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When Insurance Products Meet Retirement Plans

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Contents

About this Document

This Special Report is the Seminar Outline for Natalie Choate's seminar "When Insurance Products Meet Retirement Plans." Most of the material in this Special Report is NOT included in Natalie Choate's book *Life and Death Planning for Retirement Benefits* (7th ed. 2011). It was contained in an earlier edition of that book (6th ed. 2006) but was removed to this separate *Special Report* for reasons of space. The 2011 edition of *Life and Death Planning for Retirement Benefits* contains nine chapters. The topics in this Special Report can be considered to be "Chapter 10" (minimum distribution rules for annuitized retirement plans) and "Chapter 11" (life insurance and retirement plans) of *Life and Death Planning for Retirement Benefits* (7th ed. 2011).

Abbreviations, Acronyms, and Defined Terms Used in this Document

§ Section symbols refer to sections of the Code.

¶ A "¶" reference in this document refers to another section of this document if the cross-referenced section begins with the number 10 or 11. If the referenced section begins with a number 1–9, it refers to a section of Natalie Choate's book *Life and Death Planning for Retirement Benefits* (7th ed. 2011) that is NOT reproduced in this document. *Life and Death Planning for Retirement Benefits*, published by Ataxplan Publications, is a reference work of over 500 pages on estate and distribution planning for retirement benefits. The book may be purchased for $89.95 plus shipping at www.ataxplan.com or by calling 800-247-6553.

ASD Annuity starting date. See PART I, ¶ 10.2.02.
Code Internal Revenue Code of 1986, as amended through February 2014.
DB plan Defined benefit plan. See PART I, ¶ 10.1.04.
DC plan Defined contribution plan. See PART I, ¶ 10.1.05.
Designated Beneficiary. See PART I, ¶ 10.2.09.
Distribution Year. See PART I, ¶ 10.2.07.
ERISA Employee Retirement Income Security Act of 1974 (P.L. 93-406).
IRA Individual retirement account. § 408.
IRS Internal Revenue Service.
MRD Minimum required distribution. § 401(a)(9).
Participant The individual whose retirement benefits we are talking about; for example, the owner of an IRA. For convenience, the male pronoun is usually used for the participant and the feminine pronoun refers to the participant's spouse.
PLR Private letter ruling issued by the Internal Revenue Service.
QRP Qualified retirement plan. A retirement plan that is qualified under § 401(a).
RBD Required beginning date. See PART I, ¶ 10.2.06.
Roth IRA Roth individual retirement account. § 408A.
Uniform Lifetime Table. The table used by most participants to calculate MRDs during the participant's lifetime. See Appendix A.

About the Author

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PART I: MINIMUM DISTRIBUTION RULES FOR ANNUITIZED PLANS & IRAS

Most practitioners are familiar with the minimum required distribution (MRD) rules for Defined Contribution (DC) plans, also called individual account plans. Those rules are explained in Chapter 1 of *Life and Death Planning for Retirement Benefits* (7^{th} ed. 2011). This PART I explains the completely different MRD rules that apply to defined *benefit* plans and to defined contribution plans that are annuitized.

10.1 Two Types of Retirement Plans

10.1.04 ***What a "Defined Benefit plan" is***

A Defined Benefit (DB) plan is a type of qualified retirement plan (i.e., qualified within the meaning of § 401(a)). Under a DB plan, also called a "defined benefit pension plan," the employer promises to pay the employee a specific pension, starting at retirement, and continuing for the employee's life. Social Security is similar to a DB plan.

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

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

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

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

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

With a DB plan, the plan (or insurance company issuing the annuity contract used to fund the benefits) takes the excess-longevity risk. See Wanda Example, ¶ 10.2.05.

Theoretically, under a DB plan, the plan also takes all the investment risk. If the plan's investments go down in value, the employee's promised benefit remains the same; the employer must contribute more money to the plan to fund that benefit. There are two exceptions to this statement. First, under one type of annuity, the variable annuity, the participant also has investment risk; see PART III(A)(1). Second, the employee has the risk that the employer will default on its obligation to fund the plan. If the plan becomes insolvent and/or the employer goes bankrupt, the employee may find his benefits limited to the amount insured by the government's pension insurer, the Pension Benefit Guarantee Corporation (PBGC). The employee will not receive the full benefits promised by the plan.

10.1.05 ***What a "Defined Contribution plan" is***

A Defined Contribution (DC) plan is, along with the Defined Benefit plan, one of the two broad categories of qualified retirement plan (QRP). DC plans are also called "individual account plans." § 414(i). IRS regulations use the terms individual account plan and defined contribution plan interchangeably; thus even individual account plans that are NOT QRPs (such as IRAs and 403(b) plans) may be considered DC plans.

Under a DC plan, the employer may commit to making a certain level of contribution to the plan (such as "10% of annual compensation," an example of a Money Purchase plan formula), or (under a profit-sharing plan) may make such contributions periodically on a discretionary basis or based on profit levels. 401(k) plans and ESOPs are other examples of DC plans.

Once the employer has contributed to the DC plan, the contributions are allocated among accounts for the individual participants who are members of the plan. What the participant will eventually receive from the plan is determined by (1) how much is allocated to his account under the contribution formula and (2) the subsequent investment performance of that account. The employer does not guarantee any level of retirement benefits. If the plan's investments do well, the profits will increase the participant's account value. If the plan's investments do poorly, the participant will receive less at retirement.

The minimum distribution rules for DC plans require that, for each Distribution Year (see ¶ 10.2.07), the participant (or beneficiary) must withdraw an amount computed by dividing the prior year-end value of the account by a factor taken from the applicable IRS life expectancy table.

10.2 MRDs for Defined Benefit Plans

The DC plan MRD rules are based on a simple system: Each year, the prior year-end account balance is divided by a factor obtained from an IRS table. The factors (divisors) are designed to liquidate the participant's account through annual distributions over the joint life expectancy of the participant and a beneficiary.

Under a DB plan, in contrast, there is no account balance to be liquidated. Instead, there is simply a promise by the plan to pay a certain amount periodically (typically monthly) to the participant for his lifetime, with or without a further promise to continue the periodic payments to the participant's beneficiary after the participant's death. So the IRS had to come up with a different approach to insure that DB plans are not used to accumulate money in a retirement plan for too long a period. It accomplished this with Reg. § 1.401(a)(9)-6, issued in 2004 (well after the final MRD regulations for DC plans, issued in 2002).

This explanation of the DB MRD rules is for the guidance of professionals advising individual retirees and small business owners. Most of the work involving DB and annuity MRDs is done by actuaries, plan administrators, and insurance companies, working on behalf of the employer and plan. They should consult a source designed for their use such as *The Pension Answer Book* (see Bibliography).

The DB regulation defines basic terms and concepts, such as "annuity," "payment interval," and "annuity starting date" (ASD). ¶ 10.2.02.

The regulation's core provisions tell us when the distributions must begin (¶ 10.2.06), and how benefits must be paid. The plan can offer the employee a menu of life annuities, fixed-term payouts, and combinations thereof, within limits set by the regulation. ¶ 10.2.03. Generally, the annuity payments cannot increase once the annuity payout has started, but the regulation allows several generous exceptions to that rule. ¶ 10.2.04. Once the form of annuity has been selected and the annuity payout starts, it cannot be changed, except in certain circumstances permitted by the regulation. ¶ 10.2.05.

The regulation also deals with special situations, such as what happens if the employee starts taking annuity payments prior to his RBD, ¶ 10.2.08. The most difficult "special situations" arise when the DC rules and the DB rules interact with each other, for example, when the employee converts his annuity benefit to a cash lump sum (¶ 10.2.07), or annuitizes benefits in a DC plan account (¶ 10.2.10).

The regulation focuses primarily on the type of annuity an employee can elect at or before his RBD, but also provides rules for death benefits paid under a DB plan. See ¶ 10.2.09.

The final regulation applies to distributions in 2006 and later years. For 2003–2005, distributions "based on a reasonable and good faith interpretation" of § 401(a)(9) will satisfy the MRD rules. Reg. § 1.401(a)(9)-6, A-17.

*10.2.01 **Differences between DB, DC plan rules***

Here are the differences between the DC and DB plan MRD rules:

A. **There is no account balance in a DB plan.** See Ralph Example, ¶ 10.2.07.

B. **The annuity payments are the MRD.** Once the participant's plan benefit has been annuitized, each year's payments under the contract apparently *are* the MRD for that year with respect to that benefit. See Reg. § 1.401(a)(9)-6, A-1(a), § 1.401(a)(9)-5, A-1(e). As MRDs, the annuity payments are not eligible for rollover. § 402(c)(4)(B), § 408(d)(3)(E), Reg. § 1.402(c)-2, A-7(c). This is true even if the participant could have elected some other form of annuity contract that would have paid him a smaller annuity. See Clyde Example, ¶ 10.2.10.

C. **MRD rules apply after ASD, even if before the RBD.** Unlike with a DC plan, the DB MRD rules will apply to the annuity prior to the RBD, if the annuity payments start before the RBD. See ¶ 10.2.08.

D. **Postponing the start of annuity distributions until the RBD does not require a "double distribution" in the second Distribution Year.** See ¶ 10.2.06.

*10.2.02 **Payment intervals; other DB terminology***

The DB plan MRD rules contemplate that benefits are paid in the form of an annuity: level payments made at regular intervals over a predetermined period of time. The interval between payments (**payment interval**) may not exceed one year (the usual interval is monthly payments), and must be the same throughout the distribution period. Reg. § 1.401(a)(9)-6, A-1(a).

The annuity may be paid to the participant (or beneficiary) directly from the plan's assets, or the plan may purchase an annuity contract from an insurance company and transfer the contract to the participant or beneficiary. Buying an annuity contract or electing a particular form of annuity benefit (i.e., "annuitizing" the participant's benefits) is an insurance transaction, involving a shifting of investment and/or longevity risk. See Wanda Example, ¶ 10.2.05.

The **annuity starting date** (ASD) is the first day of the first period for which an amount is received as an annuity. § 1.72-4(b). This is the date when the participant's accrued benefit in a DB plan (or account balance in a DC plan) is converted to an annuity payout, that is to say, is "annuitized." The ASD may be difficult to determine if the participant starts payments while he is still working and accruing further benefits, or starts receiving payments then stops them when he resumes employment, or does not start payments until some time after retiring.

*10.2.03 **Permitted forms, durations, of annuity***

The core provisions of the regulation tell us how long an annuity payout can last. Remember, the point of the MRD rules is to avoid unduly prolonged deferral of distribution of the plan benefits.

Thus, the regulation could not allow a retiring employee to elect to have his benefits paid out over 1,000 years. A thousand-year payout would violate the fundamental concept of § 401(a)(9), which is that retirement benefits must be completely distributed over the life or life expectancy of the participant and (within limits) of the participant's beneficiary. Similarly, the rules could not allow a participant to choose a form of benefit that would defer all distributions until the participant's death; such a payout form would violate the principle that death benefits must be "incidental" to the primary benefit, which is a retirement pension. Reg. § 1.401-1(b)(1)(i).

The regulation permits a variety of different possible durations for the annuity payments. The payments can last for the participant's life, for a fixed term, or for life with a minimum guaranteed term. The amount of the employee's monthly pension will vary depending on which form he elects; generally, the more survivor benefits and guarantees the employee opts for, the lower his own monthly pension will be. All forms of benefits are supposed to be of equivalent value (though often they're not; see ¶ 10.3.03); those computations are a function of the plan's benefit formula and actuarial calculations, not the MRD rules.

Here are the forms of payout the IRS allows a DB plan to offer to a retiring employee who is commencing his annuity payout at approximately age 70. If the annuity starts at an earlier age, see ¶ 10.2.08. Regarding the ability to delay "annuitization," see ¶ 10.2.06.

A. **An annuity for the life of the participant, with no minimum guaranteed term.** Reg. § 1.401(a)(9)-6, A-1(a), A-2(a). This would give the participant the largest annuity payments during his life, but would provide no benefits for his beneficiaries.

B. **An annuity for the joint lives of the participant and his spouse, terminating at the death of the surviving spouse, with no minimum guaranteed term.** Reg. § 1.401(a)(9)-6, A-1(a), A-2(b). The monthly payments to the surviving spouse cannot be larger than the payments the participant receives, but can be the same amount or anything less. (The spouse's consent would be required in order for her survivor payment to be less than 50 percent of the participant's payment; see § 417 and ¶ 3.4 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011) regarding the spousal consent requirements.) This form of benefit would provide no benefits after the death of the surviving spouse.

C. **An annuity for the joint lives of the participant and his nonspouse beneficiary, terminating when both of them are deceased, with no minimum guaranteed term.** Reg. § 1.401(a)(9)-6, A-1(a), A-2(c). This option is the same as "B," with one difference: If the nonspouse beneficiary is more than 10 years younger than the participant, the monthly payment to the beneficiary cannot exceed a certain percentage of what the participant was receiving. The percentage depends on the age difference between the participant and the beneficiary, using the Table in Reg. § 1.401(a)(9)-6, A-2(c). (If the participant is married, his spouse's consent is required for him to name a nonspouse beneficiary; see § 417 and ¶ 3.4 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011) regarding the spousal consent requirements.) This "minimum distribution incidental benefit" (MDIB) rule, by forcing most of the benefits out during the participant's projected lifetime, assures that distribution of the benefits is not unduly prolonged. See "E" for how this rule interacts with a minimum guaranteed term.

D. **An annuity for a period certain, with no life component.** Reg § 1.401(a)(9)-6, A-1(a), first sentence. If the ASD is on or after the participant's RBD, the period certain must not be longer than whichever of the following is applicable. (If the ASD is before the RBD, see ¶ 10.2.08.)

1. The **General Maximum Period Certain** is the Applicable Distribution Period (ADP) from the Uniform Lifetime Table (see Appendix A) determined using the participant's age in the calendar year the ASD occurs. Reg. § 1.401(a)(9)-6, A-1(a), A-3(a), first sentence. For example, if the participant's ASD is in the year she turns 71, the General Maximum Period Certain would be 26.5 years; the participant could elect to receive annuity payments for a fixed term of 26.5 years. If she lives longer than 26.5 years? Too bad. Under this option, her payments end after 26.5 years. If she dies in less than 26.5 years, her beneficiary would receive the payments for the balance of the 26.5-year term certain.

