has never been distributed or made available. See note 27 infra and accompanying text.

14. Trebotich v. Commissioner, 492 F.2d 1018, 1024 (9th Cir. 1974).

15. "A [qualified] pension plan . . . 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." Treas. Reg. § 1.401-1(b)(1)(i) (1956).

16. "A [qualified] profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite predetermined formula . . . for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment." Id. § 1.401-1(b)(1)(ii) (1956).

17. "A [qualified] stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. For the purpose of . . . distributing the stock of the employer . . . such a plan is subject to the same requirements as a profit-sharing plan." Id. § 1.401-1(b)(1)(iii) (1956).


Before the enactment of ERISA, there was "no effective appeal from a Service determination (or refusal to make a determination) that a proposed pension plan fails to qualify . . . ." H.R. Rep. No. 779, 93d Cong., 2d Sess. 105 (1974) [hereinafter cited as H.R. Rep. No. 779]. Such a
been developed and supplemented over the years through numerous rulings, regulations, court decisions and enactments of law that permit certain distribution options, exclude others, and otherwise permit the plan to offer the distributee a degree of flexibility. Some of these options will result in immediate taxation of the distribution at favorable rates while others will allow the taxation of the distribution to be deferred in various ways.

C. Deferral and the IRA

One distribution option that has attracted the attention of both qualified plan beneficiaries and law review commentators is the IRA. An employee who receives a lump sum distribution, or a distribution because of the termination of his employer’s plan, may consider a rollover of the amount into an IRA to avoid taxation in the year of the distribution.

However, the general interests in deferrals discussed above may be offset by other possible advantages, or avoidable disadvantages, peculiar to certain options associated with the distribution of qualified plan benefits. In considering whether to roll over a distribution otherwise available under his plan, a beneficiary should be aware that there may be other deferral options available under a qualified plan, such as an annuity election or a deferral agreement with the plan administrator. These other options may be available in the absence of the rollover, or they may preserve certain tax benefits which would be lost through a rollover. Moreover, the provisions for taxation of a lump determination or refusal may now be reviewed by the Tax Court. Int. Rev. Code of 1954, § 7476. It is unclear whether this will dilute the authority of the IRS in determinations regarding plan qualification.

19. See IRA’s: A Hot Deal for Some, Bus. Week, Dec. 29, 1975, at 112. The total number of IRA’s, inclusive of rollovers, was placed at 500,000 at the end of 1975, with an anticipated doubling by the end of 1976. Id.


21. Briefly, a lump sum distribution must be (1) paid from a qualified plan or exempt trust, (2) the balance to the credit of the employee, (3) paid within one taxable year of the recipient, and (4) paid to the recipient because of the employee’s death, attainment of age 59½, separation from service, or disability. See Int. Rev. Code of 1954, § 402(e)(4)(A). In addition, if the distribution is to the participant, he must have been a participant in the plan for five or more taxable years. Id. § 402(e)(4)(H).


24. See notes 117-27 infra and accompanying text.

25. See notes 60-63 infra and accompanying text.

26. See notes 79-87 infra and accompanying text.
sum distribution in the year it is made may eliminate at least some of the reasons for wanting to defer the tax through a rollover.

II. TAX DEFERRAL UNDER QUALIFIED PLANS

A qualified plan offers tax deferral advantages to both the corporate employer and employee. The employee is not taxed on his employer's payments into the plan until benefits are actually distributed or "made available" to him.\(^27\) Thus, he pays no tax on his accumulating interest in a qualified plan between the point at which contributions are made into the plan on his behalf and the point at which benefits are distributed to him. As for the employer, if he makes contributions into a qualified trust\(^28\) for the benefit of his employees, the earnings in this trust are not taxed\(^29\) until distributed or made available to the employees. Thus, an invested trust contribution accumulates more rapidly by virtue of the qualification, and the amount of contributions necessary in the current year to guarantee a given level of benefits to the employees upon their eventual retirement is correspondingly lower.

The interests of the employer and of the employee in a qualified plan may be interrelated,\(^30\) but they are not concurrent. For example, the initial design of the plan, including provisions for distribution of benefits to the employee, will probably be completed before the employee has any actual accrued benefit. Thus, the question of tax advantages in options for deferral of distributions from qualified plans can be considered from two perspectives: (1) that of an employer trying to draft a plan that will qualify for certain tax benefits, and (2) that of an employee trying to arrange distribution of benefits from the plan so as to minimize the tax effects to himself and his survivors.

A. The Employer and Plan Qualification

A qualified plan must meet various requirements affecting the ability of a participant to defer the availability of his benefits. These may take the form of requirements that distributions be made by certain times or to certain beneficiaries. One effect of these requirements has been to limit the period of deferral possible in distribution of a participant's benefits by requiring that the plan provide for distribution before the participant dies.

\(^27\) Int. Rev. Code of 1954, § 402(a)(1). Certain exceptions to this taxation are capital gains treatment for part of a lump sum distribution, partial exemption of certain distributions to nonresident aliens, exclusion of rollover amounts, and exclusion of the net unrealized appreciation in securities of the employer corporation attributable to employee contributions. See id. §§ 402(a)(1)-(2), (4)-(5). Also, if the amount constitutes a lump sum distribution, all net unrealized appreciation in securities of the employer corporation, as well as a part of the distribution representing employee contributions, will be excluded whether the distribution is taxed as an annuity, id. § 72(f), or under the separate tax on lump sum distributions, id. § 402(e)(4)(D)(i)-(ii).

\(^28\) A qualified plan is described only in connection with a "trust created or organized in the United States." Id. § 401(a). The "trust" may include such nontrusteed means of funding as an annuity contract or custodial account. Id. § 401(f).

