Chapter One

Introduction

A. Scope of Monograph

This monograph covers planning considerations with respect to distributions from qualified retirement plans and individual retirement accounts (IRAs). For purposes of this monograph, the term qualified retirement plan includes tax-deferred annuities for employees of certain tax-exempt organizations and public school systems. Qualified retirement plans are plans that receive favorable tax benefits because they satisfy certain requirements of the Internal Revenue Code (the Code). IRAs also receive favorable tax treatment. The monograph does not deal with distributions from nonqualified retirement plans or deferred compensation plans, including so-called rabbi and secular trusts, nor with Education IRAs that were added by the Taxpayer Relief Act of 1997. Further, this monograph does not deal with decisions about participation in, or contributions to, qualified retirement plans or IRAs, including decisions about whether to roll over or convert balances from a traditional IRA to a Roth IRA.

Income and transfer tax issues are covered in detail. In addition, the rights of a nonparticipant spouse to certain benefits under the participant’s qualified retirement plan are explained. Estate and trust administration issues are noted where appropriate. Finally, practical and planning suggestions are provided. Investment and financial planning issues are not addressed.

B. Importance of Subject Matter for Estate Planners

Although most estate planners do not draft qualified retirement plans on a regular basis, they should be aware of the various tax and nontax considerations affecting distributions from qualified retirement plans and IRAs. Benefits from such plans represent a significant portion of the net worth of many clients. In fact, qualified retirement plan benefits, IRAs, and life insurance proceeds may constitute as much as 75 to 80 percent of the intangible wealth of most middle-class Americans.

Unfortunately, properly advising clients with respect to distributions from qualified retirement plans and IRAs involves many complex issues.
Congress has tinkered with the provisions of the Code dealing with the taxation of distributions in almost every major tax act since the adoption of the Employee Retirement Income Security Act of 1974 (ERISA). These changes have continued to accelerate in the years since enactment.

Planning for distributions is also complex because distributions may take many forms, such as lump sum distributions, annuities, installment payments over a fixed period, and distributions qualifying for rollover treatment. Because the identity of the beneficiary can have significant tax and nontax consequences, careful planning is required when designating the beneficiaries who will take any benefits remaining at the death of the participant. When to begin to receive the benefits and over what period they should be paid are decisions that involve many difficult and often competing financial and tax considerations.

These issues must be considered on at least five different occasions for each participant. First, when the participant becomes eligible to participate in a qualified retirement plan or opens an IRA, the participant must select the beneficiary or beneficiaries to take any death benefits payable under the plan or the balance in the IRA account at death (although that selection may usually be changed by the participant at any time up to his or her death, subject to consent rights of his or her spouse). In some cases, the participant must also initially choose a form of payment (although the selection of the form of payment under a qualified retirement plan must be revocable until just before retirement). Second, if the participant is getting a divorce, he or she must ensure that any plan benefits payable to a former spouse are specified in a qualified domestic relations order (QDRO) to avoid being taxed on the amount paid to the former spouse. Third, before the participant retires, the participant must select the form of payment, the period over which the payment will be made, and the beneficiary of any remaining benefits at his or her death. Fourth, after the death of the participant, whether before or after retirement, the personal representative of the deceased participant must determine who is the proper beneficiary or beneficiaries of the decedent’s benefits. In many cases, the beneficiary will be free to select the form of benefit. The personal representative or beneficiary must also consider whether a disclaimer of the benefits produces better tax and nontax results. Also, the source of payment of estate, generation-skipping, and income taxes must be factored into the

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planning process. Fifth, the participant should consider a Roth IRA rollover any time he or she would qualify for such a rollover.

In making these decisions with respect to qualified retirement plan benefits and IRAs, the participant, beneficiary, or planner must consider a number of factors. First, and perhaps most importantly, the financial needs of the retired participant or beneficiaries must be taken into account. It is futile to plan to postpone the receipt of benefits to defer the payment of income taxes if the participant needs the benefits to pay for his or her current living expenses.

In addition to the financial needs of the participant or beneficiaries, the health of the participant, the participant’s spouse, and other beneficiaries must be taken into account. For example, if the participant is in poor health, an annuity, based on standard mortality assumptions, that terminates at the participant’s death should not be selected. On the other hand, if the participant’s spouse is in poor health, the participant should not select a joint and survivor annuity. However, if the plan is subject to the survivor annuity rules discussed in Section A of Chapter Five, the spouse must consent to any form of payment other than a qualified joint and survivor annuity.