2. The **Special Maximum Period Certain** is the ADP determined using the IRS's Joint and Survivor Life Expectancy Table (found at Reg. § 1.401(a)(9)-9, A-3), based on the ages the participant and spouse attain on their birthdays in the year of the ASD. This Special Maximum Period Certain applies only if the participant's sole beneficiary is his spouse, and only if it provides a longer payout period than the General Maximum Period Certain. Reg. § 1.401(a)(9)-6, A-1(a), A-3(a), last sentence. If either spouse lives past that fixed term, too bad—the payments will stop when the term expires.

E. **Life annuity with period certain.** The employee can elect a life annuity ("A" above) or a joint and survivor life annuity ("B" or "C" above) with a minimum guaranteed term. The minimum guaranteed term can be any term that does not exceed the General Maximum Period Certain described at "D(1)" above, namely, the ADP determined under the Uniform Lifetime Table using the participant's attained age as of his birthday in the year of the ASD. Reg. § 1.401(a)(9)-6, A-1(b), A-2(d), A-3(a). Note that, even if the employee's sole beneficiary is his more-than-10-years-younger spouse, the joint and survivor life expectancy of the participant and spouse (the Special Maximum Period Certain in "D(2)" above) *cannot* be used as a minimum guaranteed term in conjunction with a life annuity. It can be used as a period certain on its own but not in conjunction with a life annuity.

The "E" option is the most complicated, because of the interaction of the period certain and the MDIB rule.

Which form of benefit should a participant choose? See ¶ 10.3.

10.2.04 ***Payments must be nonincreasing, except…***

The other core provision of the regulation is that the annuity payments generally may not increase after the ASD. Reg. § 1.401(a)(9)-6, A-1(a). After all, the purpose of the DB plan MRD rules is to prevent "backloading" the distributions; Congress wants to collect taxes on this pension as soon as possible.

(Payments can be set up so that they *decrease* after the ASD; in fact, in the case of death benefits paid to a nonspouse beneficiary, the MDIB rule may require that payments decrease after the participant's death; see ¶ 10.2.03(C).)

The regulation permits several significant exceptions to the no-increases rule. The pension payable under a DB plan may provide for the following payment increases. All of these represent payout increases that are either built in to the annuity terms from the beginning (A–E), or added later as a result of a plan amendment (F) or the participant's accrual of additional benefits under the plan (G). For other types of changes in the annuity payout after the ASD, see ¶ 10.2.05.

A. **Cost of living adjustment (COLA).** The payout may provide for an annual adjustment to reflect (or for periodic upward adjustments limited by) increases in certain IRS-approved cost-of-living indices. Reg. § 1.401(a)(9)-6, A-14.

B. **Elimination of survivor benefit.** If the employee's benefit payments were in a reduced amount to reflect a survivor payment payable to his beneficiary, the contract can provide that the employee's payments will be increased (eliminating the reduction prospectively) if the beneficiary either ceases to be the beneficiary "pursuant to a qualified domestic relations order" (QDRO) or dies. Reg. § 1.401(a)(9)-6, A-14(a)(3). The IRS calls this a "pop up" of benefits. T.D. 9130, 2004-1 C.B. 1082, Preamble.

C. **Lump sum conversion by beneficiary.** A beneficiary may be allowed to convert his survivor annuity benefit into a lump sum. Reg. § 1.401(a)(9)-6, A-14(a)(5).

D. **Other permitted increases: contracts purchased from insurance company.** If the benefit is funded with an annuity contract that the plan purchases from an insurance company, the contract can *also* provide for:

1. Annual percentage increases in the benefit that are not tied to a cost-of-living index;

2. A "final payment" at the employee's death equal to the difference between the "total value being annuitized" and the payments made to the employee during his life;

3. Annual dividends or adjustments reflecting "actuarial gains" in the policy; this allows use of a variable annuity contract (see PART III(A)(1) of this Report); and/or

4. "Acceleration" of the annuity.

Generally, the total value of the future expected payments under the contract must be the same, regardless of which of these extras are included. Reg. § 1.401(a)(9)-6, A-14(c). However, the regulation is not overly strict on this point because essentially the IRS is relying on the insurance company that issues the annuity contract to "police" the values. Presumably a rational insurance company would not offer the annuitant a choice of packages that have wildly differing values. If benefits are paid directly from the plan, options are more limited, presumably because the IRS does not trust private employer plans not to try to bend the rules for the benefit of certain individuals; see "E." For definitions of "total value being annuitized," "actuarial gain," "total future expected payments," and "acceleration of payments," see Reg. § 1.401(a)(9)-6, A-14(e).

E. **Other permitted increases: benefits paid directly from the plan.** If the benefits are paid directly from the plan, rather than being funded with an annuity contract purchased from an insurance company, acceleration of the annuity (D(4) above) is not permitted. The plan may provide for increases similar to those described at D(1)–(3) above, but subject to additional limitations (for example, an annual increase not tied to a cost-of-living index must be less than 5%). Reg. § 1.401(a)(9)-6, A-14(d).

F. **Plan amendment.** Benefits may be increased to reflect a plan amendment. Reg. § 1.401(a)(9)-6, A-14(a)(4).

G. **Additional benefits accrued after ASD.** If the employee accrues additional benefits after the ASD, and after his RBD, the distribution of the additional accrued benefit must begin with the first payment interval ending in the calendar year immediately following the calendar year in which such amount accrues. Reg. § 1.401(a)(9)-6, A-5.

10.2.05 ***Other changes permitted after the ASD***

The theory of an annuity is that, once the terms of the payout are set, they cannot be changed. That principle is fundamental to an insurance transaction in which one side is taking a risk regarding future events; if one party to the transaction can change his mind after the facts have become known, the system won't work.

Wanda Example: Wanda, age 70, believes she is in the best of health; coming from a long-lived family, she expects to live well beyond average life expectancy. She opts for a life annuity with no minimum guaranteed term, to get the largest possible monthly payments for herself. The insurance company that issues the annuity to Wanda is simultaneously issuing annuity contracts to thousands of other 70-year-olds who want to be protected against the risk of living too long. The insurance company knows some of them will live longer than average and some will die prematurely; the company will make a "profit" on those who die prematurely, enabling the company to stay in business and pay benefits to those who live "too long." A year later, Wanda discovers she has a serious illness and is likely to die prematurely. She wants to change the type of contract she selected, to one that has a minimum guaranteed term. But if all the terminally ill people in the group are allowed to switch to a minimum guaranteed term, while the insurance company is still required to make payments for life to those who live extra long, the insurance company will go out of business.

So the question of whether an annuity payout can be changed after the ASD is usually moot. The annuity issuer usually won't allow such changes. However, in case a particular pension plan or insurance company does allow changes, the MRD rules also recognize the possibility of changes. For example, a payment can be modified in connection with plan termination or the employee's retirement or marriage. For more on permitted post-ASD modifications, see Reg. § 1.401(a)(9)-6, A-13.

10.2.06 ***When the annuity payments must commence; the RBD***

The first payment under the annuity must be made not later than the employee's Required Beginning Date (RBD). Reg. § 1.401(a)(9)-6, A-1(c)(1).

The "required beginning date" (RBD) is the deadline by which a retirement plan participant must begin taking minimum required distributions. § 401(a)(9)(A). For traditional IRAs, the RBD is April 1 of the year following the year in which the participant reaches age 70½. For 401(k) plans, 403(b) plans, and other qualified or nonIRA plans, the RBD is generally April 1 of the year following the year the participant (1) reaches age 70½ or (2) retires, whichever is later, provided the participant owns less than five percent of the employer that sponsors the plan. The post-death minimum distribution rules are different depending on whether the participant died before or after his RBD. For full details on the RBD, see ¶ 1.4 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011).

Note the following:

- Because minimum distributions are not required from a Roth IRA prior to the participant's death, this requirement simply does not apply to annuities purchased inside a Roth IRA. A Roth IRA does not have an "RBD." § 408A(c)(5); see ¶ 5.2.02 of *Life and Death Planning for Retirement Benefits*.

- The requirement that annuity payouts must begin by the RBD means that it is "illegal" to purchase a "longevity annuity" (one that does not start paying out until the owner reaches his 80s) inside a traditional IRA. The IRS has proposed regulations that would change this situation by permitting a portion of an individual's traditional IRA to be used to purchase a longevity annuity; see ¶ 10.2.11 below.

The amount that must be paid on or before that date is whatever the regular annuity amount is. For example, if the employee is to receive $6,000 per month, he receives the first $6,000 on or before his RBD, the next $6,000 a month later, and so on until the expiration of the agreed-upon duration of the annuity.

Here we have another difference from DC plans. Under a DC plan, if the employee took no distribution from the plan in his first Distribution Year, he would have to take two years' worth of distributions in the second Distribution Year. This concept does not apply to annuity payouts. As long as the periodic payments start no later than the RBD, there is no need to take some kind of "catch-up distribution" for the first Distribution Year. Under a DB plan, there simply is no MRD for the first Distribution Year—with one major exception: If the participant takes all or part of his benefits in the form of a lump sum distribution rather than as an annuity, in or after his first Distribution Year, then there *is* an MRD for the first Distribution Year; see ¶ 10.2.07.

Expert Comment: Late Retiree's Dilemma

The regulations force the DB plan participant to annuitize his benefits starting no later than the RBD. A top actuary, the late Ed Burrows (see ¶ 10.3.03), pointed out that this creates a problem for a business owner who is still working and participating in his DB plan when he reaches age 70½. As a "5-percent owner," he must start taking MRDs by April 1 following the year he reaches age 70½. § 401(a)(9)(C); Reg. § 1.401(a)(9)-2, A-2(a). However, typically the entrepreneur does not want to be forced into making annuitization choices prior to retirement, while he is still accruing benefits under the plan. At one time, the IRS allowed MRDs for a DB plan to be computed using the DC plan method, treating the lump sum equivalent value of the benefit as the "account balance." Unfortunately, the final regulations removed this option, preserving that concept solely for purposes of certain restrictions on rollovers (¶ 10.2.07). This change has made retirement decisions more difficult for the small business owner who has a DB plan and wants to keep working past age 70½.

10.2.07 ***Converting an annuity payout to a lump sum***

Under some DB plans, the participant has a choice at retirement. Instead of taking an annuity payout, he can take a lump sum cash distribution. The amount of the lump sum equivalent of the participant's vested accrued pension is determined by the plan's actuary, using interest rates and life expectancy factors dictated by the IRS. Under a cash balance plan, the participant would be made aware of the lump sum equivalent of his benefit every year; under more traditional DB plans, he would not learn this number until he approached retirement.

The lump sum alternative is not the same as an account balance under a DC plan. The value of the lump sum equivalent fluctuates with interest rates; it goes down as interest rates go up, which can be a shock to an employee near retirement:

Ralph Example: Ralph expects to retire at age 65. Rather than take a $3,000 per month life pension, he plans to take the lump sum equivalent value, which the plan projects will be $622,000 when Ralph reaches age 65, using a four percent interest rate. However, when Ralph actually reaches age 65, the interest rate has changed to five percent. He can still elect to take a monthly pension of $3,000, but if he wants a lump sum, he will get only $553,000! Ralph is shocked and thinks he has been cheated, but unfortunately for him this is exactly what is supposed to happen. If it's any consolation, remind him the plan is not even required to offer him a lump sum distribution; many DB plans offer only the annuity benefit. If the applicable interest rate had decreased, the lump sum equivalent value of his pension would have *increased*. [Numbers in the examples in this section were made up for purposes of illustration only, and do not represent realistic actuarial values.]

If the plan allows the lump sum option, the plan will tell the employee what the lump sum equivalent value is. The minimum distribution rules have nothing to say about that computation. In fact, if the employee takes the lump sum distribution instead of a pension, the MRD rules are completely finished with him—*unless* the lump sum is to be paid to him in a year for which a minimum distribution is required. Even then, the MRD rules "don't care" about the lump sum distribution—*unless* the participant wants to roll it over! If the annuity is converted to a lump sum, and the lump sum is paid to the participant in or after his "first Distribution Year," then the MRD rules care about one thing and one thing only: how much of that distribution is treated as an MRD, which is not eligible to be rolled over to another plan. ¶ 2.6.04.

Definition of "Distribution Year"

A year for which a minimum distribution is required is called a "distribution calendar year" in the regulations, **Distribution Year** in this Special Report. Reg. § 1.401(a)(9)-5, A-1(b). For plans subject to the lifetime MRD rules, the "first Distribution Year" is the year the participant reaches age 70½ (or, in some cases, retires; see ¶ 1.4.03 and ¶ 1.4.06 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011)). Normally, the deadline for taking the MRD for a particular Distribution Year is December 31 of such year (§ 1.401(a)(9)-5, A-1), but, for lifetime distributions only, in the case of the first Distribution Year, the deadline is April 1 of the *following* year. Reg. § 1.401(a)(9)-5, A-1(c). That final deadline for the first year's MRD is call the **Required Beginning Date** or **RBD**. § 401(a)(9)(C); see ¶ 10.2.06.

Reg. § 1.401(a)(9)-6, A-1(d), provides two methods whereby a DB plan can compute the nonrollable "MRD portion" of a lump sum distribution.

Method #1: Under Method #1, you compute the MRD portion using the DC plan MRD rules (see ¶ 10.1.05), "pretending" that the lump sum distribution the employee receives is the prior year-end balance.

Method #2: Method #2 is more complicated. Essentially you treat one year's worth of pension payments as the MRD for the first year. The regulation permits "expressing the employee's benefit as an annuity that would satisfy" the MRD regulations (apparently *any* annuity that would satisfy the MRD regulations), beginning as of the first day of the Distribution Year for which the MRD is being determined. Reg. § 1.401(a)(9)-6, A-1(d)(2).

Which method is better? Method #1 is easier to calculate, and will always produce a smaller MRD. It seems extremely strange to have a "minimum required" distribution that could be any one of several different possible amounts.

Suppose the participant postpones taking her benefits until her Required Beginning Date (RBD), then receives a lump sum distribution on the RBD. How much of that distribution is treated as a nonrollable MRD? The regulation gives us the same two methods, but in this case we must compute two years' worth of MRDs, since the year of the RBD is actually the second Distribution Year.

Method #1: This is tricky! We must compute two years' worth of MRDs, using the "pretend" DC plan method. That means there are two different divisors, one for the first Distribution Year (the year the participant reached age 70½) and one for the second year (the year he reached age 71½). But the pretend "prior year-end balance" we use for both these computations is the same, the amount of the lump sum distribution. Reg. § 1.401(a)(9)-6, A-1(d)(1).