\(^29\) Id. § 501(a).

\(^30\) It has been observed, for example, that employees have become increasingly involved in employer investment policy in meeting deferred compensation obligations. See Fischer, Executive Compensation Today, 53 Taxes 886, 891 (1975).
It is basic under section 401(a) of the Code that qualified plan funds must be accumulated for the benefit of the "employees or their beneficiaries." On its face, this should mean that either group could be the exclusive beneficiary. However, in a ruling with implications broader than could be justified by the specific facts and authority on which it was based, the IRS interpreted this section as requiring that provisions in any qualified plan for payments to beneficiaries other than the employee be "incidental" in relation to provisions for payments to the employee himself during his life. The IRS did not give a precise formula for determining when such provisions are "incidental," although recent rulings indicate that where the participant will receive at least 50 percent of his accumulated benefit under the plan during his life, the test will be met.

The effect of the "incidental" test, and apparently the purpose, was to prevent the possibility that qualified plans could be drawn to allow employees to avoid both income and estate taxes on all or part of such funds by electing not to receive benefits during their lives. Despite this, the test was nevertheless later interpreted as not excluding pension plans providing for a death benefit to a beneficiary named by the employee whether the death occurred after or before the employee's retirement. Deferral options were permitted as long as they were available nondiscriminately to participants and the period of the deferral was not beyond the participant's life expectancy.

32. See Treas. Reg. § 1.368-2(b) (1955) on the disjunctive meaning of "or".
33. Rev. Rul. 56-656, 1956-2 Cum. Bull. 280. The ruling specifically dealt with a profit-sharing plan, although the IRS held its decision applicable to employees' stock bonus plans as well. The IRS relied on Treas. Reg. § 1.401-1(b)(1)(ii) (1956), which no more supports the interpretation that a profit-sharing plan must make the employee the primary beneficiary than does Int. Rev. Code of 1954, § 401(a). Treas. Reg. § 1.401-1(b)(1)(i) (1956), concerning pension plans, does state that such a plan must provide primarily for payments to employees, "usually for life," and only incidentally for death benefits. This distinction between plan types is not dealt with in the ruling, which simply states: "It is believed that the requirement in the regulations that the funds be distributed after a fixed number of years, or the attainment of a stated age, was intended to mean 'distributed to the employee.' Payments to others should be merely incidental as, for example, in a joint and survivor annuity contract, or where an unused balance in the account of an employee is paid to a beneficiary upon the death of the employee." Rev. Rul. 56-656, 1956-2 Cum. Bull. 280.
34. See notes 49-50 infra and accompanying text.
35. Sollee, Working with Flexible Settlement Options for Qualified Employee Plans, 38 J. of Tax. 146 (1973) [hereinafter cited as Sollee]. The part of the death benefits from a qualified plan attributable to employer contributions are excluded from the decedent's estate. Int. Rev. Code of 1954, § 2039(c). This section has been the basis for tax avoidance schemes associated with qualified plans. See, e.g., Northern Trust Co. v. United States, 389 F.2d 731 (7th Cir. 1968) (the claim for an estate tax exemption was denied). See also Int. Rev. Code of 1954, § 2517 (providing a gift tax exclusion for qualified plan distributions).
38. In considering the reverse situation, where a profit-sharing plan provided no deferral option, i.e., mandatory lump sum distributions upon retirement or other separation from service, the IRS held that the plan would not qualify because, among other reasons, it did not "provide
In time, however, the IRS went far beyond the "incidental" test in ruling that a qualified pension plan must begin distribution of a participant's benefit "no later than actual retirement after attainment of normal retirement age . . . and completion of service and other reasonable and uniform requirements . . . ." Similarly, the IRS took the position that distributions from a profit-sharing or stock bonus plan should begin no later than attainment of a stated age after retirement, or occurrence of a specified event. Such a requirement, if strictly applied, would bar plan provisions for elective deferral of distributions to a participant past his actual retirement after attainment of an age stated in his plan. Although this ruling is open to criticism for misapplying the statutory or administrative authority on which it relied, it has never been explicitly modified or revoked by the IRS. Even so, subsequent rulings have not strictly followed this line of authority.

The IRS has permitted the payout of qualified plan benefits to take place in various "modes of settlement," including periodic or lump sum distributions. This is satisfactory as long as "under each mode the distribution has the same value as a distribution determined under any other mode of settlement provided for under the plan," i.e., the present value of any one option is the actuarial equivalent of any other. Thus, a plan providing for a fixed monthly benefit at a given age would have to provide a somewhat higher monthly benefit where the participant was permitted to elect benefits after attainment of that age, but the payout could still be deferred over his remaining life.

Also, notwithstanding the requirement that death benefits be "incidental," the IRS has allowed, and ERISA now requires, a qualified plan to offer a


40. Id. The specified event could be layoff, illness, disability, retirement, death, or severance of employment. Treas. Reg. § 1.401-1(b)(1)(ii) (1956). It was later clarified that this was not an exhaustive listing of events. Rev. Rul. 68-24, 1968-1 Cum. Bull. 150.
41. The statutory authority offered was Int. Rev. Code of 1954, § 401(a)(9), which provides for mandatory distributions only for plans covering employees "within the meaning of subsection (c)(1)," i.e., the self-employed. It has been suggested that the ruling was based on a misunderstanding of this section. See Sollee, supra note 35, at 147 n.11.
joint and survivor annuity option under which payments to the employee commence at his retirement and continue after his death to his spouse for her life. Thus, if there is a surviving spouse, neither the participant nor his estate will be taxed on at least a part of the accrued benefits. In cases not involving such options for annuity payments to a spouse, a general rule was laid down that any settlement option provided for in a plan, including annuities, would meet the "incidental" test if more than 50 percent of the total payments would be made "to the participant and his beneficiaries." A later ruling interpreted this as precluding a settlement option under which payments to the participant were "nominal" while "more than 50 percent of the present value of the funds accumulated for his benefit [were] distributed to his surviving spouse and another person." Further, at least in the case of a profit-sharing plan, it was held that the "incidental" test precluded provisions for payments to a beneficiary or beneficiaries concurrently with the participant, i.e., prior to the death of the participant.