Because distributions from qualified retirement plans and traditional IRAs will be subject to current income tax except to the extent that the participant has made nondeductible contributions, income tax planning is extremely important. Conversely, all “qualified distributions” from Roth IRAs will not be subject to income tax. In addition, irrevocable beneficiary designations during the participant’s lifetime may involve taxable gifts, and qualified retirement plan benefits and IRAs will usually be includible in the participant’s federal gross estate for estate tax purposes. A distribution of plan benefits may also be a generation-skipping transfer subject to the GST tax.

**C. Tax Benefits of Qualified Retirement Plans and IRAs**

Qualified retirement plans receive favorable tax treatment under the Code. First, an employer receives a current deduction for contributions made to the plan, while under a nonqualified deferred compensation plan an employer is not entitled to a deduction for a benefit provided to an employee until the employee must include the value of the benefit in taxable income. Second, the employee does not recognize income when the contributions
are made to the plan for his or her benefit, but instead pays tax on the benefits when they are actually distributed. Third, the trust that holds the funds is exempt from federal income tax, unless the trust receives unrelated business income; consequently, the trust fund grows more rapidly than a taxable investment since income taxes do not reduce the income or the realized gains added to the fund each year.

Fourth, when distributions from the plan are made to the participant or the participant’s beneficiary, favorable tax treatment may be available. For a person who reached age 50 before January 1, 1986, ten-year averaging and capital gain treatment may be available. In addition, certain distributions qualify for rollover treatment. Rollover treatment permits the recipient of the distribution to place the funds in an IRA, or in some cases another qualified retirement plan, thereby deferring the income tax on the distribution until a later date and retaining the benefits in a tax-exempt fund. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA 2001) liberalized the rollover rules.

In 2015, an individual may contribute the lesser of $5,500 or the individual’s compensation for the year to a traditional IRA or a Roth IRA (or it can be allocated between the two). The dollar amount is adjusted for inflation in increments of $500. An individual who reached age 50 during the taxable year may make an additional catch-up contribution of $1,000. The catch-up amount is not adjusted for inflation. The dollar limit can be doubled if at least half is contributed to an IRA of a spouse of the individual. No contributions may be made to a traditional IRA in the year in which the individual attains age 70½ or any later year. Once amounts have been contributed to an IRA, the investment return is not currently subject to income tax.

The contributions made to a traditional IRA may be deductible for income tax purposes. If either the participant or the participant’s spouse is an active participant in a qualified retirement plan, then the amount deductible is reduced or eliminated once the participant’s or couple’s adjusted gross income (AGI) exceeds a certain amount.

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2 Code §§ 219(b)(1), 408(0)(2), 408A(c)(2).
3 Code § 219(b).
4 Id.
5 Code § 219(c).
6 Code § 219(d)(1).
7 Code § 219(g)(1).
In 2015, in the case of a single individual who is an active participant in a qualified retirement plan, the deductible amount of the individual’s IRA contribution is reduced pro rata as the individual’s AGI, determined before the IRA deduction, increases from $61,000 to $71,000. For example, if a single individual who is an active participant in a qualified retirement plan has AGI of $66,000 (before taking into account any deduction for a contribution to an IRA), his or her deduction for an IRA contribution during the year is limited to $2,750, or 50 percent of the $5,500 limit on IRA contributions for an individual. The 50 percent reduction is determined by taking the excess of the individual’s AGI over $61,000, which is $5,000, and dividing it by $10,000, the excess of $71,000 over $61,000.

In 2015, in the case of a couple filing a joint return, the reduction of the deductible amount begins at $98,000 of AGI, and the couple may no longer deduct contributions to a traditional IRA once their AGI exceeds $118,000. The phase-out range for a married person filing separately is from $0 to $20,000. A special rule allows a married person who is separated from his or her spouse for the entire year and who files a separate return to be treated as a single person for purposes of determining the amount of deductible contributions he or she can make to a traditional IRA.

There is a $200 de minimis deduction available to an individual whose AGI has not reached the complete phase-out amount; i.e., $71,000 for a single taxpayer and $118,000 for married taxpayers filing a joint return.

In addition, the Tax Relief Act of 1997 (TRA 97) allows a spouse of an active participant to make deductible contributions to a traditional IRA, unless the AGI of the couple exceeds $183,000 in 2015. The amount the spouse may deduct is reduced proportionately after the AGI of the couple reaches $183,000, until it reaches $193,000.