Any distributions the participant had received in the first Distribution Year would reduce the amount of the MRD for the "first Distribution Year" portion of the second Distribution Year MRD.

Method #2: If the plan uses this method it would treat two years' worth of annuity payments as the MRD for the second Distribution Year. The "annuity payments" for this purpose would be based on an annuity that started on the first day of the first Distribution Year.

10.2.08 ***If participant's ASD is prior to the RBD***

If an employee retires before age 70½, at, say, age 65, and starts receiving his pension then, he and the annuity issuer are making their insurance bargain irrevocably at that time. This situation poses another contrast to the DC plan situation, and again required the IRS to come up with different rules for DB plans.

Under a DC plan, any distributions the participant takes prior to his first Distribution Year are irrelevant to the MRD rules. The DC rules kick into action during the first Distribution Year and/or on the RBD or date of death. If the IRS tried to use this same approach for DB plans, then every DB plan participant who retired and started receiving a pension earlier than his RBD would have to calculate everything *again* when he reached age 70½, and annuities issued to participants younger than age 70½ would have to contain different death-benefit rules depending on whether the participant died before or after his RBD. The IRS did not so provide.

If the ASD is prior to the RBD, the annuity contract can provide anything it wants to with respect to distributions prior to the first Distribution Year, but must provide for distributions that satisfy the MRD rules in the first Distribution Year and subsequent years. Reg. § 1.401(a)(9)-2, A-4, last sentence. The ASD is treated as the RBD for certain purposes. Reg. § 1.401(a)(9)-6, A-10, first sentence. For example, if the participant dies after the ASD he is treated as dying *after his RBD*, even if his death occurred prior to April 1 of the year after the year in which he would have reached age 70½. Reg. § 1.401(a)(9)-6, A-10(a), last two sentences.

Treating the ASD as the RBD requires certain adjustments to the computations discussed at ¶ 10.2.03(D). For example, we know that the General Maximum Period Certain is determined using the Uniform Lifetime Table, based on the employee's age as of his birthday in the first Distribution Year, but the ULT does not have factors for ages below 70. Accordingly, the regulation provides that, for an annuity commencing prior to the year the participant reaches age 70, the maximum period certain is 27.4 (which is the ULT factor for age 70) plus the difference in years between 70 and the participant's age as of his birthday in the year of the ASD.

Curt Example: Curt retires from Acme in Year 1, taking his pension in the form of an annuity for a term certain, starting immediately. He will turn age 62 on his Year 1 birthday. The maximum term certain his annuity can last for is 35.4 years (27.4 + [70 − 62] = 35.4).

Another adjustment required if the annuity starts before age 70 has to do with the maximum benefit payable to a nonspouse beneficiary under a joint and survivor annuity (see ¶ 10.2.03(C)). Because the participant will be receiving the annuity payments for a longer time (because he is starting the annuity at a younger age), the participant will "automatically" be receiving a larger share of the joint and survivor life annuity, and the survivor's share will "automatically" be less. Accordingly, the IRS allows the survivor benefit to be a larger percentage of the participant's benefit. This is done by "adjusting" the age difference between the employee and the beneficiary for purposes of applying the table in Reg. § 1.401(a)(9)-6, A-2(c)(2).

First, determine the actual age difference between the participant and beneficiary. Then, reduce the age difference so determined by the number of years by which the participant is younger than age 70. For example, if the participant turns age 64 in the year of the ASD, and his nonspouse beneficiary is age 34 (30 years younger than the participant), the 30-year age difference is reduced by six (70 − 64), so the "adjusted age difference" is 24 (30 − 6), and the beneficiary's maximum annuity is 67 percent of the participant's annuity. Reg. § 1.401(a)(9)-6, A-2(c)(1).

*10.2.09 **MRD rules for DB plan death benefits***

The regulation provides different rules for death benefits depending on whether the participant died before or after his annuity starting date (ASD).

Regarding whether any death benefits discussed here can be rolled over to another retirement plan or to an IRA by the beneficiary, see generally ¶ 3.2 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011) regarding the ability of a surviving spouse to transfer or "roll over" inherited benefits to her own or an "inherited" retirement plan; and see § 402(c)(11) (discussed at ¶ 4.2.04 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011)) for the ability of a nonspouse Designated Beneficiary to transfer inherited QRP benefits to an "inherited" IRA or Roth IRA.

If the participant died before the ASD, the regulation is a little hazy on the requirements and options. It appears that the beneficiary could take the benefits in a lump sum (if that option is offered by the plan), though that option is not discussed in the regulation.

Definition of "Designated Beneficiary"

A Designated Beneficiary means an *individual* (or group of individuals) who are named as beneficiary(ies) of the plan by the participant or under the terms of the plan. § 401(a)(9)(E); Reg. § 1.401(a)(9)-4, A-1, A-2. Under IRS regulations, if a *trust* is the named beneficiary, and the trust meets numerous requirements, the individual trust beneficiaries are treated as if they had been named directly as beneficiaries, and thus can be treated as "Designated Beneficiaries." For details on the rules for such so-called "see-through trusts," see Chapter 6 of *Life and Death Planning for Retirement Benefits*. However, an estate cannot be a "Designated Beneficiary" and thus can NOT use the life expectancy, life annuity, or rollover options available to a Designated Beneficiary. The same is true of a trust that is named as the participant's beneficiary but that does not qualify as a "see-through trust."

Alternatively, a Designated Beneficiary could take the benefits in any of three annuity forms:

A. **Life annuity with minimum guaranteed term.** The Designated Beneficiary can take a life annuity with a minimum guaranteed term, provided the guaranteed term may not exceed the beneficiary's life expectancy, determined using the IRS's Single Life Table. Reg. § 1.401(a)(9)-6, A-3(b)(1); § 1.401(a)(9)-5, A-5(b), (c).

B. **Life annuity.** He can take a life annuity with no minimum guaranteed term. Although the regulation does not specifically mention this form of benefit, it can be inferred from § 401(a)(9)(B)(iii)(II) and the regulations mentioned at "A."

C. **Annuity for term certain.** He can take an annuity for a period certain. The period certain may not exceed his life expectancy (see "A").

Whichever of these annuity options is chosen, the first payment must be made no later than the end of the year after the year of the participant's death (or, if later, and if the sole beneficiary is the participant's spouse, the end of the year in which the participant would have reached age 70½). Reg. § 1.401(a)(9)-6, A-1(c)(1), fourth sentence; § 1.401(a)(9)-3, A-3(a), (b).

If the beneficiary is not a Designated Beneficiary, the options are more restricted because all benefits must be distributed within five years after the participant's death. § 401(a)(9)(B)(ii), Reg. § 1.401(a)(9)-3, A-4. See ¶ 1.5.06 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011) for more on this so-called five-year rule.

Note that the above discusses the participant's death "before the ASD," rather than "before the RBD." See ¶ 10.2.08.

If the participant died <u>on or after the ASD</u>, the payout to the beneficiary is determined by the type of survivor annuity the participant selected when the annuity payout began. See the alternatives listed at ¶ 10.2.03(B)–(E). The survivor annuity can be accelerated (converted to a lump sum), if the beneficiary wishes to do so and the plan permits this option. Reg. § 1.401(a)(9)-6, A-14(a)(5).

Furthermore, "the annuity starting date will be treated as the required beginning date" for purposes of Reg. § 1.401(a)(9)-2 and § 1.401(a)(9)-6. Reg. § 1.401(a)(9)-6, A-10(a). Thus, the employee's death after the ASD is treated as death after the RBD even if it was in fact before the RBD. Similarly, if the participant died before the year he would have reached age 70½, and his surviving spouse starts a regulation-compliant annuity payout *prior* to that year (even though she could have waited *until* that year), distributions after her death must continue to be made over her life expectancy (or whatever other regulation-compliant period she elected). Her death does not trigger a new determination of Designated Beneficiary, as it would have had she died before commencing her payout. Reg. § 1.401(a)(9)-6, A-11. Compare Reg. § 1.401(a)(9)-3, A-5, A-6, § 1.401(a)(9)-4, A-4(b).

Note: Despite this rule treating the ASD as the RBD for certain purposes, it would appear that annuity payments made to the participant prior to his first distribution year should not be considered "minimum required distributions" for purposes of the rule that minimum distributions are not eligible for rollover.

10.2.10 ***Buying an immediate annuity inside a DC plan or IRA***

Reg. § 1.401(a)(9)-6 applies to defined benefit plans. It also applies to "annuity contracts purchased with an employee's account balance under a defined contribution plan." T.D. 9130, 2004-1 C.B. 1082. Thus, if a retiring employee's 401(k) balance is used directly to purchase an annuity contract, the annuity contract must comply with the DB plan rules, even though a 401(k) plan is a DC plan. The same is true if the employee rolls his 401(k) plan balance over to an IRA (another form of DC plan), and uses part or all of the IRA funds to purchase an annuity contract. Reg. § 1.401(a)(9)-5, A-1(e), second sentence. In the year of the purchase, the account is still subject to the DC plan MRD rules; for that year *only,* distributions under the annuity contract will be taken into account as satisfying the MRD requirement for the account under the DC rules. Reg. § 1.401(a)(9)-5, A-1(e), third sentence.

(Note: Another approach is to take cash out of the DC plan, pay the income tax on the distribution, and use the after-tax proceeds to purchase an annuity outside the plan. That scenario is not what is being discussed here.)

If only *part* of the employee's benefit in a DC plan is used to purchase an annuity, the regulations treat the two portions of the employee's account as two separate accounts, beginning the year *after* the year of the purchase. The annuity contract must comply with Reg. § 1.401(a)(9)-6 (the DB plan rules) and the rest of the account must comply with the DC plan MRD rules (Reg. § 1.401(a)(9)-5). See Reg. § 1.401(a)(9)-5, A-1(e), § 1.401(a)(9)-8, A-2(a)(3). If the annuity contract is purchased after the RBD, all distributions received under the annuity contract are considered minimum required distributions and accordingly cannot be rolled over. Reg. § 1.401(a)(9)-5, A-1(e), third sentence; § 402(c)(4)(B), § 403(b)(8)(A)(i), § 408(d)(3)(E).

Roz Example: Roz, who turns age 73 in 2005, owns an IRA. The account balance was $2 million as of December 31, 2004, so her MRD for 2005 is $80,972 ($2,000,000 ÷ 24.7, the divisor for age 73 from the Uniform Lifetime Table). In July 2005, she uses $500,000 of the IRA balance to purchase an annuity contract which will pay her $5,000 a month for life, on the first day of each month, starting August 1, 2005. According to Reg. § 1.401(a)(9)-8, A-2(a)(3) (which is made applicable to IRAs by Reg. § 1.408-8, A-1(a)), the IRA will be treated as two separate accounts for MRD purposes, beginning in 2006: The MRDs for the "DC portion" of the IRA will be computed based on the prior year-end account balance excluding the value of the annuity contract; the MRD requirement with respect to the "annuity portion" is satisfied by the payments to Roz under the annuity contract. For the year 2005 *only*, the $25,000 of annuity payments Roz receives from the contract for August–December (five months times $5,000) count towards her $80,972 MRD for 2005; she will have to withdraw the rest of the 2005 MRD ($55,972) from the nonannuity portion of the account by December 31, 2005. Starting in 2006, the payments under the annuity contract will not count towards the MRD requirement for the nonannuity portion of the account (see Clyde Example, below).

Although it does not specifically address this point, it appears that Reg. § 1.408-8, A-9 (allowing the owner of multiple IRAs to take the aggregate MRDs for all IRAs he holds as "participant" from any one or more of such IRAs; see ¶ 1.3.04 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011)) applies only to IRAs that are DC plans, not to any IRA (or portion of an IRA) that has been annuitized.

Clyde Example: Clyde, age 70, has a $2 million IRA. He uses $500,000 of the balance to purchase a 10-year term-certain annuity that pays him $60,000 per year. Now his IRA holds $1.5 million of securities and a $60,000-per-year 10-year annuity contract. He could have purchased an annuity that would have lasted for up to 27.4 years; see ¶ 10.2.03(D). If he had elected a longer annuity term payout, his annual annuity payment under the contract would have been much smaller. Can Clyde treat the "excess" payments (i.e., the part of the annuity payment in excess of the smallest annuity payment he could have elected) as satisfying the MRD requirement for the remaining IRA balance, under the aggregation rule of Reg. § 1.408-8, A-9?

The answer unfortunately for Clyde appears to be "no." Once the participant has chosen an annuity contract with particular terms, those terms create the MRD under that annuity contract. Thus, the entire $60,000 per year payment to Clyde from his annuity contract *is* the MRD for the annuity, and there is no "excess distribution" to be applied to the DC portion of the IRA (even though he could have chosen a different annuity with smaller payments). Similarly, it appears that no part of the annuity payment can be rolled over, even though he could have purchased a longer-term annuity with smaller payments. Reg. § 1.402(c)-2, A-7(c).

10.2.11 ***One exception to the rules: "Qualified Longevity Annuities"***

Many retirees worry about running out of money in their later years. One solution is to hoard money (spend less) today because you might live beyond the average life expectancy. The problem with that solution is that it causes everyone to live below his possible standard of living even though not everyone will live long enough to have the problem.

The insurance industry's solution: For a lump sum payment that is relatively small while you are only in your 50s or 60s, buy an annuity now that doesn't start paying out until you reach your mid 80s. Such a "longevity annuity" enables you to spend more during your "young old years" without worrying that you will run out of money if you live too long. But that type of annuity could not, prior to July 2014, be purchased inside a traditional IRA (or other defined contribution/individual account plan, such as a 401(k) plan) because of the rule that payments under a plan-owned annuity contract must begin by the required beginning date (RBD) (generally approximately age 70½).

The IRS has ridden to the rescue. Under proposed regulations issued in 2012, as modified and finalized effective July 2, 2014, up to 25 percent of the participant's account balance (but not more than $125,000) can be invested in a "qualified longevity annuity contract" (QLAC) without violating the minimum distribution rules. See Regs. § 1.401(a)(9)-5, A-3, § 1.401(a)(9)-6, A-17.

Definition of a QLAC

Reg. § 1.401(a)(9)-6, A-17, defines the qualified longevity annuity contract. A QLAC:

- Must begin its payments no later than the first day of the month next following the 85th anniversary of the participant's birth. A-17(a)(2).