The series of rulings explicating the "incidental" test seems to be intended primarily to require that qualified plans provide for distribution of benefits in a manner reasonably calculated to cause the plan participant himself to pay taxes on the greater part of his benefits prior to his death. The prior refusal to allow deferrals of distributions after the participant's retirement but before his death rests on questionable authority, and present law seems motivated by an intention that otherwise distributable benefits be retained in the plan at least until they may be used "for retirement purposes." As modified under ERISA, the Code now provides that a qualified plan must begin distributions within a specified time "unless the participant otherwise elects..."

In the case of a stock bonus plan, the IRS had previously held that an annuity option was not permissible. See Rev. Rul. 71-256, 1971-1 Cum. Bull. 118. It is unclear whether that ruling applies to the joint and survivor annuity option mandated by ERISA.


52. See note 35 supra and accompanying text.

53. See note 33 supra and accompanying text.

54. See H.R. Conf. Rep. No. 1280, 93d Cong., 2d Sess. 272 (1974) [hereinafter cited as H.R. Conf. Rep. No. 1280]. Plans may provide for a cashout of an employee's accrued benefit only where the present value of the benefit does not exceed $1,750 (unless the Secretary of the Treasury prescribes a lower amount) or where the cashout is elected by the employee. Int. Rev. Code of 1954, § 411(a)(7)(B).

56. Int. Rev. Code of 1954, § 401(a)(14). The specific time must be no later than the 60th day after the close of the plan year in which the latest of the following occurs: (1) the date the participant attains the earlier of age 65 or the normal retirement age under the plan, (2) the 10th anniversary of the year in which the participant commenced participation in the plan, or (3) the participant's...
elective deferrals of distributions was to ensure either estate taxation or income taxation of the distributions over the life of the taxpayer. However, where the period of deferral is not beyond the participant's actual life expectancy, this rationale would not seem to apply, since the participant could be expected eventually to receive, and pay tax on, his benefits during his life.

B. The Plan Beneficiary and Deferred Distribution

As discussed above, a beneficiary of a qualified plan will be taxed for any amount actually distributed or "made available" to him. However, annuity options, conditions on withdrawals of benefits from the plan, or written deferral agreements may be effective in avoiding "availability," and thus taxability, of an accrued benefit in the year a beneficiary first becomes eligible to receive it.

One plan feature that can prevent immediate taxation of the total benefit otherwise distributable to a beneficiary is an annuity option. If his plan provides for such an option, a participant can elect to receive an annuity contract purchased with the amount of a lump sum distribution otherwise available without being taxed at the time of the election for either the cash surrender value of the annuity or the amount of the lump sum distribution. The distribution will then be taxed "under section 72 (relating to annuities)," which means that the tax is deferred over the period of the distribution.

Another plan feature that may prevent taxation of an accrued benefit is a condition on the right of withdrawal. The IRS initially took the position that an employee's interest would be considered "made available" on the earliest date upon which he could receive a cash lump sum distribution from the trust if he had requested the trustee therefor in accordance with the plan. A later ruling limited that position by providing that a beneficiary's interest is not "made available" when there are "substantial conditions or restrictions on his right of withdrawal." That ruling distinguished two general situations in which a particular plan benefit otherwise available would not be considered taxable: (1) where the plan allowed withdrawal of the benefit at that point only on assessment of a substantial penalty, and (2) where the plan permitted an election to defer the distribution past the point of termination of service with the employer. Id. See also ERISA § 206(a), 29 U.S.C.A. § 1056(a) (applying the same requirement to plans independently of the Code).

58. See note 27 supra and accompanying text.
59. See notes 45-51 supra and accompanying text.
62. Id. § 402(a)(1).
63. For the tax treatment of annuity distributions, see generally id. § 72; Treas. Reg. §§ 1.72-1 to -15 (1956), as amended.
TAX DEFERRAL

when the benefit would otherwise have been payable. A requirement that the employee discontinue participation in the plan or forfeit a portion of his interest was found sufficient to defer taxation in the first situation.66 Other examples of conditions sufficiently substantial to defer taxability of plan benefits were later found where the funds could not be withdrawn without prior permission of an administrative committee upon a showing of financial need,67 and where withdrawal of the funds would cause the participant to lose prior service credits if he were reemployed.68 Thus, where distribution of a participant's benefit under a qualified plan is possible at more than one point, a requirement in the plan that a participant who elects to receive his benefit at the later point will suffer a penalty, such as discontinuance of participation, will prevent taxation of his benefits at the earlier point.