TRA 97 added another type of IRA, known as a Roth IRA. Contributions to a Roth IRA, which could be made only in tax years

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10 Code § 219(g)(4).
11 Code § 219(g)(2)(B).
12 TRA 97 § 301(b), amending Code § 219(g), adding new paragraph (7).
13 Code § 408A, added by TRA 97 § 302(a).
beginning after December 31, 1997, are not deductible.\textsuperscript{14} The annual amount that can be contributed is the same as for a traditional IRA, \textit{i.e.}, in 2015, $5,500 in the case of an individual, or $11,000 in the case of a married couple, provided that the contribution to either spouse’s IRA does not exceed $5,500.\textsuperscript{15} The same increases in the annual amount that can be contributed to a traditional IRA (discussed earlier) also apply to Roth IRAs. In addition, the amount that can be contributed is reduced by any amounts contributed to a traditional IRA. Contributions to a Roth IRA are permitted after age 70\(\frac{1}{2}\).\textsuperscript{16} Contributions for a year (plus earnings) may be shifted from a traditional IRA to a Roth IRA or vice versa at any time before the tax return due date (including extensions) for that year.\textsuperscript{17}

Annual contributions to a Roth IRA are subject to a phase-out similar to the contribution deduction phase-out for a traditional IRA, although that phase-out is not dependent on participation in a qualified retirement plan.\textsuperscript{18} For a single taxpayer or head of household, the phase-out in 2015 begins at $116,000 of AGI, and no contribution is permitted once AGI reaches $126,000. For a married couple filing a joint return and certain qualifying widowers, the phase-out begins at $183,000 of AGI, and no deduction is permitted once AGI reaches $193,000. For a married individual filing a separate return, the phase-out begins at $0 of AGI, and no deduction is permitted once AGI reaches $10,000. Excess contributions to a Roth IRA are subject to the 6 percent excess contribution excise tax under Code § 4973(f).

A traditional IRA can be rolled into a Roth IRA. The taxable portion of the IRA will be subject to income tax, but not to the 10 percent additional income tax for premature withdrawals or the 6 percent excess contributions excise tax. In lieu of a rollover, the traditional IRA may be converted to a Roth IRA, with the same tax consequences.

Effective for distributions after December 31, 2007, a distribution from a tax-qualified retirement plan, tax-sheltered annuity, or governmental 457 plan may be rolled over directly from such plan into a Roth IRA. The amount rolled over in excess of any nondeductible contributions made to the plan is included in gross income. After 2009, as a result of the 2005

\textsuperscript{14} Code § 408A(c)(1).
\textsuperscript{15} Code § 408A(c)(2).
\textsuperscript{16} Code § 408A(c)(4).
\textsuperscript{17} Code § 408A(d)(6).
\textsuperscript{18} Code § 408A(c)(3).
Tax Increase Prevention and Reconciliation Act,\textsuperscript{19} which amended § 408A to eliminate the income limits on conversions of traditional IRAs to Roth IRAs (which was AGI of $100,000),\textsuperscript{20} any individual, regardless of his or her AGI, may roll over amounts from traditional IRAs and eligible retirement plans to a Roth IRA. As a result of this rule, a participant in a qualified retirement plan or other tax-favored plan will not have to roll over a distribution to a traditional IRA in order to roll the same amount into a Roth IRA. With the elimination of the income limitation after 2009, every individual who is either an account holder of a traditional IRA or a participant in a qualified retirement plan will need to consider whether to convert the existing traditional IRA to a Roth IRA or to roll the qualified retirement plan benefit into a Roth IRA.

The ability to roll a benefit directly from a qualified retirement plan into a Roth IRA not only eliminates a step in achieving a Roth IRA conversion, but may also allow more of the amount rolled over to be treated as after-tax contributions not subject to income tax, thus reducing the tax cost of the rollover. Under the normal rules regarding distributions from IRAs, any distribution, including a rollover, will be treated as a pro rata portion of before-tax and after-tax contributions to all the person’s IRAs. Consequently, a participant in a qualified retirement plans who has made substantial after-tax contributions to the plan would want to avoid having the plan benefit aggregated with his or her traditional IRAs if they consist of mostly before-tax contributions. A direct rollover of the qualified plan benefit to a Roth IRA would avoid aggregating the plan benefit with the participant’s traditional IRAs in determining the amount of before-tax and after-tax contributions.

Although contributions to a Roth IRA are not deductible for income tax purposes, and an individual recognizes taxable income upon the conversion of a traditional IRA to a Roth IRA or the rollover of a qualified retirement plan benefit to a Roth IRA, earnings on the investments in the Roth IRA and qualified distributions from the Roth IRA more than five years after the first contribution to the Roth IRA are not subject to income tax. In addition, the owner of the Roth IRA is not required to take out minimum distributions once he or she has reached age 70½. If the owner’s spouse is the beneficiary of the Roth IRA, the spouse is also not subject to


the minimum distribution rules after the owner dies. Other beneficiaries, however, are subject to the minimum distribution rules.