- Must satisfy all requirements applicable to annuitized defined contribution plans *other than* the requirement that payments must start by the RBD. A-17(a)(3). For detail on these other requirements, see Reg. § 1.401(a)(9)-6 and the author's *Special Report: When Insurance Products Meet Retirement Plans* (www.ataxplan.com). The principle other requirements are (1) the rule that the contract must provide level payments paid annually (or more frequently) that do not increase (except within certain permitted limits, such as a COLA), (2) limitations on the survivorship benefit allowed, and (3) rules for how to compute the RMD with respect to the nonannuitized portion of the plan when only part of the account is "annuitized."

- May not provide a commutation benefit, cash surrender right, or other similar feature. A-17(a)(4).

- Must state that the contract is intended to be a QLAC. A-17(a)(6).

- Must not be a variable, equity-indexed, or "similar" contract except as may be later permitted by Treasury guidance. A-17(a)(7).

- Must limit death benefits as described below. A-17(c).

Dollar and percentage limits on QLAC purchases

The amount paid for QLACs may not exceed the lesser of $125,000 or 25 percent of the account balance. A participant can buy multiple QLACs in his/her traditional IRA(s) provided the cumulative total premiums paid for them does not exceed these limits. Note the following details about these purchase limits. Citations are to subsections of Reg. § 1.401(a)(9)-6, A-17, unless otherwise noted.

✓ The $125,000 amount will be adjusted upwards for inflation starting in 2015. A-17(d)(2)(I).

✓ Premiums paid for QLACs (or contracts intended to be QLACs) purchased in any other defined contribution plan for the participant's benefit are counted in applying the dollar limit. For example, if the participant spends $125,000 on a QLAC in her 403(b) plan account at work, she has used up her dollar limit and cannot buy any additional QLAC in the IRA. A-17(b)(2)(ii)(B).

✓ The 25 percent limitation is applied to the total account balance (including the value of any QLAC). Unlike the dollar limit, the percentage limit is apparently applied without regard to the account balance in other types of plans. A-17(b)(3). The Preamble to the regulation states that all traditional IRAs will be considered a single account for applying this limit, just as required minimum distributions taken from one traditional IRA can satisfy the distribution requirement with respect to other traditional noninherited IRAs owned by the same individual. See T.D. 9673 (7/2/14), Section II ("IRAs"), second paragraph. However, I cannot find this statement in the regulation itself.

Roth IRAs

The limitations on purchases of longevity annuities do not apply to Roth IRAs during the owner's life. That's because there is no lifetime minimum distribution requirement applicable to a Roth IRA, therefore, buying an annuity that does not start payments until much later than age 70½ is "not a problem" for a Roth IRA. See § 408A(c)(5); Reg. § 1.408A-6, A-14(d).

Longevity annuities held in a Roth IRA are not considered QLACs and do not count when applying the 25 percent/$125,000 limit on QLAC purchases in the participant's traditional IRA. A-17(d)(3)(ii). This regulation also provides rules for applying the limits after a QLAC owned by a traditional IRA is converted to a Roth.

Rules regarding death benefits under a QLAC

Since a QLAC is supposed to be insurance against living "too long," it makes no sense for the QLAC to provide a death benefit. The cost of providing a death benefit must necessarily reduce the true "longevity insurance" the contract can provide. But human nature being what it is, people only want to buy this product if it is heads I win tails you lose, so the regulation permits certain limited death benefits that can be provided in a QLAC. In general, the permitted death benefits must *either* be in the form of one of the following types of survivor annuity, *or*, alternatively, the contract can provide a "return of premium" guarantee-type death benefit *in lieu of* any survivor annuity. (The contract could also provide no death benefit at all.) A-17(c)(4).

✓ If the participant's surviving spouse is the sole beneficiary, the contract can provide a life annuity to the surviving spouse provided the annuity payments do not exceed the annuity payments the participant would have received. A-17(c)(1).

✓ If the participant died before the annuity starting date of his own annuity, a greater survivorship annuity to the spouse-sole beneficiary is permitted if necessary to satisfy the qualified pre-retirement survivor annuity (QPSA) requirements of § 417 [this would not apply to IRAs, which are not subject to this requirement], and the survivor annuity must commence no later than the annuity to the participant would have commenced had he lived. A-17(c)(1)(ii).

✓ If the participant's surviving spouse is not the sole beneficiary, the contract can provide a life annuity to the surviving beneficiary. If the beneficiary is the same age as, or older than, or not more than two years younger than, the participant, the maximum annuity is the same annuity the participant would have received. If the beneficiary is more than two years younger than the participant, the amount of the maximum survivor annuity is reduced per a table in the regulation. A-17(c)(2

Planning use for QLACs

Like other "annuitized" portions of the IRA, the value of a QLAC is excluded from the account balance when determining the value of that account balance for purposes of computing the required minimum distribution from the nonannuitized portion of the account. See ¶ 10.2.10. This may create a minor planning opportunity for certain individuals:

Bob Example: Bob is nearing age 70½. Soon he will have to start taking required minimum distributions from his large traditional IRA. Because he is still working, his income (and his income tax bracket) are both high, so he is not feeling good about having taxable distributions from the IRA added onto that already-high income. By purchasing a QLAC now for $125,000, with payments to start at age 85, he removes $125,000 (plus the money that sum will hopefully earn in the future) from the account balance that is used to compute his required distributions. That should reduce his first year's required distribution by $4,000–$5,000 he figures, saving a couple thousand of income taxes annually. True, he is just postponing the problem, since his distributions will balloon after age 85, when the QLAC starts paying out. But by then he will be retired, he figures, so his income tax bracket will be lower.

10.3 Annuity Payouts from Plans: Putting It All Together

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

10.3.01 ***Drawback of nonspouse survivor annuities***

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

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

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

10.3.02 ***Illustrations: Different choices***

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

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

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

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

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

Unlike Hugh, Stu, Stu's wife, and Lou, Sue is not in good health. She would "lose" by choosing a life annuity payout, because she is likely to live less long than the "average" person her age. She is also uninsurable, so she can't use the life insurance technique Lou uses. She will choose a period-certain payout, the shortest one the plan offers so as to move the money out of the plan as quickly as possible. That way it is maximally available for her needs, or for estate planning moves such as lifetime gifts.

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

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

The late Ed Burrows, who was a pension actuary and consultant in Boston, and President of the College of Pension Actuaries, liked to remind us that a retirement plan may subsidize certain options. Typically, for example, a plan may subsidize the joint and survivor spousal annuity option:

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

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

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

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

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

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

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

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

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

10.3.05 ***Problems with the annuity rules***

Though the minimum distribution regulations assume that the world is divided neatly into annuities and nonannuity contracts, the insurance industry (in response to market demand) is busy developing more and more "hybrid" products: Contracts that provide guaranteed life income (like an immediate annuity) while preserving investment upside potential and capital access (like a nonannuity). Also, some annuity contracts sold today are combined with "long term care" benefits, so the annuity payout increases if the contract holder goes into a nursing home. Can a contract with that type of rider be purchased inside an IRA? The hybrids will challenge the IRS, plan administrators, and practitioners, as they try to figure out which set of rules governs each product.

PART II: LIFE INSURANCE INSIDE A RETIREMENT PLAN

This PART II explains the tax consequences (to the participant and beneficiaries) of life insurance held inside a retirement plan. ¶ 11.2 explains the *income tax* rules applicable to the plan participant and his beneficiaries when life insurance is held in a qualified retirement plan (QRP). ¶ 11.3 discusses the choices regarding the policy that arise at the participant's retirement. See ¶ 11.4 for the *estate tax* consequences and other planning considerations with respect to plan-owned life insurance.

This Report discusses plan-owned life insurance only from the perspective of the participant and beneficiaries. Rules that are of concern only at the plan level (such as the limits on how much life insurance may be purchased in a QRP, and ERISA fiduciary investment rules) are beyond the scope of this Report. For other sources, see the Bibliography. Similarly, the analysis of insurance products is beyond the scope of this Report.

11.2 Plan-Owned Life Insurance: Income Taxes

This ¶ 11.2 explains the *income tax* and income tax -related rules applicable to the plan participant and his beneficiaries when life insurance is held in a qualified retirement plan (QRP).

*11.2.01 **Tax consequences to participant: During employment***

In this Report, **Current Insurance Cost** means "the amount the participant is required to include in gross income (or pay himself) because of the plan-held life insurance."

A. **Income taxes due on "Current Insurance Cost."** When a retirement plan owns a life insurance policy, and the proceeds of the policy are payable to the participant or the participant's beneficiary, the participant must pay income tax, each year, on the portion of the employer's plan contribution (or of the plan earnings) that is deemed to be providing pure life insurance protection (as opposed to adding cash value in the policy). Reg. § 1.402(a)-1(a)(3); § 1.72-16(b). This is an exception to the normal rule that an employee pays no income tax on his employer's contributions to a retirement plan, or on plan earnings, until these are actually distributed to him. § 402(a).

The Current Insurance Cost is determined, for each year that the policy is held in the plan, in two steps. The first step is determining the <u>amount of life insurance protection</u> that is provided by the plan-owned policy. The second step is to determine the <u>amount applied to purchase</u> such life insurance protection. § 72(m)(3)(B); Reg. § 1.72-16(b).

1. **How to determine the amount of life insurance deemed provided.** The amount of life insurance protection that the plan is deemed to have purchased for the employee in any year is the amount of the *death benefit* payable under the policy ("at any time during the year"), minus the *cash surrender value* (CSV) of the policy (determined as of the end of the year). Reg. § 1.72-16(b)(3). It is not clear how to determine this amount (which is sometimes called the "net amount at risk" or "pure insurance") if the death benefit changes during the year.

2. **How to determine the amount applied to purchase the pure insurance.** Once the amount of "pure insurance" is thus determined, the IRS next tells us how much of the employer contribution and plan earnings are deemed to be applied to purchase this life insurance protection. According to Notice 2002-8, 2002-4 I.R.B. 398, the cost of the pure insurance may be determined using Table 2001 (¶ 11.2.02), *or* (if certain conditions are met) may be based on the insurer's actual term insurance rates, if lower (¶ 11.2.03).

B. **10 percent penalty if under age 59½.** Generally, retirement plan distributions to the plan participant are subject to a 10 percent "additional tax" if made while the participant is younger than age 59½. § 72(t)(1). There are more than a dozen exceptions to this general rule. One of the exceptions is that the deemed distribution resulting from the Current Insurance Cost is not subject to the penalty. IRS Notice 89-25, 1989-1 C.B. 662, A-11. For more on the early-distributions penalty and the exceptions thereto, see Chapter 9 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011).

C. **Minimum required distributions.** Generally, a plan participant must start taking annual distributions from his retirement plan(s) at approximately age 70½ (or in the case of some plans and some participants, upon retirement if later). § 401(a)(9). The Current Insurance Cost that the employee must include in his gross income each year is *not* treated as a distribution to him for purposes of satisfying this minimum distribution requirement. Reg. § 1.401(a)(9)-5, A-9(b)(4), (6). For more on minimum required distributions, see Chapter 1 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011).

11.2.02 ***Current Insurance Cost: From P.S. 58 to Table 2001***

The rules for determining the Current Insurance Cost have changed over the years.

Originally, Rev. Rul. 55-747, 1955-2 C.B. 228, provided a table, called "P.S. 58," to calculate the amount includible in the participant's gross income. This ruling was later modified by Rev. Ruls. 66-110, 1966-1 C.B. 12, and 67-154, 1967-1 C.B. 11, which expanded Table P.S. 58 and also provided that the insurer's lowest published rate for one-year term insurance available on an initial issue basis for "all standard risks" could be used if that rate was lower than the "P.S. 58 cost." Although the "P.S. 58-or-insurer's-actual-rates-if-lower" regime lasted for several decades, there was a continuing problem: The P.S. 58 table rates were unrealistically high, while some parties were tempted to use alleged "insurer's actual rates" that were unrealistically low, in the sense that the insurer rarely if ever sold one-year term insurance at such rates.

In Notice 2001-10, 2001-5 I.R.B. 459, the IRS revoked Rev. Rul. 55-747, thus killing Table P.S. 58; published a new table, "Table 2001," with considerably lower rates; and announced its intention to issue further rules on this subject, and to prevent abuse of the "insurer's actual rates" alternative.

Notice 2002-8, 2002-4 I.R.B. 398, revoked Notice 2001-10 (except for Table 2001, which was re-issued), and announced that the IRS would issue proposed regulations providing "further guidance" on the tax treatment of insurance held in QRPs. In the meantime, Notice 2002-8 (Part III, 2) provides "interim guidance" on the tax treatment of life insurance held by a QRP, summarized in the next paragraph. Though the IRS has since issued extensive guidance on other aspects of employment-related life insurance (including split-dollar, § 79, § 83, and distribution of policies by QRPs), it has issued no further guidance on how to determine the amount applied to purchase pure insurance in QRP-owned life insurance since Notice 2002-8.

Under Notice 2002-8, for 2002 and later years (unless and until changed by the promised future "guidance"), the amount reportable as the value of the employee's current insurance protection under a plan-owned policy must *either* be determined under Table 2001 *or* (if certain conditions are met) be based on the insurer's actual term rates, if lower.

11.2.03 ***Current Insurance Cost: Using insurer's actual rates***

Taxpayers may determine the Current Insurance Cost using the insurer's lower published premium rates "that are available to all standard risks for initial issue one-year term insurance" instead of the Table 2001 rates. However, the IRS reserves the right to take away this option, in future regulations, for "arrangements entered into" after the effective date of such future regulations. For arrangements entered into before the effective date of future regulations, the insurer's actual term rates can be used, but only if the following requirements are met:

For any arrangement entered into after January 28, 2002, the IRS (for years after 2003) "will not consider an insurer's published premium rates to be available to all standard risks who apply for term insurance unless (i) the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage...and (ii) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance...through the insurer's normal distribution channels." Thus, post-January 28, 2002, "arrangements" must meet this stricter standard, beginning in 2004, if the parties want to use the insurer's lower term rates. If this standard is not met, the employee will have to report income (or pay a share of the premium himself) based on the Table 2001 rates.

Policies already in place prior to January 29, 2002, will apparently not have to meet this strict standard of proof. However, it is not clear what standard of proof will apply to such policies, since there was no IRS definition of "insurer's one-year term rates" prior to Notice 2002-8. Also, it is not clear whether modifying an existing plan-owned policy, or swapping it for a replacement policy, would be considered entering into a new arrangement.

11.2.04 ***Current Insurance Cost: Term life insurance***

The discussion at ¶ 11.2.01–¶ 11.2.03 deals with life insurance policies that have a cash surrender value, such as "whole" or "universal" insurance. A "term" life insurance policy has no cash value; thus, it provides only the "pure insurance protection" that is considered taxable when provided by a QRP.