The other situation in which a benefit would not be considered "available" was where the plan specifically provided for "an irrevocable election by the employee prior to the time his interest [became] distributable to him to have distribution of such interest deferred to a fixed or determinable future time . . . ."69 Although this may have been intended to apply primarily in the case of profit-sharing plans,70 deferral of pension benefits was found permissible in certain situations. It was held that in the case of a qualified pension plan providing for distribution of retirement benefits at a specified retirement age, an employee who continued to work beyond that age could, by prior irrevocable election to defer receipt of the distribution, avoid taxation until he actually terminated his services.71 Thus, even before the enactment of ERISA, the requirement that the plan contain language providing for distribution to beneficiaries at certain points did not preclude the employee from electing to receive the distribution at a later point, perhaps even later than actual retirement. Distributions at points even beyond retirement72 were found to fall within the bounds of a qualified plan.73

72. However, no case has been found where the deferral has been officially sanctioned by permitting lump sum treatment after separation in excess of one year. Problems relating to such deferrals under ERISA are discussed at note 125 infra and accompanying text.
73. See Rev. Rul. 62-190, 1962-2 Cum. Bull. 130, 131. The issue here was whether any increment in the amount credited to an employee's account subsequent to his separation from service would be treated as part of the balance which becomes payable to a distributee on account of separation from service, and therefore subject to long term capital gains treatment under the then Int. Rev. Code of 1954, § 402(a)(2). The profit-sharing plan considered in the ruling provided for a lump sum distribution in the year following retirement, and it was held that at least the
A recent case, *Leavens v. Commissioner*,\(^7\) indicates that by drafting a suitable deferral agreement, a participant may avoid taxation on what would have otherwise been available income under the plan instrument. The case concerned a profit-sharing plan under which a participant had the right, upon attainment of thirty years of age and five years' participation in the plan, to receive the balance of his account in the plan in five annual installments. Under prior authority,\(^7\) taxable income would seem to accrue inevitably upon fulfillment of both conditions. However, before completing five years in the plan, certain participants signed agreements to delay their withdrawal rights for about eighteen months, and subsequently, for five years. The trust agreement of the plan was not amended to incorporate the terms of the separate deferral agreements, and the IRS took the position that the outside agreements did not defer the availability of the funds to the participants.\(^7\)

The court rejected a "four corners" approach in suggesting that outside written agreements could be considered a factor in determining the availability of plan funds.\(^7\) The separate agreements were found to be of sufficient permanence and scope to be a substantial impediment to appellants' right to withdraw their shares from . . . [the] plan. Therefore, during the life of the waiver agreements, no funds from the plan were made available to any of the appellants within the contemplation of Section 402(a)(1) of the Internal Revenue Code.\(^7\)

*Leavens* provides a perspective from which the interests of the employer in plan qualification and the employee in tax deferral may be seen to coincide. Regardless of what is specifically permitted under the plan as approved, the employee may arrange, at some point before his interests have actually become distributable, to irrevocably defer the distribution to a fixed or determinable future time.

C. The Employer and the Beneficiary After ERISA

In response to ERISA,\(^7\) and possibly *Leavens*, the IRS has promulgated proposed\(^8\) and temporary\(^8\) regulations which are basically identical,\(^8\) mod-

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74. 467 F.2d 809 (3d Cir. 1972).
75. The court suggested that the following rulings had "cast doubt" on the participant's ability to defer recognition of income under the plan: Rev. Rul. 55-425, 1955-1 Cum. Bull. 43; Rev. Rul. 55-423, 1955-1 Cum. Bull. 41; and Rev. Rul. 54-265, 1954-2 Cum. Bull. 239. Id. at 811. These rulings established the principle that a distribution would be considered available where there are no substantial conditions or restrictions on the right of withdrawal. See notes 64-70 supra and accompanying text.
76. 467 F.2d at 812.
77. Id. at 813-14.
78. Id. at 815.
79. See note 57 supra and accompanying text.
82. The temporary regulation includes language dispensing with notice and public procedure not included in the proposed regulations. Id.
ifying its position on the commencement of benefits under qualified plans. The regulations allow most plans to permit elective deferrals\(^8\) by a participant where: (1) the participant makes the election in a signed written statement to the plan administrator, (2) the statement describes the benefit and the date on which it will commence, and (3) the election will not cause "benefits payable under the plan with respect to the participant in the event of his death to be more than 'incidental' within the meaning of paragraph (b)(1)(i) of [Treasury Regulation] § 401-1."\(^8\) The latter language incorporates the earlier refusal to qualify plans that permit deferral of distributions until after the death of the participant,\(^6\) and the IRS has also indicated that it will adhere to its pre-ERISA rulings explicating the "incidental" test for distribution of plan benefits.\(^7\) Otherwise, the regulations accept deferral by means of written agreement.

Thus, assuming it is to his advantage to do so, a qualified plan beneficiary should be able to defer a taxable distribution of his benefits without resorting to the IRA. However, it is useful to consider whether the interests of such a participant may best be served by a rollover of the distribution.

III. TAX DEFERRAL AND THE IRA

At some point during or after his participation in a qualified plan, a corporate employee will be faced with a distribution of benefits.\(^8\) Having

\(^83\) Both the proposed and temporary regulations apply to plans under Int. Rev. Code of 1954, § 411, which covers minimum vesting schedules for all plans covered under § 401(a) except for those identified in § 411(e)(1). This excludes governmental plans, church plans, or plans maintained by an order, society, or association described in § 501(c)(8) or (9) (certain fraternal beneficiary societies, orders or associations, and voluntary employees' beneficiary associations) if no part of the contributions to or under such plans are made by employees of participants in such plans.


\(^85\) See note 35 supra and accompanying text.

\(^86\) As indicated in the Preamble to Temporary Treas. Reg. § 11.401(a)-(14), 40 Fed. Reg. 47107, the IRS followed the specific language of H.R. Rep. No. 807, 93d Cong., 2d Sess. 70 (1974) ("To ensure that a participant can reasonably expect to receive his benefits during his retirement years, the committee bill requires a qualified plan (to which the basic vesting provisions apply) to commence payment of benefits to the participant (unless he elects otherwise in writing and this election is permitted by the incidental death benefits rule) not later than [a specified point]"") rather than the more general language of H.R. Conf. Rep. No. 1280, supra note 54, at 281 ("Under the conference substitute, a plan is generally required to commence benefit payments (unless the participant otherwise elects) not later than [a specified point]""). The source of the "incidental death benefits rule" adopted in H.R. Rep. No. 807 seems to be Rev. Rul. 56-656, 1956-2 Cum. Bull. 280. Thus, the extension of Treas. Reg. § 1.401-1(b)(1)(i) (1956) achieved in that ruling, see note 33 supra, has now been endorsed by at least one branch of Congress.