As mentioned in the last paragraph, distributions from a Roth IRA are not subject to the minimum distribution rules during the account holder’s lifetime.\(^21\) Distributions from a Roth IRA are not included in gross income for federal income tax purposes if they are qualified distributions.\(^22\) A qualified distribution is any distribution from a Roth IRA if a five tax-year holding period is fulfilled and the distribution is made after the individual reaches 59½, after the individual’s death, or on account of the individual’s total and permanent disability, or if it is a qualified first-time homebuyer distribution.\(^23\) If the distribution is attributable to annual Roth IRA contributions, the five tax-year holding period is fulfilled if the individual has maintained any Roth IRA for the preceding five taxable years. If the distribution is attributable to amounts rolled over or converted from a traditional IRA, the five tax-year holding period begins with the year of the rollover or conversion. A first-time homebuyer distribution must be used for the cost of acquiring, constructing, or reconstructing (including usual or reasonable settlement, financing, or other closing costs) the principal residence of the account holder or his or her spouse, or the principal residence of a child, grandchild, or ancestor of the owner or spouse and is subject to a lifetime limitation of $10,000 per individual.\(^24\) Other rules apply in determining whether a distribution is a qualified first-time homebuyer distribution.

If a distribution is made before the five-year period, but would otherwise have been a qualified distribution, it will not be subject to the 10 percent premature withdrawal tax. Nonqualified distributions of non-rolled-over amounts are treated as coming first from contributions, and to that extent will not be subject to either the traditional income tax or the 10 percent tax.\(^25\) However, a distribution from a Roth IRA of an amount rolled over from a traditional IRA within the five-year period beginning with the year of the rollover will be subject to the 10 percent premature withdrawal tax absent an exception, even though the distribution would not be includible in the recipient’s gross income.\(^26\)

\(^{21}\) Code § 408A(c)(5).
\(^{22}\) Code § 408A(d)(1).
\(^{23}\) Code § 408A(d)(2).
\(^{25}\) Code § 408A(d)(4)(B).
\(^{26}\) Code § 408A(d)(3)(F).
Whether an individual should make contributions to a traditional IRA or a Roth IRA and whether the individual should roll over or convert a traditional IRA to a Roth IRA depends on a number of factors, and is outside the scope of this monograph.

D. Types of Qualified Retirement Plans

Planning for distributions from qualified retirement plans is complicated partly because of the many types of plans that are available, each of them having different characteristics that affect the timing and form of the distribution of benefits. The type of plan may also affect the extent of a spouse’s rights to the participant’s interest in the plan. The following is merely a summary of the types of qualified retirement plans and does not explain the factors an employer should consider in choosing one type of plan over another.

Qualified retirement plans are divided into two major categories: defined benefit plans and defined contribution plans.

1. Defined Benefit Plans

Under a defined benefit plan, a participant is promised a specific benefit that is determined under a formula contained in the plan. The formula may provide that a participant is entitled to receive, at the participant’s normal retirement age, a percentage of the participant’s average compensation over some period of time, multiplied by the participant’s number of years of service. For example, a participant may be entitled to a monthly pension equal to 1 percent of his or her average monthly earnings over the consecutive five-year period during which the participant had his or her highest average compensation, multiplied by the participant’s number of years of service with the employer. Under such a plan, the participant can depend on receiving the promised monthly payment when he or she retires, assuming that the participant remains a participant in the plan until normal retirement age and the employer continues to fund the plan.

The employer is required to make contributions to fund the benefits provided under the plan. The amount of the contribution is determined actuarially, based on certain assumptions, such as expected rates of return, mortality, and turnover. If the employer fails to fund the plan sufficiently, some or all of the participant’s benefit may be guaranteed by the Pension Benefit Guaranty Corporation (PBGC). Since the employer has promised
the employee a specific benefit, it is the employer who is subject to the risk that the funds in the plan may not earn an adequate rate of return. On the other hand, it is the employer who benefits if the investments achieve a high rate of return, as future contributions needed to fund the benefits will be reduced.

In a defined benefit plan, a participant is frequently not entitled to receive his or her plan benefits in the form of a lump sum distribution. The sponsoring employer may have at least two good reasons for not permitting lump sum distributions from the plan. First, the employer may be concerned that if a participant elects a lump sum distribution, the participant may spend most of the money soon after receipt, leaving nothing for the participant’s retirement years. Second, if a significant number of participants retire in any one year and all want lump sum distributions, the plan may be forced to sell a large portion of its investments at an unfavorable time in the marketplace. In addition, many defined benefit plans do not provide a death benefit other than the survivor annuity to which a participant’s spouse may be entitled under the Retirement Equity Act of 1984 (REA).