In the case of group term life insurance, the actual annual premium paid, rather than the Table 2001 cost, is considered the Current Insurance Cost; see Rev. Rul. 54-52, 1954-1 C.B. 150.

It is not clear whether the Notice 2002-8 rules apply to individual *term* life insurance policies, or only to policies that provide something (such as cash value or annuity benefits) in addition to the pure insurance protection. Possibly, the actual premium of a term life policy, rather than the Table 2001 cost, is considered the Current Insurance Cost, as is true for a group policy under Rev. Rul. 54-52.

11.2.05 ***Current Insurance Cost: Investment in the contract***

Generally, the amount included in the employee's gross income over the years on account of the Current Insurance Cost is "considered as premiums or other consideration paid or contributed by the employee…with respect to any benefits attributable to the contract." In other words, it becomes his "investment in the contract" (similar to tax "basis" in other types of property). The exception to this rule is that an *owner-employee* does not get to treat even the Current Insurance Cost as investment in the contract. Reg. § 1.72-16(b)(4).

Definition of "Owner-employee"

An **owner-employee** is the sole proprietor of an unincorporated business, or a partner "who owns more than 10 percent of either the capital interest or the profits interest" in the partnership. § 401(c)(3). The author has found no rule as to *when* the 10 percent test for determining owner-employee status is applied; do we test only at the end of the plan year? Or must we determine whether the individual owned more than 10 percent of the capital *at any time during* the year? And is the test applied yearly? Or is the individual considered *forever* an owner-employee if he was *ever* an owner-employee?

The employee is entitled to recover his investment in the contract income tax-free, *but only with respect to benefits he receives under the policy itself*. Reg. § 1.72-16(b)(4). If the policy lapses, or is surrendered for its cash value at the plan level, the investment in the contract disappears and cannot be offset against other plan distributions. If the policy is sold to the employee (¶ 11.3.04), he may not be able to reduce the price he pays by the amount of his investment in the contract, depending on how the bargain sale (¶ 11.3.03) and prohibited transaction (¶ 11.3.05, #2) rules apply to the purchase. Thus, the payment of income taxes (or a share of premiums) over the years generates an "investment in the contract" that may or may not be recouped later.

Difference Between "Basis" and "Investment in the Contract"

The Internal Revenue Code taxes "income." When an individual sells or otherwise disposes of property in exchange for consideration, the resulting "income" that is subject to taxation is generally the gross consideration the individual receives minus the *cost* of the property, i.e., the amount the individual originally paid to get that property plus whatever amounts he invested in the property prior to disposing of it. When property is sold in a transaction taxable under § 61(a)(3), the cost offset the taxpayer can deduct from the sale price to determine his gain is called his "basis." § 1001(a). In the case of insurance products, however, a different approach applies. Amounts the individual receives under the policy from the issuer are taxable under § 72, not § 61. § 72 allows an offset for the individual's "investment in the contract" rather than his "basis." Reg. § 1.72-6.

Tax afficionados tend to treat the two terms as interchangeable, and assume that (however the individual may dispose of the insurance policy, whether via surrendering it to the insurance company or selling it to a third party, the individual's gain would be measured the same way. Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, has exploded this notion, making it clear that a policy holder's "investment in the contract" (relevant for measuring income under § 72 if the policy holder receives payments under the contract from the insurer) is not necessarily the same as his "basis" (used for measuring gain if the policy is sold to a third party). In particular, *premiums paid for current insurance protection* are included in "investment in the contract" but not in "basis." So the sale of a policy to a third party may generate taxable gain even if surrendering the same policy in exchange for the same amount of money to the issuing insurer would not generate gain.

For what happens to the investment in the contract if the policy is sold to the beneficiaries, see ¶ 11.3.06; on the participant's death, see ¶ 11.2.06.

*11.2.06 **Income tax consequences to beneficiaries***

Normally, life insurance proceeds are income tax-free to the policy beneficiaries. § 101(a). However, when proceeds of *plan-owned* life insurance are paid to the beneficiaries, § 72(m)(3)(C) dictates that, to the extent of the policy's cash surrender value (CSV) immediately prior to the participant's death, the distribution is treated as a "retirement plan distribution" (taxable under § 402) rather than as a tax-free distribution of "life insurance proceeds." Thus, to the extent of the pre-death CSV, life insurance proceeds are treated the same as all other retirement plan distributions, and are subject to income tax when paid out to the beneficiaries. Only the "pure insurance protection" portion of the distribution is tax-exempt under § 101(a).

Despite the fact that the participant might have been taxable on *more* than the CSV if the policy had been distributed to him during life (see ¶ 11.3.02), only the CSV is treated as gross income to the beneficiaries. Also, the beneficiaries are entitled to deduct the amount of the participant's investment in the contract (¶ 11.2.05) from the amount otherwise includible in their gross income. See Reg. § 1.72-16(c)(3), Example 1; Rev. Rul. 63-76, 1963-1 C.B. 23.

11.3 Plan-Owned Life Insurance: The "Rollout" at Retirement

If the participant does not die while still employed, he must make some choices regarding the life insurance policy when he retires.

*11.3.01 **Options for the policy when the participant retires***

The IRS generally requires that life insurance policies be either converted to cash or distributed to the participant at retirement. This is one of the constellation of plan qualification requirements known as the "incidental death benefits rule," the gist of which is that a retirement plan is supposed to provide *retirement benefits*, and may provide death benefits only to the extent they are "incidental." See Rev. Rul. 54-51, 1954-1 C.B. 147, as modified by Rev. Ruls. 57-213, 1957-1 C.B. 157, and 60-84, 1960-1 C.B. 159, and ¶ 1.4.05 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011).

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

If the life insurance policy is <u>distributed</u> to the participant, the policy's fair market value, less the amount of his investment in the contract (¶ 11.2.05), becomes gross income to him. See ¶ 11.3.02. He can not roll over the policy to an IRA; an IRA cannot own life insurance. ¶ 11.4.05.

If the policy is <u>surrendered</u> to the insurance company, the plan receives the cash value from the insurance company. The participant could then leave those proceeds in the plan, or roll them over to an IRA, thus continuing tax deferral on the policy's value. However, he would lose the insurance protection provided by the policy. His "investment in the contract" disappears under this scenario; he cannot apply it to subsequent cash distributions from the plan. ¶ 11.2.05.

Selling the policy to the participant or to the beneficiaries requires the parties to navigate the "transfer for value" (¶ 11.4.02) and "prohibited transaction" (¶ 11.3.05, ¶ 11.3.07) rules.

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

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

When a QRP distributes a life insurance policy to the insured participant, the value of the policy (minus the participant's investment in the contract, if any; ¶ 11.2.05) is includible in the participant's income. Reg. § 1.402(a)-1(a)(1)(iii). Prior to February 13, 2004, the "value" of a life insurance policy for this purpose was either the policy's cash surrender value (CSV) or in certain cases the policy reserves. See Reg. § 1.402(a)-1(a)(2) (pre-amendment), Notice 89-25, 1989-1 C.B. 662, A-10. For policy distributions after February 12, 2004, the amount includible is the policy's fair market value (FMV). The "policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed) are included" in determining FMV. Reg. § 1.402(a)-1(a)(1)(iii), as amended 8/29/2005.

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

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

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

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

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

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

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

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

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

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

11.3.03 ***Tax code effects of sale below market value***

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

For the implications of this new rule regarding bargain sales, see ¶ 11.3.04 (sale to the participant) or ¶ 11.3.06 (sale to a beneficiary). For how to determine FMV of an insurance policy see ¶ 11.3.02.

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

11.3.04 ***Plan sells the policy to the participant***

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

Sale of the policy to the participant creates a prohibited transaction issue. See ¶ 11.3.05.

Sale of the policy to the participant is considered to be partly a "distribution" to him if the consideration he pays to the plan is less than fair market value; see ¶ 11.3.03. Such a deemed distribution has two Code consequences. First, the excess value is gross income to the participant. However, if the participant has "investment in the contract" (see ¶ 11.2.05) equal to the amount of the "bargain element," there will be no gross income generated by the transaction.

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

11.3.05 ***Sale to participant: Prohibited transaction issue***

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

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

The Department of Labor (DOL) has issued a class Prohibited Transaction Exemption (PTE) exempting such sales if certain requirements are met. PTE 1992-6, 2/12/92, 57 FR 5190; amended 9/3/02, 67 FR 56,313. The PTE exempts the transaction from both IRC § 4975 and ERISA § 406. Thus, if the desired approach is to have the participant buy the policy from the plan, the transaction must comply with PTE 1992-6 if the participant is a party-in-interest. This PTE can be read at the DOL's website, http://www.dol.gov/ebsa/regs/fedreg/notices/2002022376.htm.

To comply with PTE 1992-6 when the *insured participant* is buying the policy from the plan, the following two requirements must be met. If the purchaser is someone *other than* the participant-insured, there are additional requirements; see ¶ 11.3.07.

1. The contract would, but for the sale, be surrendered by the plan. PTE 92-6, II(c). This requirement is not a problem, if the participant is retiring, for the type of QRP that is *required* to sell or surrender the policy at that point (¶ 11.3.01).
2. The price must be "at least equal to the amount necessary to put the plan in the same cash position as it would have been [sic] had it retained the contract, surrendered it, and made any distribution owing to the participant on [sic] his vested interest under the plan." PTE 92-6, II(e). This requirement does not permit any price reduction for the participant's investment in the contract (¶ 11.2.05).

Prior to the 2005 IRS policy-valuation rule changes (¶ 11.3.02), it was most common for these sales to take place at CSV. The participant can still pay just the CSV as far as the DOL is concerned. However, if the price he pays is less than the FMV, he will have to deal with the tax Code consequences described at ¶ 11.3.04.

11.3.06 ***Plan sells policy to the beneficiary(ies)***

Sometimes, instead of selling the policy to the participant, the rollout is accomplished by having the plan sell the policy to the beneficiaries. This is usually done for estate tax-planning reasons, to avoid the "three-year rule" (¶ 11.4.02). As with the sale of the policy to the participant, this raises both tax and PT issues.

For tax purposes, if the policy is sold to the beneficiary at its FMV (¶ 11.3.02) there is no income tax consequence; note, however, that the FMV standard allows no reduction of the purchase price to reflect the participant's investment in the contract (¶ 11.2.05).

If the price paid by the beneficiary is less than the FMV, Reg. § 1.402(a)-1(a)(1)(iii) provides that the bargain element will be includible in the gross income *of the beneficiary who buys the policy*. This treatment seems questionable. The plan account belongs to the participant, who is the only person entitled to receive distributions during his lifetime.

In another context (ruling on the income tax effects of certain community property laws), the Tax Court has ruled that distributions from an IRA are gross income *to the participant only*, under federal income tax law. *Morris*, 83 TCM 1104, T.C. Memo 2002-17; *Bunney*, 114 T.C. 259 (2000).

A bargain sale of an insurance policy from the participant's account to his beneficiary can only occur with the participant's consent. ¶ 11.3.07, #3. Thus, such a bargain sale would more properly be treated as a distribution of the bargain element *to the participant*, followed by a gift of the bargain element from the participant to the beneficiary.

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

Because of the risks associated with sale of an insurance policy to the participant's beneficiaries caused by the final version of Reg. § 1.402(a)-1(a)(1)(iii), it may be better to avoid this approach. Instead, have the plan sell or distribute the policy to the participant. Once the participant has the policy (either because he bought it from the plan or because he took it as a distribution from the plan), the participant can sell it to the beneficiary to avoid estate tax inclusion (but see ¶ 11.4.02). Reg. § 1.402(a)-1(a)(1)(iii) would not apply to a sale by the insured to the beneficiary; it applies only to sales by a QRP. There would be no income tax consequences; the valuation concerns would be solely for gift and estate tax purposes.

11.3.07 ***Sale to beneficiary: Prohibited transaction aspects***

The DOL's class exemption PTE 1992-6 (see ¶ 11.3.05) exempts the sale of a life insurance policy by the plan from various PT rules if certain requirements are met. The requirements that must be met if the purchaser of the policy is the participant-insured himself are described at ¶ 11.3.05. If the sale is to someone *other than* the participant, and would be a PT if not exempted, the following three *additional* requirements must be met:

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

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

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

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

Note that the PTE's definition of permitted buyers does not mention partnerships. If the strategy is for the plan to sell the policy to a partnership, the plan's ERISA counsel must determine whether the transaction is a PT and, if it is, seek a DOL exemption. For how to apply for a DOL PT exemption, visit http://www.dol.gov/ebsa/regs/PTE_procedures.html.

11.4 Plan-Owned Life Insurance: Other Aspects

This ¶ 11.4 explains the estate tax aspects of holding life insurance in a retirement plan, planning principles regarding such insurance, and the rules regarding IRAs and life insurance.

11.4.01 ***Estate tax avoidance: The life insurance subtrust***

For the estate tax-conscious client, an important consideration in buying life insurance is to keep the insurance proceeds out of the insured's estate (and the estate of his spouse, if any), to increase the value of the benefits for subsequent beneficiaries (typically the client's children). If the policy is purchased *outside* the retirement plan, it is easy to accomplish this goal: The client creates an irrevocable trust for the benefit of his intended beneficiaries; and the trust buys the policy. The policy proceeds are never part of either spouse's estate. If the policy is bought through a retirement plan, in contrast, it is doubtful whether the proceeds can be kept out of the estate of the participant.

Generally, the estate tax treatment of retirement plan benefits is governed by § 2039. However, § 2042 governs the estate tax treatment of life insurance, even if the insurance is held inside a retirement plan. § 2039(a). Life insurance is subject to estate tax if it is payable to the insured's estate, or if the insured owns any "incident of ownership." § 2042. To keep plan-held life insurance out of the participant's estate, therefore, it is necessary to deprive the participant of such "incidents of ownership" as a five percent or more reversionary interest in the policy and the powers to name the beneficiary of the policy or surrender or borrow against the policy. § 2042(2); Reg. § 20.2042-1(c)(2).

Some practitioners believe this goal can be accomplished by establishing a "subtrust," defined as "an irrevocable life insurance trust slotted within the trust otherwise used to fund the pension or profit sharing plan" (from "The Qualified Plan as an Estate Planning Tool," by Andrew J. Fair, Esq., published by Guardian Life Insurance Company of America, New York, NY, 1995, Pub. No. 2449).