\(^88\) See notes 31-37 supra and accompanying text.
deferred taxation of his benefit over the period of its accrual, the employee may have various reasons for wanting to defer it for an additional period. In deciding whether to commit funds to an IRA, the employee should compare the tax consequences with those of his other possible options.

A. The Case for an Immediate Distribution

A major reason for wanting to defer receipt of a large distribution, the expectation that it will be taxed at more favorable rates when other income is reduced in retirement, has decreased in importance under the Code. If the distribution is in the form of an annuity contract or periodic payment, the incidence of the tax will be spread over a number of years. Also, the taxable amount of the distribution will exclude both an amount representing contributions by the employee and the net unrealized appreciation in securities of the employer corporation attributable to employee contributions. If the payout meets the definition of a lump sum distribution, it is subject to further advantageous tax treatment.

The taxable amount of a lump sum distribution is included in gross income, being divided into ordinary income and capital gains elements. The latter is included in the year's income as a long term capital gain, regardless of the employee's holding period, while the former is eligible "for a favorable ten year averaging tax computed separately from any other

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89. See notes 6-13 supra and accompanying text.
90. See note 7 supra and accompanying text.
91. See notes 62-63 supra and accompanying text.
92. This is so whether the payout is taxed as an annuity, Int. Rev. Code of 1954, § 72(f), or as a lump sum distribution, id. § 402(e)(4)(D)(i).
93. Id. §§ 402(a)(1), (e)(4)(J). This part of the distribution will be taxed only when the employee sells the securities, and it will be taxed at long term capital gains rates regardless of the holding period by the employee, except for capital gains appreciation subsequent to the distribution. Treas. Reg. § 1.402(a)-1(b)(1)(i) (1956).
94. See note 21 supra.
95. Proposed Treas. Reg. § 1.402(e)-2(d)(1)(viii), 40 Fed. Reg. 18798, 18808 (1975). The proposed regulation is consistent with prior law, see notes 60-61 supra and accompanying text, in providing an exception where the amount of the distribution is used to purchase an annuity.
96. See Int. Rev. Code of 1954, § 402(a)(2). Roughly, the capital gains element is determined by multiplying the total taxable amount by a fraction equal to the number of years of active participation in the plan before January 1, 1974 over the total number of years of active participation. Thus, the amount of the distribution given capital gains treatment will be less in future years. However, a taxpayer may elect to treat an entire distribution received after December 31, 1975 as ordinary income without regard to pre-1974 participation. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2705 (Oct. 4, 1976), adding subparagraph (L) to Int. Rev. Code of 1954, § 402(e)(4).
98. This is elective. Id. § 402(e)(4)(B). If no election is made, the amount of the distribution not taxed as capital gain would be includible in ordinary income. This might be preferable, for example, where the taxpayer has offsetting deductions or losses in the year of the distribution.
99. See Table I in H.R. Rep. No. 779, supra note 18, at 147. Average effective income tax rates on lump sum distributions consisting of ordinary income are shown to be well below the marginal
TAX DEFERRAL

available income.\textsuperscript{100} Thus, even though other income has been received during the year, the tax on this part of the income is not computed at a higher rate.\textsuperscript{101}

The availability of ten year averaging, capital gains treatment, annuity options, and certain exclusions, therefore, diminishes the increase in taxable income resulting from a qualified plan distribution without resorting to the IRA or a deferral of the distribution. However, an immediate distribution will not always be advantageous to the taxpayer, and a lump sum distribution will sometimes be impossible. One advantage in leaving an otherwise distributable benefit in the trust\textsuperscript{102} of a qualified plan is that the investment earnings\textsuperscript{103} in such a trust are tax exempt.\textsuperscript{104} Where the funds and their anticipated accumulation of earnings are part of a participant's retirement plan, and the participant does not intend to retire in the near future, the tax exemption for earnings may significantly increase the ultimate amount of the accumulation.\textsuperscript{105} Rather than receive the immediate distribution of his account balance, the participant may prefer to have the funds accumulate in a tax free shelter until his retirement.

Further, no more than one ten year averaging election is permitted to a taxpayer after attainment of age 59\frac{1}{2}.\textsuperscript{106} For the purposes of this limitation, an election with respect to an employee's benefit in any one of the three plan rates of taxation for single or married taxpayers at given levels of adjusted gross income through $100,000. Compare Table I, id., with Int. Rev. Code of 1954, § 1.


\textsuperscript{101} See H.R. Conf. Rep. No. 1280, supra note 54, at 348.

\textsuperscript{102} See note 28 supra.

\textsuperscript{103} The investment earnings, e.g., interest, dividends, or capital appreciation, from qualified plan trusts may be distinguished from the benefits available to participants in qualified plans. The earnings from these trusts may be more or less available to participants in the form of benefits, depending on whether the plan provides for defined benefits or defined contributions.

A defined contribution plan provides an individual account balance for each participant and allocates earnings on contributions directly to the participant's account. See Int. Rev. Code of 1954, § 414(i). This account, including the earnings, constitutes the employee's accrued benefit. Id. § 411(a)(7)(A)(ii). Profit-sharing plans, stock bonus plans, and some pension plans are considered defined contribution plans. T.I.R. No. 1334 (Jan. 8, 1975) (question M-6).