2. Defined Contribution Plans

Under a defined contribution plan, the employer makes contributions to the plan that are allocated to the accounts of the participants, usually based on the participant’s compensation. When the participant separates from service, dies, or becomes disabled, or at any other time specified in the plan, the participant is entitled to his or her account balance under the plan. The participant’s account balance includes employer contributions, forfeitures from the nonvested portions of the accounts of former participants allocated to his or her account while an active participant in the plan, any contributions made by the participant, and any earnings and gains on these amounts, reduced by any losses or administration expenses allocated to the participant’s account. Under most defined contribution plans, a participant is entitled to receive a lump sum distribution of his or her account balance upon retirement. In addition, upon the participant’s death before retirement, his or her account balance usually is payable in full to the participant’s beneficiary or, if no beneficiary has been designated, to the participant’s estate. In a defined contribution plan, the participant bears the risk of poor investment performance of the funds allocated to his or her account, but also enjoys the benefit of a high rate of
return on such funds. Some defined contribution plans permit the participant to direct the investment of the funds in his or her account.

There are a number of types of defined contribution plans. The simplest to administer, and the most flexible from an employer standpoint, is a profit-sharing plan. Under a profit-sharing plan, each year the employer may contribute as much as 25 percent of the total compensation of all the participants in the plan during the year, or may make no contribution at all. However, a profit-sharing plan that does not have substantial and continuing contributions may be required to fully vest all participants. As in the case of most defined contribution plans, a profit-sharing plan usually provides that the employer’s contribution will be allocated to the accounts of the participants based on their compensation.

A money purchase pension plan requires the employer to make a specific contribution to the plan each year, usually in an amount equal to a percentage of the compensation of each participant. A target benefit plan, which also requires a specific contribution each year, provides for proportionately greater allocations to the accounts of older participants. In a target benefit plan, a specific target benefit is selected and the contribution on behalf of each participant is computed to be sufficient to provide this targeted benefit, based on an assumed rate of return. However, as in the case of all defined contribution plans, at the participant’s retirement or other event permitting a distribution, the participant is entitled only to the amount that is actually in the account, regardless of whether that amount is sufficient to provide the targeted benefit. Since the account of an older participant has less time to accumulate funds to provide the targeted benefit, the regulations permit a plan to allocate a proportionately larger percentage of the contribution to the accounts of the older participants than would be allocated in a profit-sharing or money purchase pension plan.27

In some cases, depending upon the demographics of the employer, a so-called new comparability plan may result in proportionately greater benefits going to the highly compensated employees than under a profit-sharing or money purchase pension plan. Under such a plan, the amount allocated to an employee’s account is treated as if it were funding a defined benefit plan for that employee. The retirement benefit that is deemed provided by the contribution to non-highly compensated employees is

compared with the benefits provided to the highly compensated employees, and as long as the comparability of the benefits meets certain minimum standards, the plan satisfies the nondiscrimination rules.

In the previously popular thrift plans, the participant usually makes nondeductible contributions that may or may not be matched by the employer. For example, a thrift plan may permit a participant to make a nondeductible contribution to the plan of up to 10 percent of the participant’s compensation during the year. The employer may then match all or part of the participant’s contribution.

Thrift plans have been largely supplanted by another type of defined contribution plan permitting participant contributions, the so-called 401(k) plan or cash or deferred arrangement. Under such a plan, a participant may elect to have his or her compensation reduced or may elect to forgo a bonus and have the forgone salary or bonus contributed to the plan. Although the forgone salary or bonus will be includible in the participant’s gross income for purposes of Social Security taxes and Medicare taxes, it will not be includible in the participant’s gross income for income tax purposes.28 In such a plan the employer may also match part or all of the participant’s contribution.

There are also several types of plans that are designed to promote ownership of stock of the sponsoring employer corporation. A stock bonus plan is similar to a profit-sharing plan except that it is designed to acquire employer stock.29 In an employee stock ownership plan (ESOP), the plan may borrow money that it uses to buy stock from the employer or shareholders and pledge the stock acquired as security for the loan.30 The employer may be a guarantor for a loan.31 An employer’s guarantee of a loan to a plan that is not qualified as an ESOP under the Code and regulations is a prohibited transaction, as would be the plan’s pledge of its stock.32

An employer may choose to adopt a simplified employee pension plan (SEP) to avoid the administrative expense involved in establishing and maintaining a qualified retirement plan. Under such a plan, the

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28 Code § 402(e)(3).
29 Treas. Reg. § 1.401-1(b)(1)(iii).
30 Code § 4975(d)(3).
31 Code § 4975(c).
32 Code § 4975(e).
participants set up their own IRAs, and the employer makes contributions to these IRAs in much the same manner as the employer would make allocations to the participants’ accounts in a profit-sharing plan. Unlike a qualified retirement plan that may have graded vesting, however, the participants are always 100 percent vested in the amount contributed by the employer to the IRA.  