The merits of the subtrust have been debated in numerous publications. See Zaritsky, H., and Leimberg, S.R., *Tax Planning with Life Insurance* (see Bibliography), sections 6.08[2][f] and 6.08[4][b], and articles cited in the Bibliography. Some authors conclude that the subtrust works to keep policy proceeds out of the estate, without disqualifying the underlying retirement plan. Others argue that either the existence of the subtrust disqualifies the plan, or, if the plan *is* qualified, it is impossible for the participant not to have estate-taxable incidents of ownership in the policy.

To date, there is no published ruling or case either upholding or denying estate tax exclusion for life insurance held in a retirement plan subtrust. However, in an unpublished IRS private letter ruling (technical advice memorandum) the IRS apparently opined that the existence of a "subtrust" would *disqualify the retirement plan* of which it was a part! The basis for this conclusion was that the subtrust's assets could not under any circumstances be used to provide retirement benefits under the plan. Although this TAM was never officially issued by the IRS, and although the plan and subtrust discussed in the ruling had many unique features that make this ruling not necessarily applicable to all subtrust arrangements, use of the subtrust device must be considered risky. For discussion of this unpublished TAM, see Steve Leimberg's *Employee Benefits and Retirement Planning Email Newsletter* - Archive Message #385 (September 19, 2006), and "Subtrust Triggers Plan Disqualification," by Choate, N., Leimberg, S., and Zaritsky, H., *Tax Notes,* Vol. 113, No. 8 (11/20/06), p. 753.

Because the subtrust may not work to keep policy proceeds out of the insured's estate, and/or may disqualify the entire retirement plan, it is not recommended unless a favorable IRS ruling is first obtained.

Even if the subtrust device does keep the death benefit out of the estate if the participant dies prior to retirement, new problems arise once the participant reaches retirement. If he then either buys the policy out of the plan or receives it as a distribution the participant is right back in the position of owning the policy.

The bottom line: If estate tax avoidance is important to the client, buy the life insurance outside of the retirement plan.

11.4.02 ***Avoiding estate tax inclusion and "transfer for value"***

As discussed at ¶ 11.3, the normal course is for the retirement plan to sell or distribute the policy to the participant at retirement. The participant may wish at that point to transfer the policy to his intended beneficiaries (or to an irrevocable trust for their benefit) to get the proceeds out of his estate for estate tax purposes. Since giving away the policy would not remove the proceeds from the participant's estate until three years after the gift (§ 2035(a)), practitioners look for an alternative way to get the policy into the hands of the beneficiary(ies) without the three-year waiting period. The obstacles to success in this endeavor are discussed in this ¶ 11.4.02; for further discussion of ways to deal with what its authors call this "vastly over-exaggerated problem," see the article by Ratner, C.L., and Leimberg, S.R., "Planning Under the New Split-Dollar Life Insurance Prop. Regs., Part 2," 29 *Estate Planning* 12 (Dec. 2002), p. 603, at 606.

Since the plan cannot distribute benefits to anyone other than the participant during the participant's lifetime, the only ways the policy can be moved from the plan to the intended beneficiaries without triggering the three-year rule are for the plan (1) to sell the policy directly to the beneficiaries, or (2) distribute or sell the policy to the participant who then sells it to the beneficiaries. *The second method is safer, due to the IRS rule changes discussed at ¶ 11.3.03.*

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

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

11.4.03 ***Second-to-die insurance***

A plan's ownership of a "second-to-die policy" (insuring the lives of the participant and the participant's spouse) introduces additional complexity.

A. **Estate tax minimization.** If a second-to-die insurance policy is purchased *outside* the plan, the only legal paperwork required to avoid estate and gift tax is the drafting of one irrevocable trust to buy the policy, plus "Crummey" notices. If the policy is bought *inside* a retirement plan, on the other hand, one author recommends using a trust, plus either three or four separate life insurance policies, and possibly a family partnership to deal with all the issues involved trying to keep the policy proceeds out of both spouses' estates.

B. **Current Insurance Cost.** Table 2001 (¶ 11.2.02) covers only single life policies. Notice 2002-8 provides that "Taxpayers should make appropriate adjustments" to the Table 2001 rates "if the life insurance protection covers more than one life." Insurance experts do not find this computation difficult, despite the absence of an official table.

C. **Prohibited transaction meets transfer-for-value.** Attempting to sell a second-to-die policy to the participant creates a dilemma. The Department of Labor has indicated that PTE 92-6 (¶ 11.3.05) applies to second-to-die insurance policies on the life of the employee and his/her spouse as well as to single life policies on the life of the employee. PTE 92-6 exempts the plan's sale of a life insurance policy from the PT rules provided that (among other conditions) the sale is made *to the participant or beneficiary*. This would *not* permit a sale of the policy to both the participant *and the spouse*; the spouse is not the beneficiary of the policy (because it is a policy on her own life) nor is she the participant. However, if the participant *alone* purchases the second-to-die policy, this may be considered only partly a sale "to the insured" for purposes of the transfer-for-value rule (¶ 11.4.02), because the policy insures *both* spouses. Thus, it may be necessary to seek a DOL PT exemption for such a sale.

11.4.04 ***Reasons to buy life insurance inside the plan***

Here are some reasons why people buy life insurance inside a retirement plan. "★" indicates a good reason. "☹" indicates a less good reason.

A. ★ **Client uninsurable.** The client is rated or uninsurable, and wants to buy insurance, and there is a policy available through the plan that the client can purchase without evidence of insurability.

B. ★ **Favorable group policy available through plan.** The plan may have a negotiated group insurance rate that is lower than the rate the participant would have to pay if he bought the insurance outside the plan.

C. ★ **Increase defined benefit plan contribution.** It is possible in some cases that the purchase of insurance, as an incidental death benefit, could increase permitted contributions to a defined benefit (DB) plan (or help absorb some funds in an overfunded DB plan). See McFadden, J.J., and Leimberg, S.R., "Fully Insured 412(i) Pension Plans Offer Simplicity and Low Risk," 30 *Estate Planning* 4, p. 155 (April 2003).

D. ★ **Only available money is in the plan.** The client needs life insurance but has no money to pay for it outside the retirement plan. In this case, however, first consider, instead, taking some money out of the plan to buy the insurance. Unless the client cannot get money out of the plan (due to unacceptable level of tax on plan distributions, creditor or marital problems, or because the plan doesn't permit it), the purchase of insurance outside the plan may be more tax-effective.

E. ☹ **Minimize tax on plan distributions.** A discredited planning strategy involved pouring plan assets into a life insurance policy, which (due to inflated surrender charges and other valuation gimmicks) had a cash value that was much less than the amount the participant had invested. The policy would then be distributed or sold to the participant at the depressed value, he would give the policy to a trust for his family, and the trust would exchange the policy for another policy on the participant's life. The new policy miraculously would have a much higher value than the original policy. This was the type of valuation "game" that cause the IRS to change the policy valuation rules in 2004–2005. See ¶ 11.3.02.

F. ☹ **Buy policy with tax-deductible dollars.** Some advocate buying insurance inside a retirement plan because this mode of purchase enables the participant to "buy insurance with tax-deductible dollars." This is not a valid reason to buy life insurance. *Any* investment bought inside a retirement plan is bought with "tax-deductible dollars." There is nothing special about buying insurance as opposed to stocks, bonds, or mutual funds with the tax-deductible dollars inside the retirement plan. In fact, buying life insurance makes the "dollars" in the plan *less* "tax-deductible" than they otherwise would be, because insurance necessitates the participant's paying income tax on the Current Insurance Cost (¶ 11.2.01).

11.4.05 ***Life insurance and IRAs and 403(b)s***

403(b) plans may legally be invested only in annuity contracts and/or mutual funds; however, a 403(b) annuity can provide "incidental life insurance protection." Reg. § 1.403(b)-1(c).

A requirement of a valid IRA is that "No part of the [IRA's] funds will be invested in life insurance contracts." § 408(a)(3). The guaranteed death benefit under an annuity contract generally does not violate § 408(a)(3). Specifically, "An individual retirement account may invest in annuity contracts which provide, in the case of death prior to the time distributions commence, for a payment equal to the sum of the premiums paid or, if greater, the cash value of the contract." Reg. § 1.408-2(b)(3). Thus, an IRA can hold an annuity contract that provides this type of incidental death benefit.

When a participant wants to buy life insurance, and the only money he has available to use for this purchase is inside an IRA, he has the following choices:

A. **Roll money to a QRP.** One approach is to roll over money from the IRA into a QRP, where it can be used to buy insurance. This solution helps an IRA owner who happens to participate in a QRP that accepts rollovers and permits insurance purchases. If the IRA owner has no QRP available, but does have a business, some planners recommend having the business start a QRP so that the IRA owner can roll his IRA money into it (and buy insurance). In view of the many drawbacks of plan-owned insurance, and the costs and burdens of starting a QRP the participant would not otherwise want, it is hard to believe that it would not be more cost-effective to simply take the money out of the IRA, pay tax on it, and use what's left to buy the life insurance.

B. **Own the policy through an IRA-owned entity.** Another approach is for the IRA not to own the insurance directly, but rather to own an interest in an entity (such as a partnership) which in turn owns the insurance policy. There is no authority regarding what degree of control by the IRA (or other factors) might be considered sufficient to cause an entity-held life insurance policy to be deemed held by the IRA, causing disqualification of the IRA.

There are "look-through" rules that apply to IRA-owned entities for prohibited transaction purposes: See the "plan assets" rule, 29 CFR § 2510.3-101(a)(2), discussed at ¶ 8.1.06(B) of *Life and Death Planning for Retirement Benefits* (7th ed. 2011). There is a different set of "look-through rules" for purposes of the tax on a retirement plan's "unrelated business taxable income" (UBTI); see § 512(b)(13), (c)(1), discussed at ¶ 8.2 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011). To date, the IRS has NOT spelled out any look-through rule for purposes of § 408(a)(3).

C. **Take a taxable distribution.** Finally, the participant could simply take the money out of the IRA, pay income tax on the distribution, and buy the insurance with what's left. If the participant is under age 59½, the distributions could be arranged as a "series of substantially equal periodic payments" (SOSEPP) under § 72(t)(4) to avoid the 10 percent premature distributions penalty under § 72(t). For details regarding this "SOSEPP" exception, see Revenue Ruling 2002-62, 2002-42 I.R.B. 710, and ¶ 9.2 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011). This solution is simpler than "A," and less risky than "B."

11.4.06 ***Planning principles with plan-owned life insurance***

Here are some estate planning ideas for a client who has life insurance in his QRP account.

A. **Use insurance to fund credit shelter trust.** The "pure insurance portion" of a life insurance policy held by a QRP is income tax-free to the death beneficiary. ¶ 11.2.06. So, if it is possible under the plan to designate one beneficiary for the life insurance policy proceeds, and a different beneficiary for other plan death benefits, determine how much of the life insurance proceeds would be subject to income tax if the client died today, *i.e.*, the cash surrender value (CSV) of the policy (less the participant's investment in the contract if applicable). If the income-taxable CSV is relatively small, and the client has insufficient other assets to fully fund a credit shelter trust, consider naming the credit shelter trust as beneficiary of the plan-held policy. Since most of the proceeds would be income tax-free, the usual drawbacks of funding a credit shelter trust with plan benefits would be minimized. The rest of the plan benefits, being fully income-taxable, could be left to the surviving spouse, who could roll them over to an IRA and continue to defer income taxes.

B. **Buy favorable group insurance in plan.** If the client is not insurable at standard rates, investigate the availability of group insurance through his retirement plan (and elsewhere).

C. **Plan ahead for rollout.** Be sure the client is aware of, and develops a realistic plan for, the issues that will arise regarding "rollout" of the policy at retirement. ¶ 11.3. Consider ways to get/keep the policy out of the client's gross estate following rollout, without triggering the "three year rule" of § 2035, while avoiding a "transfer for value" or "prohibited transaction."

11.4.07 ***Plan-owned insurance and the tax on UBTI***

Normally, retirement plans are tax-exempt entities; however, like other tax-exempt entities, plans are subject to tax under § 511 on "unrelated business taxable income" (UBTI). The idea of the UBTI tax is that a tax-exempt organization (such as a charity or retirement plan) is granted its tax exemption to foster its exempt purposes, not to enable the entity to compete with tax-paying businesses. Reg. § 1.513-1(b). If the tax-exempt entity has UBTI, it must pay income tax on that income. § 511.

Don't be fooled by the term "unrelated *business* taxable income" into thinking that the UBTI tax applies only if the IRA runs a business. An IRA can have UBTI even without owning or operating a business, because income from "debt-financed property" is UBTI regardless of whether there is a trade or business. § 512(b)(4), § 514. "Debt-financed property" is property acquired with borrowed funds and held to produce income. § 514(b).

The UBTI tax does not apply if the indebtedness is incurred in furtherance of the plan's exempt purpose. One could argue that the purpose of a retirement plan is to invest and accumulate funds for the owner's future retirement, and therefore any debt incurred to increase investment return is in furtherance of the plan's exempt purpose. However, this argument was rejected in *Elliot Knitwear Profit-Sharing Plan*, 614 F. 2d 347 (3d Cir. 1980), which was followed in *Henry E. & Nancy Horton Bartels Trust*, 209 F. 3d 147 (2d Cir. 2000); Cert. Denied 531 U.S. 978 (2000), on the basis that "in furtherance" of the exempt purpose means inherent in or essential to the fulfilment of the exempt purpose; while borrowing for investment purposes may be useful for the accumulation of funds, it is not essential.

If a QRP carries a life insurance policy to provide incidental death benefits, and the plan borrows on the policy in order to invest the loan proceeds in a different investment, the policy loan generates debt-financed income that is taxable as UBTI, according to PLR 7918095. On the other hand, if the borrowing against the policy is *solely for the purpose of financing the policy premiums*, presumably the loan thus incurred would not create debt-financed income because it is incurred in an essential function of the exempt purpose of the plan. However, there is no ruling on this point.

For more on the UBTI tax, see IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*; or Freitag, C.N., *Unrelated Business Income* Tax (T.M. 874-2) and *Debt-Financed Income* (T.M. 875).