Under a defined benefit plan, the participant's accrued benefit is simply "determined under the plan." Int. Rev. Code of 1954, § 411(a)(7)(A)(ii).

Thus, investment earnings in a defined benefit plan trust are not available directly to a plan participant. Hopefully, where these earnings are high and the cost to the employer in contributions necessary to maintain the funding standards of section 412 is correspondingly low, the earnings will be passed along to the participants in the form of increased benefits through amendment of the plan. However, an employee may have reason to prefer the certainty of a defined benefit plan to the investment risks of a defined contribution plan. See Drive Is On To Cut Risks In Profit-Sharing Plans, U.S. News & World Rep., Feb. 2, 1976, at 71-72. Where a participant in a defined benefit plan elects to defer receipt of a periodic benefit which would otherwise become fixed and payable, an actuarial adjustment could be made in the amount of the benefit. See note 44 supra and accompanying text.

\textsuperscript{104} Int. Rev. Code of 1954, § 501(a).

\textsuperscript{105} See, e.g., Andrews, supra note 9, at 1125.

categories with a particular employer (pension, profit-sharing, and stock bonus) is considered separately from an election with respect to his interest in another plan with the same employer in a different category. Therefore, where an employer maintains plans in more than one category, only one such advantageous election will be available to a participant who retires after age 59½. Where multiple ten year averaging elections are not barred by this rule, the tax under such an election would be computed on an amount aggregating any other amounts which are or were subject to ten year averaging in the current year or the five previous years. The effect is that when more than one distribution is subject to a ten year averaging election in a six year period, they will be taxed at a rate higher than that applicable to a single distribution. Thus, the advantages of an immediate lump sum distribution may be decreased or lost because of the timing of the distribution.

B. The Case for a Rollover

A plan participant eligible for an immediate distribution of his benefits may find it advantageous to roll over this distribution, even when it would otherwise be taxed at favorable rates. For example, a rollover may be preferable when an employee separates from service with no immediate plans for retirement, or when two distributions otherwise eligible for ten year averaging become available within a six year period or after the participant attains age 59½. Also, when a distribution is made because of the termination of the employer's plan, a rollover into an IRA will be possible even though a ten year averaging election is not. In such a case, if the rollover is made within sixty days of the distribution, the amount will: (1) not be currently taxed, (2) not be aggregated with earlier lump sum distributions subject to

107. Id. § 402(e)(4)(C).
108. Id. § 402(e)(2). However, the aggregation rule does not apply to amounts received before January 1, 1974.
111. Formerly, lump sum treatment for a distribution received upon termination of a plan but not paid into another plan trust was not available. See Rev. Rul. 72-440, 1972-2 Cum. Bull. 225. The Code now suggests that a distribution to an employee who is at least 59½ years old would be eligible for lump sum treatment regardless of the reason for the distribution. See Int. Rev. Code of 1954, § 402(e)(4)(A)(ii). But see T.I.R. No. 1403 (Sept. 17, 1975) (question M-15) which indicates that a distribution from a pension plan to an employee who continues as an active employee will not be permitted lump sum treatment even where the employee is over age 59½.
113. Id. § 402(a)(5).
a ten year averaging election,\textsuperscript{114} and (3) regain its tax exemption on investment earnings.\textsuperscript{115}

However, this would be accomplished at the cost of certain tax advantages associated with distributions made directly from qualified plans.\textsuperscript{116} If the funds are rolled over into an IRA and then later distributed, the amount of the distribution will then be taxed as ordinary income.\textsuperscript{117} Additional taxes on premature or late distributions will limit the availability of IRA funds to the taxpayer.\textsuperscript{118} In addition, if the participant dies after having rolled over his

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\textsuperscript{114} See notes 108-09 supra and accompanying text. Note that under § 402(e) when a taxpayer is eligible for two lump sum distributions in a six year period, a rollover of one of the distributions would be an effective way of avoiding the disadvantageous effects of aggregation where the first distribution was subject to a ten year averaging election under § 402(e) and the second distribution, in a later year, was rolled over. However, if the order were reversed, or if both distributions were received in the same year, the wording of § 402(e)(2) seems to require aggregation of both distributions in computing the ten year averaging tax on the one even though the other was rolled over. See Proposed Treas. Reg. § 1.402(e)-2(c)(ii)(E)(2), 40 Fed. Reg. 18798, 18806 (1975), which requires aggregation of one distribution with another if the other "is treated as a lump sum distribution under [section 402(e)]." Since § 402(e) includes both subsections 402(e)(1)(A), relating to ten year averaging, and 402(e)(4)(A), relating to rollover amounts as described in § 402(a)(5), the proposed regulation would apparently require aggregation of both types of distributions in computing a ten year averaging tax.

This was not the legislative intent, which required a distribution otherwise meeting the lump sum definition to be aggregated with a subsequent lump sum distribution only if the taxpayer had actually elected ten year averaging to apply to the first. See H.R. Rep. No 779, supra note 18, at 150-51. As it happens, the 1975 Instructions for Form 4972, Special 10-Year Averaging Method, published by the IRS, call for aggregation of lump sum distributions received in 1975 only if both are the subject of a special averaging election rather than a rollover. Pending receipt of the final version of the regulations, this should help avoid certain traps in the timing and sequence of multiple plan distributions.

\textsuperscript{115} Int. Rev. Code of 1954, § 408(e)(1). The value of the exemption is demonstrated by comparisons of accumulations possible in various IRA plans with non-IRA savings at the same rate of interest. See Hearings on Individual Retirement Accounts Before the Subcomm. of the House Comm. on Ways and Means, 94th Cong., 1st Sess. 17 (1975).