Finally, the Small Business Job Protection Act of 1996 added the so-called SIMPLE plan, available to employers of 100 or fewer employees. Contributions of up to $10,000 (as adjusted for inflation) are made to a special IRA account for each employee based on salary deferral elections by each employee. The employee’s contribution is generally matched by an employer contribution of up to 3 percent of the employee’s compensation. The SIMPLE plan is designed to have even lower administrative expenses than an SEP.

E. Non-Tax Rules Relating to Qualified Retirement Plans

1. Timing of Benefit Payments

The timing of the payment of benefits from qualified retirement plans and IRAs is controlled under rules contained in both the Code and ERISA. These rules require a plan to give a participant two rights with respect to the timing of benefit payments. First, these rules require a plan to allow a participant to begin receiving his or her benefits by a certain time. Second, these rules permit a participant to postpone the receipt of benefits until the participant reaches the later of the normal retirement date under the plan or age 62. In addition, the Code requires that distributions commence no later than a certain time and imposes a 50 percent tax on undistributed required distributions. The required distribution rules are dealt with in Chapter Two.

Unless the participant otherwise elects, distributions to a participant must commence no later than 60 days after the close of the plan year in which occurs the latest of:

1. The date the participant attains the earlier of age 65 or the normal retirement age under the plan;

33 Code §§ 408(a)(4), (k)(1).
34 Code § 408(p).
(2) The tenth anniversary of plan participation; or

(3) The participant’s termination of employment.\(^{35}\)

A qualified retirement plan may not distribute any portion of a participant’s benefit before the later of the attainment of normal retirement age or age 62 without the participant’s written consent.\(^{36}\) For the consent to be valid, the participant must be notified of the material features of the plan’s optional forms of benefit payments and of his or her right, if any, to defer the commencement of distributions.\(^{37}\)

This notice must be given no less than 30 and no more than 90 days before payment of the benefits is scheduled to begin.\(^{38}\) The participant’s written consent may not be required before receipt of the notice and may not be given earlier than 90 days before payment of the benefits is scheduled to begin.\(^{39}\) If the plan is subject to the survivor annuity rules discussed in Chapter Five, the notice must also describe the rights of the participant’s spouse to receive either a survivor annuity or the participant’s vested accrued benefit.\(^{40}\)

Generally, no consent is required if the value of the participant’s benefit is $5,000 or less.\(^{41}\) TRA 2001 provides that a plan may disregard the value of a rollover in determining the value of a participant’s benefit.\(^{42}\) If the plan is subject to the survivor annuity requirements, the cash-out of a benefit with a value of $5,000 or less is not permitted after the participant’s annuity starting date, unless the participant and spouse (or if the participant has died, the surviving spouse) consent to the distribution.\(^{43}\)

The participant’s annuity starting date is the date regular payments of the participant’s benefit are scheduled to begin. Furthermore, a distribution may be made without the consent of the beneficiary after the death of the participant unless the plan is subject to the qualified survivor annuity rules and the beneficiary is the participant’s surviving spouse.\(^{44}\)

\(^{35}\) Code § 401(a)(14); ERISA § 206(a).
\(^{36}\) Code § 411(a)(11)(A); Treas. Reg. § 1.411(a)-11(c)(4).
\(^{37}\) Treas. Reg. § 1.411(a)-11(c)(2)(i).
\(^{38}\) Treas. Reg. § 1.411(a)-11(c)(2)(ii).
\(^{39}\) Id.
\(^{40}\) Code § 417(a)(3); Treas. Reg. § 1.401(a)-20, Q&A 36.
\(^{41}\) Code § 411(a)(11)(A).
\(^{43}\) Code § 417(e)(1).
\(^{44}\) Treas. Reg. §§ 1.411(a)-11(c)(5), 1.417(e)-1(b)(1).
The Code requires that distributions commence no later than April 1 of the calendar year following the calendar year during which the participant attains age 70 1/2, regardless of whether the participant retires, except for a participant in a qualified retirement plan who does not own more than 5 percent of the sponsoring employer, in which case the payment of benefits can be deferred until April 1 after the year in which the participant retires. This rule is subject to certain exceptions that are discussed in Chapter Two.