11.4.08 ***Plan-owned life insurance subject to spousal ERISA rights***

Under a qualified retirement plan, the surviving spouse of a deceased employee/participant is given certain inheritance rights, which may be as much as 100 percent of the death benefit under the plan. See § 401(a)(11) and § 417, and Regs. § 1.401(a)-20 and § 1.417(e)-1. The spouse can waive this right if various requirements are met. For full details on spousal rights under plans, including how to waive such rights, see ¶ 3.4 of *Life and Death Planning for Retirement Benefits* (7^{th} ed. 2011). The plan death benefit for this purpose *includes* proceeds of any life insurance policy held in the plan. Reg. § 1.401(a)-20, A-12(b).

PART III: MISCELLANEOUS LITTLE-KNOWN PLAN/INSURANCE RULES

A. The Three Valuation Rules for Annuity Contracts

Strangely, annuity contracts are valued in different ways for different purposes.

1. RMD Valuation Rule for Annuity Contract Held in Plan

Reg. § 1.401(a)(9)-6, A-12(a), explains how an annuity contract held inside a defined contribution (DC) plan is to be valued for MRD purposes. The method described here may NOT be used to value a contract for purposes of a Roth IRA conversion (see Rule #3).

Variable vs. fixed annuities

An "annuity" is an arrangement under which one party (the issuer) is obligated to pay another (the annuitant) a series of periodic payments continuing for a certain period of time; see PART I, ¶ 10.2.02. In general, when this Report refers to an annuity, a fixed annuity is intended—one in which the payments in the series are fixed in amount—for example, $1,000 per month. However, there is another type of annuity: A variable annuity is similar to a "regular" annuity in that it represents an insurance company's promise to make periodic payments to the annuitant for life or a term of years. Under a variable annuity, however, the periodic payments are not fixed; they fluctuate in tandem with the performance of an investment portfolio. The valuation rules of Reg. § 1.401(a)(9)-6, A-12(a), apply to both kinds of annuity contracts if held in a DC plan. This section discusses "variable annuities" because those are the contracts that raise most of the valuation issues dealt with in the Regulation.

Prior to the Annuity Starting Date (PART I, ¶ 10.2.02), a variable annuity resembles a mutual fund portfolio held in an annuity "wrapper." A variable annuity contract, until it is annuitized, behaves like a DC plan. The contract has a cash value which is like an account balance in a DC plan; it fluctuates with investment performance.

Not surprisingly, the regulations treat variable annuity contracts as DC plans for purposes of the MRD rules. Reg. § 1.401(a)(9)-6, A-12(a). The participant determines his MRD with respect to the plan-owned variable annuity contract by dividing the value of the contract as of the prior year end by a divisor from the applicable table corresponding to his age at the end of the Distribution Year. Reg. § 1.401(a)(9)-5, A-4(a). How to compute lifetime distributions is summarized at ¶ 10.1.05; for details, see ¶ 1.3 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011).

Generally, the value of the variable annuity contract for MRD purposes is (1) its cash value ("the dollar amount credited to the employee or beneficiary under the contract") plus (2) "the actuarial present value of any additional benefits (such as survivor benefits in excess of the…[cash value]) that will be provided under the contract." The "actuarial present value" must be "determined using reasonable actuarial assumptions," but without regard to any individual's actual health. Reg. § 1.401(a)(9)-6, A-12(b).

There are two exceptions to this general rule. First, if the *only* additional benefit provided by the contract is a death benefit equal to the total premiums paid (minus prior distributions), such additional benefit can be disregarded in valuing the contract for MRD purposes. Reg. § 1.401(a)(9)-6, A-12(c)(2). Thus, for a variable annuity contract that provides no "extras" besides that return-of-premium guarantee, the "fair market value" of the contract for MRD purposes is its cash value.

If the contract provides additional death and/or life benefit guarantees beyond the mere return of premiums, it may *still* be possible to disregard the contract's additional benefits for MRD purposes—but only if the additional benefits meet complicated tests contained in Reg. § 1.401(a)(9)-6, A-12(c). The problem is that annuity companies must value every contract every year for MRD purposes if held by an individual over 70. The annuity company may not want to go through the elaborate exercises in Reg. § 1.401(a)(9)-6, A-12(c), to determine whether it can exclude additional benefits in valuing the contract. Instead, the annuity company may just play it safe by *including* the value of all additional benefits.

Furthermore, the insurance company may not want to take the time, trouble, and expense to value such additional benefits actuarially. Look at Reg. § 1.401(a)(9)-6, A-12(d), Examples 1 and 2, to see how complicated such actuarial valuation is. The insurance company may decide to simply report such additional benefits at face (rather than actuarial) value.

Connie Example: Connie, age 72, holds, in her IRA, a variable annuity contract which currently provides a death benefit of $50,000 in excess of cash value. Rather than bothering to determine the actuarial value of this death benefit (which is much less than $50,000), or to figure out whether it can exclude that value altogether under Reg. § 1.401(a)(9)-6, A-12(c), the insurance company may simply (and improperly) report the value of that benefit to the IRS as $50,000. That way, the issuer has less work to do, and by overvaluing the contract they do not risk an MRD mistake, because the MRD computed on an inflated value will be too large, not too small.

It remains to be seen what, if anything, the participant can do (short of hiring his own actuary annually to value the contract) to force the company to value the contract correctly. If the plan overvalues the contract and overstates the MRD amount, the participant is entitled to roll over the excess amount, because the MRD is determined based on the actual application of the tax law, not the assumptions of the plan administrator. Reg. § 1.402(c)-2, A-15.

2. Income Tax Treatment When a Contract is Distributed

The distribution of an annuity contract (to either the participant or the beneficiary) is generally nontaxable, provided the annuity contract is nonassignable by the recipient. Reg. § 1.402(a)-1(a)(2). This includes a variable annuity contract. PLR 2005-48027. Instead, the recipient pays income tax on distributions received under the annuity contract.

3. Valuation of Contract for Roth Conversion Purposes

If one of the IRA assets converted to a Roth IRA is an annuity contract, a special valuation rule applies.

Until Roth IRA conversions came along, it made little difference how annuity contracts were valued upon distribution from a retirement plan, because distribution of an annuity contract is generally not a taxable event. See Rule #2. The arrival of the Roth IRA conversion changed the landscape. The lower an IRA-owned annuity contract can be valued when the IRA is converted to a Roth IRA, the less income tax the participant must pay on the conversion. Subsequent distributions from the annuity contract will go into the Roth IRA, distributions from which will be tax-free.

According to the IRS, "some advisers" sought to take advantage of this loophole, and marketed, to IRA owners, "a single premium annuity contract with significant artificial penalties that apply in the" early years, "causing the annuity to have a low cash surrender value…." The IRA owner would then convert his IRA to a Roth IRA, and report the contract's artificially low cash surrender value (CSV) as the gross income resulting from the conversion. T.D. 9220, 2005-2 C.B. 596, "Explanation of Provisions."

To stop such abuses, the IRS issued a temporary and proposed regulation providing that fair market value (FMV), not CSV, must be used to determine the participant's gross income resulting from conversion of an IRA-owned annuity contract to a Roth IRA, effective for conversions on or after (and perhaps even before) August 19, 2005.

Reg. § 1.408A-4 governs Roth IRA conversions. Section A-14 of this regulation provides a rule for the valuation of an IRA-owned annuity contract that is converted to a Roth IRA. This is not the same valuation that applies when an annuity contract is simply distributed to the IRA owner (see Rule #2), nor is it the same as the special rule for valuing annuity contracts for purposes of the minimum distribution rules (see Rule #1). Rather, A-14 provides that the amount treated as distributed "is the fair market value of the annuity contract" on the date of the Roth IRA conversion, and provides guidelines (to be used pending IRS issuance of further more detailed guidance, probably to be similar to Rev. Proc. 2005-25; see PART II, ¶ 11.3.02) for determining such fair market value.

B. Pre-59½ distributions: Penalty exception for unemployed's health insurance

Generally, all retirement plan distributions taken prior to attaining age 59½ are subject to a 10 percent penalty. See § 72(t) and Chapter 9 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011). One of the 13 (+/-) exceptions to the penalty is for certain IRA distributions to pay for health insurance of an unemployed individual. Specifically, an unemployed individual can take penalty-free distributions from his IRA (but NOT from a qualified plan or 403(b) arrangement) to pay health insurance premiums. § 72(t)(2)(D).

To qualify for this exception, the person must have separated from his employment, and, as a result of that separation, must have "received unemployment compensation for 12 consecutive weeks under any Federal or State unemployment compensation law." The distributions must be made during the year "during which such unemployment compensation is paid or the succeeding taxable year." Presumably this phrase does not imply that the 12 consecutive weeks' worth of unemployment compensation must all be received in the same taxable year, but presumably it does mean that the unemployed person does not become eligible for the exception until the year the 12 consecutive weeks are completed.

Does this clause mean that the unemployed person can take penalty-free distributions only in one year—*either* the year he completes the 12 weeks of unemployment benefits *or* the following year? Or does it mean that penalty-free distributions may be taken in both years? PLR 2009-20052 says it may be taken in both years. This PLR (the only enlightenment we have to date on § 72(t)(2)(D)) reads in its entirety as follows:

"There have not been any regulations issued regarding section 72(t)(2)(D).

"A distribution qualifies under section 72(t)(2)(D) if it was made from an individual retirement plan to an individual after separation from employment:

"(1) If such individual has received unemployment compensation for 12 consecutive weeks under any Federal or State unemployment compensation law by reason of such separation, sec. 72(t)(2)(D)(i)(I);

"(2) if such distribution was made during any taxable year during which such unemployment compensation is paid or the succeeding taxable year, sec. 72(t)(2)(D)(i)(II); and

"(3) to the extent such distribution does not exceed the amount paid during the taxable year for insurance, sec. 72(t)(2)(D)(i)(III).

"A self-employed individual shall be treated as having satisfied the requirement of section 72(t)(2)(D)(i)(I) (number (1) above) if, under Federal or State law, the individual would have received unemployment compensation but for the fact that the individual was self-employed. Sec. 72(t)(2)(D)(iii). Thus, if the taxpayer is self-employed, the taxpayer has to present evidence that he would have been eligible to receive any Federal or State unemployment compensation, but for the fact that the taxpayer was self employed.

"Although not able to cite as precedence, see…Tax Court Summary Opinion 2005-78 and how the Tax Court handled a S [sic] case dealing with section 72(t)(2)(D)(iii)."

The maximum distribution under this exception in any taxable year is the amount paid for "insurance described in § 213(d)(1)(D) [medical and long term care insurance] with respect to the individual and the individual's spouse and dependents." The distribution must be made either while the individual is still unemployed or, if he becomes employed again, less than 60 days after he has been re-employed.

The IRS, in regulations, can permit a self-employed individual to use this exception "if, under Federal or State law, the individual would have received unemployment compensation but for the fact the individual was self-employed." No such regulations have been issued.

C. MRD extension for insolvent insurance company

Generally, minimum required distributions (MRDs) must be taken by a certain deadline, normally the end of the calendar year to which the MRD is attributable. Reg. § 1.401(a)(9)-5, A-1. MRDs can be delayed beyond the normal deadline (in the case of insured plans) if the delay is caused by receivership of the insurance company. Reg. § 1.401(a)(9)-8, A-7, A-8.

PART IV: PLANNING IDEAS INVOLVING INSURANCE AND RETIREMENT BENEFITS

This PART IV discusses various planning ideas that have been advanced for use of life insurance in connection with retirement benefits.

A. The CHIRA™

In PLR 2007-41016, the IRS blessed the following transaction: An IRA makes a loan to a charity (a church in this PLR). The loan would be evidenced by a 20-year promissory note, bearing interest at five percent *per annum* payable annually. The principal was due in a balloon payment at the end of the 20-year term or upon the participant's earlier death. The loan was to be secured by collateral assignment by the church to the IRA of a permanent life insurance policy on the participant's life. The church was the owner and beneficiary of the policy, subject to the security interest granted to the IRA, and was to pay the policy premiums.

The participant (who was apparently approaching or had reached age 70½) expected to pay his minimum required distributions attributable to this IRA out of the interest payments and/or by distributions from other IRAs. The participant was neither a board member nor an employee of the church, nor did he control, own, or have a financial interest in the church. The IRA was not the owner or beneficiary of the life insurance policy, and had no rights to any death benefits; its rights were limited to collecting the loan. For additional extensive details on the arrangement, see the PLR.

Two rulings were sought and obtained: That the arrangement did not constitute a prohibited transaction for the IRA, and did not constitute a forbidden investment in an insurance contract under § 408(a)(3).

This PLR has been hailed as finally showing how IRAs can legally be used to (1) benefit a charity and (2) finance a life insurance purchase. Despite the fact that no-one other than the person who obtained it can rely on a PLR, this PLR is being used to sell similar arrangements (now dubbed the "CHIRA™," for "charitable IRA") and the inventor is seeking to patent the idea. I find no fault with the conclusion of the PLR based on the facts of this particular ruling, but I do not see the CHIRA™ as the salvation of charities, IRAs, and life insurance agents. Here are my concerns:

1. **How does this help the charity?** The benefit to the charity, presumably, is that it is getting a loan at a lower interest rate than it could get in an arms' length transaction with a bank. So the charity gets some immediate cash on relatively favorable terms—but the charity does have to pay back the entire loan principal, *and* it must pay the interest, *and* it must pay the premiums on the life insurance policy, so how much of this cash will actually trickle down to the objects of the charity's bounty? The deal makes sense, presumably, only for a charity that is looking to borrow money, not for a charity that is looking for contributions. For a charity looking to borrow money, this may be a favorable way to do it. For a charity that just plain old needs money in the form of gifts not loans, this arrangement has less appeal.

2. **Below-market loan.** The IRS did not rule on or even discuss whether the loan was a below-market loan subject to § 7872. Presumably, the five percent interest rate specified in the ruling was equal to or greater than the applicable federal long-term rate (AFR) at the time of

the loan. If the loan rate were *less than* the AFR, the loan would have been a "gift loan" from the IRA to the church because the "forgoing of interest is in the nature of a gift." § 7872(f)(3). A gift-loan would be treated as a deemed transfer from the IRA to the church, which would of course result in immediate deemed income to the participant (equal to the "bargain" element of the loan on the date it was made), and a deemed charitable gift from the participant to the church. The participant would then have had to pay income tax on the deemed distribution (plus a 10 percent penalty if he were under age 59½). He would also get a deduction for the deemed charitable contribution; that might offset the income tax hit (but not the 10% penalty). An additional complication: Would the deemed distribution be added to his basis in the IRA? It appears that realistically this deal should only be done if the applicable federal rate (or higher) is used for the loan.