\textsuperscript{116} See notes 92-101 and accompanying text.

\textsuperscript{117} Int. Rev. Code of 1954, § 408(d)(1). This effect may be mitigated by some corresponding gains. For example, once an individual attains age 59\(\frac{1}{2}\), he may make distributions in any year without the penalty tax imposed by §§ 408(f) or 409(c). See note 118 infra. Thus, where he has years of offsetting losses or deductions, he may time the distributions from the IRA to minimize or eliminate the remaining tax under § 408(d)(1). Also, the amount of a distribution from an IRA may be used to purchase an annuity contract under § 408(d)(2), which will then be taxed over the period of distribution as provided by § 72. See note 63 supra and accompanying text. Finally, the amount of the distribution from the IRA will be includible in the computation of the retirement income credit under § 37(c)(1)(E) and (F).

\textsuperscript{118} In addition to the tax under § 408(d)(1), or § 409(b)(1) for retirement bonds, a 10 percent tax may be imposed on the amount of the distribution under § 408(0), or § 409(c), where the individual for whose benefit the IRA is maintained, or the registered owner, receives a distribution before age 59\(\frac{1}{2}\). Distributions from an IRA described in § 408 must begin by the end of the year in which the individual for whose benefit the IRA is maintained attains age 70\(\frac{1}{2}\), or if he dies, to his
account balance, the estate tax exemption for payments to beneficiaries of qualified plans\textsuperscript{119} will have been lost,\textsuperscript{120} and the $5,000 income exclusion for the beneficiary will probably be lost as well.\textsuperscript{121} There is also some question as to whether the rate of return possible in an IRA is as attractive as that in a qualified plan trust.\textsuperscript{122}

Moreover, there are limitations on the availability of rollover treatment for plan distributions. Unless paid because of plan termination, the distribution itself must constitute a lump sum distribution.\textsuperscript{123} As interpreted by the IRS,\textsuperscript{124} this includes the requirement that the taxpayer have been a participant in his former plan for at least five years.\textsuperscript{125} Also, that part of the beneficiary within five years of his death, as set forth in §§ 408(a)(6)-(7) and (b)(3)-(4). Otherwise, a 50 percent tax is imposed under § 4974 on a minimum amount required to be distributed.

120. H.R. Rep. No. 779, supra note 18, at 136. However, the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2209 (Oct. 4, 1976) adds subsection (e) to Int. Rev. Code of 1954, § 2039, and paragraph (5) to id. § 2517(a) to provide both estate and gift tax exclusions for amounts distributed to beneficiaries from IRA's after December 31, 1976.

121. Int. Rev. Code of 1954, § 101(b) provides a $5,000 employee death benefit exclusion, but this exclusion does not apply to amounts to which the employee had a nonforfeitable right prior to death. Lump sum distributions from qualified plans are not subject to the nonforfeitability test. Id. § 101(b)(2)(B). No similar exception is made for distributions from IRA's. The legislative history of the IRA does not specifically discuss the applicability of § 101(b), but establishes a general rule that distributions from IRA's are to be "fully taxable." H.R. Rep. No. 779, supra note 18, at 136; H.R. Rep. No. 1280, supra note 54, at 339.

122. See Hearings on Individual Retirement Accounts Before the Subcomm. of the House Comm. on Ways and Means, 94th Cong., 1st Sess. 49 (1975) (statement of C. David Gustafson). However, the rate of return on pension investments may not accrue directly to participants. See note 103 supra.

For a discussion of the investment decisions faced in establishing and managing an IRA, see How To Be Your Own Pension Manager, Money, May 1975, at 64-66.

123. See note 21 supra.
124. See 1975 Instructions to Form 5329, Return for Individual Retirement Savings Arrangement. The IRS interpretation is not strictly required by the language of the statute or regulation which underlies it. Int. Rev. Code of 1954, § 402(e)(4)(H) requires that there be a minimum period of participation in the plan of five years before a distribution from the plan can receive lump sum treatment. It can be argued that this requirement should apply only to ten year averaging elections, not rollovers. See Morgan, Qualified Plan Distributions Under the Pension Reform Act, 31 Bus. Law. 319, 328 n.49 (1975). This seems to agree with the wording of Proposed Treas. Reg. § 1.402(e)-2(e)(3), 40 Fed. Reg. 18798, 18809 (1975), which speaks of a minimum period of service only "[f]or purposes of computing the separate tax imposed by section 402(e)(1)(A)," i.e., ten year averaging.

At least one Congressman has expressed interest in legislation to eliminate the five year participation requirement for rollovers. See H.R. Rep. No. 1020, 94th Cong., 2d Sess. 25 (1976) (Supplemental View of Hon. Charles A. Vanik).

125. Proposed Treas. Reg. § 1.402(e)-2(e)(3), 40 Fed. Reg. 18798, 18809 (1975), requires that the five years must precede the taxable year in which the distribution is made. Thus, an employee who had retired after completing his fifth year of employment in 1976 could not claim a lump sum distribution in 1976. However, such a distribution could be claimed if it were deferred until 1977. A question might arise, if the distribution were deferred until 1978 (or later), whether the five years of
distribution consisting of employee contributions is not subject to rollover treatment.\textsuperscript{126} Further, a rollover is not available to the beneficiary of a qualified plan after the employee dies.\textsuperscript{127}