Qualified retirement plans may provide for the distribution of benefits upon death, disability, retirement (early, normal, or deferred), separation from service, or plan termination. Distributions from pension plans (defined benefit plans and money purchase pension plans) generally are not permitted before these events. Although money purchase pension plans are defined contribution plans, they are treated as pension plans under the Code with respect to a number of issues, including the prohibition on in-service distributions. In-service distributions are distributions made while the participant continues to work for the sponsoring employer. Pension plans may permit distributions to an active participant upon attainment of normal retirement age, and an active participant who reached age 50 before 1986 may elect special averaging for such a distribution if the distribution qualifies as a lump sum distribution, the distribution is received on or after the normal retirement age under the plan, and the participant has reached age 59 1/2. Special averaging and lump sum treatment are discussed in Chapter Three.

Although in-service distributions from pension plans generally are prohibited, the plan may permit a participant to withdraw mandatory employee contributions and the earnings on mandatory employee contributions if he or she ceases plan participation, even if he or she does not terminate employment. Mandatory contributions are contributions that are required either as a condition of employment or participation in the plan, or to receive benefits attributable to employer contributions. In addition, a pension plan may permit a participant who continues to

45 Code §§ 401(a)(9)(A), (C).
48 Treas. Reg. § 1.401-1(b)(1)(i).
participate in the plan to withdraw voluntary nondeductible contributions and the earnings on voluntary nondeductible contributions at any time.\textsuperscript{50}

Profit-sharing plans, on the other hand, may provide for distributions after a fixed number of years (at least two), the attainment of a stated age, or upon the prior occurrence of an event such as disability, retirement, death, or severance of employment.\textsuperscript{51} Profit-sharing plans may permit hardship distributions while the participant continues to work for the sponsoring employer.

Distributions of elective deferrals from 401(k) plans (amounts that are attributable to employer contributions made pursuant to a participant’s salary reduction election) are only permitted when:

(1) A participant separates from service, dies, becomes disabled, or reaches age 59½;\textsuperscript{52}

(2) The plan terminates without the establishment or maintenance of another defined contribution plan other than an ESOP, but only if the participant’s entire interest is distributed within one taxable year of the participant;\textsuperscript{53}

(3) A corporation disposes of substantially all its assets in a trade or business or its interest in a subsidiary to another corporation, but only if:

(a) The participant continues employment with the purchaser or subsidiary;

(b) The transferor corporation continues to maintain the plan after the disposition; and

(c) Distributions of the participant’s entire interest are made within one taxable year;\textsuperscript{54} or

\textsuperscript{51} Treas. Reg. § 1.401-1(b)(1)(ii).
\textsuperscript{52} Code §§ 401(k)(2)(B)(i)(I), (III).
\textsuperscript{53} Code §§ 401(k)(2)(B)(i)(II), 401(k)(10)(A), (B), as added by TAMRA § 1011(k)(1)(B).
\textsuperscript{54} Code §§ 401(k)(2)(B)(i)(II), (10)(A), (B).
(4) The participant incurs a hardship (as defined in the regulations).\textsuperscript{55}

For plan years beginning after 1988, hardship distributions from 401(k) plans are limited to elective deferrals and may not include any income earned during post-1988 plan years on the elective deferrals.\textsuperscript{56} A hardship distribution is not eligible for rollover treatment.\textsuperscript{57}

2. Type of Benefits

Generally, distributions from qualified retirement plans are made pursuant to the options set forth in the plan document. The options may include a life annuity, a life annuity with a guaranteed number of payments, a joint and survivor annuity, installments, and a lump sum. Under a life annuity, a specific dollar amount is paid to the participant (and under a joint and survivor annuity, to the participant’s beneficiary after the participant dies), and at the death of the participant (or the survivor of the participant and the beneficiary) the annuity terminates. A life annuity with a “period certain” feature (such as ten years) provides a specific dollar amount payable each month or year over the life of the participant, and if the participant dies before the end of the period certain, the remaining payments during the period certain will be made to the participant’s designated beneficiary. For example, if the participant elects a ten-year certain and life annuity with $1,000 payable each month and the participant dies before the expiration of 120 months, $1,000 will be paid to the participant’s designated beneficiary each month during the balance of the 120-month period.