3. **What if the participant doesn't die?** Like all life insurance illustrations, the plan works great (for everybody except the participant) if the participant actually dies within 20 years. Maybe the church will get a windfall in that case, if the face amount of the policy exceeds the loan amount. I guess if the participant is already over 70 when the deal starts there are pretty good odds that he will die within 20 years. But what if the participant doesn't die? Where is the church supposed to get the money to pay back the principal to the IRA in 20 years? If the church defaults on the loan, the IRA will have to foreclose on the policy. At that point, the IRA definitely will own the policy, thus disqualifying the IRA under § 408(a)(3) and causing an immediate income tax bill…not what someone likes to receive at age 90. Or is there an unwritten expectation or understanding that the participant will forgive the loan if he's still alive at the end of the 20-year term? Such forgiveness would constitute another deemed distribution from the IRA to the participant, with a hefty income tax bill. What happens to the insurance policy? Does the participant personally buy it back from the charity, thereby giving them a chunk of cash they can use partly to pay back the loan? But then the policy ends up in the participant's estate. Another exit strategy is for the participant to simply give the charity enough money at the end of the 20 years to pay back the loan; that assumes he is then rich enough to do so and is still friendly with that charity. But if he's that rich and friendly why didn't he just give them the money in the first place instead of lending it? As with all transactions, "don't get in until you know how you're going to get out."

4. **Church's annual obligation.** Where does the church get the money to pay the loan interest and the insurance premium each year? Is there an "understanding" that the participant will contribute that much in cash each year to the church? What if he fails to do so? What if he doesn't like the new pastor and resigns from the church? I'm all for charitable gifts, but this amounts to a 20-year "marriage" and lots of marriages don't last that long. Realistically, the deal only makes sense if the church has a strong enough operating budget to pay these annual charges without relying on the participant's generosity.

5. **Participant not a board member.** In this PLR, the participant was neither a board member nor an employee of the church. If the participant later becomes a board member, will that invalidate his PLR? How useful is the CHIRA™ if the only person who can use it is

someone who is *not* a board member of the charity? Isn't the person who is most likely to be interested in this type of deal also most likely to be someone involved in the governance of the charity?

6. **Prohibited transaction analysis limited.** The IRS is not expert on prohibited transactions (PTS). In this PLR, they appeared to analyze only whether there was a "direct" PT (transaction between the IRA and a disqualified person (DQP)). They did not discuss whether there was an "indirect" PT (IRA transaction that benefits a DQP). Although there does not appear to be any indirect benefit to a disqualified person in the PLR, that question should at least have been discussed.

The bottom line: This looks like a good planning idea for a charity (1) that wants to borrow money (e.g., to build a new building), and (2) that is financially strong enough to repay the loan interest and principal without relying on the kindheartedness of the IRA owner, and (3) for which the cost of borrowing at the long-term applicable federal rate, plus the cost of insurance premiums, minus whatever cash value they will acquire in the policy, comes to less than the cost of borrowing the same amount from a bank.

For a website promoting this Idea, see http://www.chirausa.com/register.html. For an article about the PLR, see "Briefing: Breakthrough to Benefit Charities," *Trusts & Estates* Nov. 2007, page 14. See ¶ 8.1.06 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011) regarding IRAs and prohibited transactions.

B. Life insurance for under-age-59½ surviving spouse

Generally, all retirement plan distributions taken prior to attaining age 59½ are subject to a 10 percent penalty. See § 72(t) and Chapter 9 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011). One of the 13 (+/-) exceptions to the penalty is for death benefits. § 72(t)(2)(A)(ii). This creates a planning problem for a surviving spouse who is under age 59½ when she inherits a retirement plan as beneficiary of her deceased spouse.

While she is under age 59½, the surviving spouse can withdraw funds as needed penalty-free under the death benefits exception. If she rolls over the benefits to her *own* retirement plan (see ¶ 3.2 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011) regarding the "spousal rollover"), then the benefits will cease to be "death benefits"; they become *her* retirement benefits, and she will not be able to withdraw any funds from the rollover account prior to reaching age 59½ unless she qualifies for some other exception.

Thus, a surviving spouse who thinks she may need to withdraw from her deceased spouse's plan prior to reaching age 59½ may choose to leave the benefits in the decedent's plan (and hold the account as "beneficiary" rather than as "owner") until she reaches age 59½. But if she dies holding an inherited plan, the minimum distribution options to the successor beneficiary(ies) may be less favorable than if she had rolled over the account prior to her death. Specifically, her beneficiaries, rather than being able to withdraw the benefits gradually over their own life expectancies (the option that would be available if the surviving spouse rolled over the benefits to her own plan and named new beneficiaries) *might* have to withdraw the benefits over the deceased surviving spouse's life expectancy or even within five years after the surviving spouse's death. See § 401(a)(9)(B)(iv)(II), and Reg. § 1.401(a)(9)-3, A-5, A-6, § 1.401(a)(9)-4, A-4(b), discussed at ¶ 1.6.05 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011), and Reg. § 1.401(a)(9)-5, A-5(c)(2), discussed at ¶ 1.6.06(E).

If her death prior to completing the rollover would produce undesirable tax results for her beneficiaries, she can buy life insurance to protect against that risk.

C. Life insurance to protect the "stretch"

For all types of retirement plans, the minimum distribution rules generally require that distributions must be made from the plan, beginning the year after the owner's death, in annual instalments over the life expectancy of the Designated Beneficiary (see PART I, ¶ 10.2.09 for definition). Payments can always be made at a *faster* rate—but the life-expectancy-of-the-beneficiary payout (sometimes called the "stretch payout") method is the *slowest* rate at which benefits can be paid out. The "stretch" payout can produce many decades of continued income tax deferral (or income tax-free buildup, in the case of a Roth IRA) after the owner's death. For full details on the minimum distribution rules, see Chapter 1 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011); for economics of the stretch payout, see ¶ 1.1.03.

The potential of a stretch payout does not do the beneficiary any good if the beneficiary must withdraw from the plan shortly after the participant's death to pay the participant's debts, expenses, or estate taxes, or even to pay for the beneficiary's own needs or wants. By purchasing life insurance inside an irrevocable trust for the benefit of his beneficiaries, the participant can assure that the beneficiaries will have enough money on hand to satisfy all these requirements, so they can leave the inherited retirement plan intact and get the deferral benefits of the stretch payout.

D. Idea for young parents: Dump the stretch, buy life insurance

Parents of young children generally want to leave their assets in trust for their children in the event that both parents die while the children are too young to manage the money. Unfortunately, the IRS makes it extremely difficult to leave retirement benefits to a "normal" minor's trust or "family pot" trust and still have such benefit qualify for favorable the life-expectancy-of-the-beneficiary payout method (sometimes called the "stretch payout") that is available under the Tax Code for death benefits paid to or for the benefit of young individuals. In order to make the trust qualify as a so-called "see-through trust" under the IRS's minimum distribution rules, the parents typically would have to include provisions or beneficiaries that they would not otherwise put into their trusts. See ¶ 6.2 and ¶ 6.3 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011) for details.

One way to solve this dilemma is with life insurance. Young parents of young children might consider drafting their children's trust to say *exactly what the parents want it to say*, ignoring the see-through trust requirements, and purchasing term life insurance to assure adequate funds for payment of any extra income taxes caused by loss of see-through status. This may make more sense than accepting the drawbacks of a conduit trust, or naming wipe-out beneficiaries the donors don't want to name.

E. Can a beneficiary roll over life insurance proceeds?

A surviving spouse is generally entitled to roll over retirement benefits inherited from the decease spouse into (among other possible destinations) a traditional or Roth IRA in the surviving spouse's own name. See, generally, regarding spousal rollovers, ¶ 3.2 of *Life and Death Planning for Retirement Benefits*. Any "designated beneficiary" of a deceased employee can cause inherited qualified retirement plan benefits to be "rolled over" (via direct transfer) from the plan to an inherited traditional or Roth IRA. See ¶ 4.2.04 of *Life and Death Planning for Retirement Benefits* ("Nonspouse beneficiary rollovers from nonIRA plans").

These options raise the intriguing question whether a surviving spouse or a nonspouse designated beneficiary could roll over life insurance proceeds paid to such beneficiary as part of his or her inherited death benefits under a qualified retirement plan.

If such a rollover is possible, rolling to a traditional IRA would be tax-free, but it is not clear how if at all the beneficiary could establish a "basis"or "investment in the contract" in the IRA with respect to the tax-free insurance proceeds rolled into the IRA. For that reason, it is probably inadvisable to seek to roll life insurance proceeds to a traditional IRA.

Rolling to a Roth IRA, if it is possible, would cause the beneficiary to be immediately taxed on the pretax portion of the rolled distribution (see ¶ 11.2.06 of this Seminar Outline for how to determine that) because he or she has done a "Roth conversion" (see ¶ 5.*** of *Life and Death Planning for Retirement Benefits* regarding Roth conversions), but would allow all the insurance proceeds to grow tax-free thereafter in the Roth environment. Though the life insurance death benefit could presumably be paid to a different destination than the rest of the decedent's plan account, and accordingly could be "rolled" without necessarily rolling the noninsurance portion of the death benefit, it is probably not possible to "segregate" the pre- and after-tax portions of the insurance proceeds and roll them to different destinations (see ¶ 2.*** of *Life and Death Planning for Retirement Benefits*).

So *can* the insurance proceeds be rolled to a Roth IRA just like any other death benefits inherited by the surviving spouse or other designated beneficiary?

An eligible rollover distribution is a permitted contribution to an IRA. What is an eligible rollover distribution? At one time, distributions that were not includible in gross income could not be rolled over; now (with some limitations) they generally can be. § 402(c)(1), (2). Otherwise, an "eligible rollover distribution" is ANY distribution except a distribution that is part of a series of equal payments, a hardship distribution, or a required distribution (under § 401(a)(9). § 402(c)(3).

The regulations don't add much to this picture. The following is from Treas. Reg. § 1.402(c)-2:

"A-3. (a) General rule. Unless specifically excluded, an eligible rollover distribution means any distribution to an employee (or to a spousal distributee described in Q&A-12(a) of this section) of all or any portion of the balance to the credit of the employee in a qualified plan. Thus, except as specifically provided in Q&A-4(b) of this section, any amount distributed to an employee (or such a spousal distributee) from a qualified plan is an eligible rollover distribution..."

A-3(b) then lists the exceptions---distributions that are NOT eligible for rollover, including generally after-tax money, but A-3(b) was written before the Code was amended to specifically allow rollovers of after-tax money, so that limitation is now nugatory. A-4 lists more exceptions (distributions that are not eligible for rollover), but none of them has any relation to the life insurance question. Reg. § 1.402(c)-2, A-12(a), dealing with spousal rollovers, seems to bless the rollover of insurance proceeds if such are considered ancillary death benefits:

"**Spousal distributee**. If any distribution attributable to an employee is paid to the employee's surviving spouse, section 402(c) applies to the distribution in the same manner as if the spouse were the employee. The same rule applies if any distribution attributable to an employee is paid in accordance with a qualified domestic relations order (as defined in section 414(p)) to the employee's spouse or former spouse who is an alternate payee. Therefore, a distribution to the surviving spouse of an employee ...including a distribution of ancillary death benefits attributable to the employee, is an eligible rollover distribution if it meets the requirements of section 402(c)(2) and (4) and Q&A-3 through Q&A-10 and Q&A-14 of this section."

The phrase "including a distribution of ancillary death benefits attributable to the employee" would seem to preclude any argument by the IRS that life insurance proceeds are somehow not part of "the balance to the credit of the employee in a qualified plan" that a spouse is entitled to roll over.

This trail would lead us to believe that a surviving spouse (and a nonspouse designated beneficiary, using the direct rollover) can roll over to the spouse's own Roth IRA (or to an inherited Roth IRA in the case of a nonspouse designated beneficiary) proceeds of insurance on the life of the deceased employee, even though a significant portion of such proceeds is income tax free. The caveat is that, at the time Reg. § 1.402(c)-2, A-12(a) was first issued (1995), the Roth conversion/rollover of income tax-free life insurance proceeds was not on the radar screen at all for several reasons, namely: there was no such thing as a Roth IRA, nontaxable distributions were not eligible for rollover, and there was no such thing as a nonspouse beneficiary rollover. However, the regulation has been amended several times since then, including after these other things became effective (most recent amendment was in 2009), and this particular provision was not changed.

Therefore the conclusion is that someone should try this and let the rest of us know how it turns out.

F. The "dream" charitable rollover

Charities dream of passage of a "charitable IRA rollover" law that would allow lifetime transfers directly from an IRA to a charity or charitable remainder trust under certain conditions. This would enable the charitably-inclined individual to fund his charitable intentions immediately with IRA funds; he would get no tax deduction, but also would not have to report the IRA distributions as gross income.

Though § 408(d)(8) did allow, temporarily (2006–2011 only), some limited direct IRA-to-charity transfers, this was a far cry from the law envisioned by charities, under which (if ever enacted) a charitably-inclined participant could transfer his IRA to a charitable remainder trust (CRT). The CRT would receive the funds income tax-free, then pay a unitrust or annuity income to the participant for his life, then to his spouse for her life. When both spouses died, the funds would pass to the participant's chosen charity. For requirements and advantages of a CRT, see § 664 and ¶ 7.5.04 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011).

The participant and spouse would get a life-long stream of income that would be somewhat steadier than an MRD payout from an IRA (and also would be longer-lasting, if they live into their mid 90s or beyond), and satisfy their charitable intent. *No income or estate taxes would ever be paid on the IRA balance* (though the annual distributions from the CRT would be taxable). The spouses could provide a replacement asset for their descendants by buying life insurance (via gifts to an irrevocable trust) with some of the income stream they received from the CRT. The life insurance also would never be subject to income tax or estate tax.

However, this is still just a pipe dream.

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Appendix A: Uniform Lifetime Table

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

This table must be used by all taxpayers to compute lifetime required distributions for 2003 and later years, unless the sole beneficiary is the participant's more-than-10-years-younger spouse. This table may not be used: by beneficiaries of a deceased participant (except in year of participant's death); or for years prior to 2002 (optional for 2002).

For each Distribution Year, determine: (A) the account balance as of the prior calendar year end; (B) the participant's age at the end of the Distribution Year; and (C) the Applicable Distribution Period (divisor) for that age from the above table. "A" divided by "C" equals the minimum required distribution for the Distribution Year. No distributions were required for the year 2009. § 401(a)(9)(H).

For full details regarding how to make these computations, see Chapter 1 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011).