C. Alternative Deferral Solutions

A qualified plan beneficiary may find it desirable to defer the tax consequences of an otherwise available distribution, yet undesirable or impossible to accomplish this deferral through a rollover into an IRA. If the plan contains a provision placing a condition on the availability of the benefit, taxation will be avoided until the condition is removed. Also, the plan may offer an option for distribution of an annuity contract or periodic payments, which will defer the tax over a period of years. Even where the plan does not specifically offer an annuity option, a recipient of a distributed lump sum benefit may consider the purchase of a tax sheltered annuity designed to defer taxation of any subsequent investment return until he retires.\textsuperscript{128} As an alternative, the beneficiary may consider an irrevocable deferral of the distribution in the form of written agreements with the plan trustee. Such a deferral may be possible even when the participant's plan is being terminated, provided that the employer is willing to assume certain administrative burdens.\textsuperscript{129} This alternative would both preserve the advantages of an eventual ten year averaging election and estate tax exclusion associated with distributions from qualified plans, and allow the beneficiary to time the distribution

employment must immediately precede the year of distribution. The Proposed Regulations do not explicitly require this, id., but the legislative history suggests such an intention: "Ten-year averaging is provided to recognize the fact that the distribution represents compensation which generally is received spread out over the taxpayer's life beginning with the time he retires." H.R. Rep. No. 779, supra note 18, at 148. In any case, the five year participation requirement applies only where the distribution is "to an employee." Int. Rev. Code of 1954, § 402(e)(4)(H). Thus, even where the beneficial effects of ten year averaging would be unavailable to the participant because of the five year participation requirement, in the event of his death, the option should be available to his named beneficiary.


\textsuperscript{127} A rollover is defined only in connection with payments to the employee himself. Id. § 402(a)(5)(A).

\textsuperscript{128} Cf. 4 J. Rabkin & M. Johnson, Federal Income, Gift and Estate Taxation § 63.02. Tax sheltered annuities in various forms are becoming increasingly popular as investment vehicles for qualified plan distributees. See A New Tax Shelter for Your Savings, Money, Aug. 1976, at 48; An Annuity for All Seasons, Forbes, May 1, 1976, at 86; The Tax Break on Investment Annuities, Bus. Week, Feb. 9, 1976, at 71-72.

\textsuperscript{129} See McKinney, An Analysis of the New Expanded Rollover Rules for Terminated Qualified Plans, 45 J. of Tax. 10 (1976). The author suggests the use of a "wasting trust" to preserve tax benefits for participants in a qualified plan that would otherwise be terminated. Id. "A plan is not considered terminated in fact where, except for the failure to make further contributions, the plan continues in effect until all the assets of the trust have been distributed to participants in accordance with the terms of the plan." Rev. Rul. 69-157, 1969-1 Cum. Bull. 115. Form 5500 would have to be filed with respect to such trusts with the IRS and the Department of Labor. See 1975 Instructions for Form 5500. Form EBS-1 may also have to be filed with the Department of Labor. See Executive Compensation J., June 1976, at 23.
so as to avoid the premature loss of a tax shelter or an aggregation of multiple distributions.

The following are examples of situations in which such a deferral of a qualified plan distribution may have advantages to the distributee:

(1) An employee, age 40, terminates his employment and, because of his participation in his employer's profit-sharing plan over ten years, is eligible for an immediate lump sum distribution. If he elects ten year averaging for this amount, he will enjoy advantageous taxation of the ordinary income and capital gains elements, but will lose the tax shelter for future investment accumulation of the funds (assuming these are part of his retirement plans). If he plans to roll over the amount, it will accumulate free of taxation, but when distributed to himself or his beneficiary, it will be taxable as ordinary income. However, if he can defer the distribution until his planned retirement, the funds will accumulate in the tax exempt trust while still remaining eligible for the tax benefits associated with qualified plan distributions when he retires or dies.130

(2) A participant dies and his 60 year old widow receives a lump sum distribution from his plan, electing to pay the ten year averaging tax. At age 65 the widow becomes eligible for another lump sum distribution through participation in her own plan. Although she would probably not be barred from doing so under the Code,131 if the widow were to elect ten year averaging on the second distribution, she would have the disadvantageous effect of aggregation132 because it would be received in the six year period beginning with the year of the first distribution.133 By electing to defer her distribution for two years, however, the second distribution would be received outside the six year period and aggregation would be avoided.

IV. CONCLUSION

Although the IRA has undoubted advantages as a tax shelter for those not participating in other retirement plans, its usefulness as a shelter for employees who terminate participation in qualified plans is offset by the necessary sacrifice of many tax benefits associated with qualified plans. The main advantages it offers are the deferral of the taxation of the distribution and the preservation of a tax free shelter for the earnings from the amount of the benefit after the distribution. Since the deferral may continue without penalty at least until the taxpayer attains age 70½,134 all the advantages generally

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130. However, accumulations during the period after the employee separates from service would not be subject to lump sum treatment. See note 73 supra.

131. Lump sum treatment can be elected no more than once "with respect to any individual after such individual has attained age 59½." Int. Rev. Code of 1954, § 402(e)(4)(B). Proposed Treas. Reg. § 1.402(e)-3(a), 40 Fed. Reg. 18798, 18810 (1975) speaks of this limitation "with respect to an employee." Apparently, then, the first election with respect to the deceased employee and the second election with respect to the widow employee would be separate for the purposes of this limitation.

132. See note 109 supra and accompanying text.

133. See note 108 supra and accompanying text.

134. See note 118 supra.
associated with such deferrals\textsuperscript{135} may be realized through the IRA. However, the rollover converts income which would otherwise be eligible for preferential tax treatment into ordinary income.

The advantages which the IRA offers must be carefully weighed against the disadvantages. If the employer or plan trustee cooperates in the design of a deferral agreement with the employee, some of these advantages may be gained without the loss of the tax benefits otherwise available under qualified plans.

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\footnotesize\textsuperscript{135} See notes 8-12 supra and accompanying text.