A plan may not condition the availability of an optional form of benefit on the discretion of either the employer or the plan administrator.\textsuperscript{58} On the other hand, a plan may condition the availability of an optional form of benefit on objective conditions that are specifically set forth in the plan.\textsuperscript{59} For example, a plan may condition a lump sum distribution on the extreme financial hardship of the participant as defined in the plan.\textsuperscript{60}

\textsuperscript{55} Code § 401(k)(2)(B)(i)(IV).
\textsuperscript{56} Id.; Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B)(6).
\textsuperscript{57} Code § 402(c)(4)(C).
\textsuperscript{58} Treas. Reg. §§ 1.401(a)-4, Q&A 3, 1.411(d)-4, Q&A 4.
\textsuperscript{59} Treas. Reg. § 1.411(d)-4, Q&A 6.
\textsuperscript{60} Treas. Reg. § 1.411(d)4, Q&A 6(a)(2).
The minimum distribution rules, discussed in Section C of Chapter Two, limit the distribution period (the period over which the payments are to be made) once the participant reaches his or her required beginning date (RBD).

Under the Code and ERISA, as amended by REA, qualified retirement plan benefits generally must be paid in the form of a qualified joint and survivor annuity, and death benefits must be paid in the form of a qualified preretirement survivor annuity. In both cases, the participant’s spouse must be named as the beneficiary of the survivor annuity.\(^{61}\) The spouse may consent to a waiver of either or both survivor annuities. These rules are discussed in detail in Chapter Five. A profit-sharing or stock bonus plan generally is not required to provide the survivor annuities if certain requirements are satisfied, including the requirement that at the participant’s death the participant’s vested accrued benefit be paid to the participant’s surviving spouse unless the surviving spouse has consented to the designation of another beneficiary.\(^{62}\)

3. **Determination of Qualified Retirement Plan Benefits**

A. **Accrual of Benefits**

A participant’s *accrued benefit* under a defined benefit plan is the actuarial value of the participant’s normal retirement benefit that would be payable at the participant’s normal retirement date, determined in accordance with the plan formula and benefit accrual rules.\(^{63}\) The actuarial assumptions and interest rates that are used in calculating the value of the accrued benefit must be set forth in the plan.\(^{64}\)

The most common method of determining the portion of the participant’s normal retirement benefit that has accrued at any given time is the fractional method. Under the fractional method, the participant’s years of participation at the time the accrued benefit is being calculated are compared to the total years of participation the participant would have if the participant continued to participate in the plan until the participant’s normal retirement age.

\(^{61}\) Code § 401(a)(11)(A); ERISA § 205; REA §§ 103(a), 203(a).
\(^{63}\) Code § 411(a)(7)(A)(i).
\(^{64}\) Code § 401(a)(25).
For example, assume that a participant commences participating in a plan at age 35, the plan has a normal retirement age of 65, and the participant separates from service at age 40. The participant’s accrued benefit is one-sixth of his or her normal retirement benefit, determined by comparing the number of years of participation that the participant has at age 40, five years, with the total number of years the participant would have at the participant’s normal retirement age, 30 years.

If the participant’s normal retirement benefit under the plan formula payable at the participant’s normal retirement age is determined to be $3,000 a month, the participant’s accrued benefit at age 40 is one-sixth of this amount or $500 a month. If the participant is entitled to elect a lump sum distribution at the time the participant separates from service at age 40, the participant will be entitled to the actuarial equivalent of the value of $500 a month payable at age 65. The actual lump sum amount will be considerably discounted from its value at the participant’s normal retirement date, because the plan has 25 fewer years to invest the employer contributions to fund the participant’s accrued benefit.

In a defined contribution plan, the participant’s accrued benefit is the participant’s account balance, which is the sum of employer contributions and forfeitures from the nonvested portions of the accounts of former participants allocated to his or her account, any employee contributions, and earnings and gains on those amounts less any losses and administration expenses deducted from those amounts.65

A participant’s accrued benefit may not be decreased by a plan amendment66 and benefit accruals may not cease because a participant has reached a certain age.67 A top-heavy plan, which is a plan that disproportionately benefits certain key employees, such as officers and major shareholders, must provide a minimum benefit to non-key employees.68

B. VESTING OF BENEFITS

A participant is only entitled to the vested portion of the accrued benefit, which may be only a fraction of the benefit. The participant must always

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66 Code § 411(d)(6).
68 Code § 416(c).
be 100 percent vested in the balances attributable to his or her own contributions to the plan and elective deferrals under a 401(k) plan. In addition, a participant must be 100 percent vested in any benefits attributable to employer contributions when he or she reaches normal retirement age or upon termination or partial termination of a plan or complete discontinuance of contributions to a profit-sharing plan or a stock bonus plan.

A plan may provide that a participant’s vested interest in employer contributions, forfeitures, and earnings on these amounts depends upon the years of service the participant has with the employer at any given time. For example, a participant in a defined benefit plan may be entitled to no vested interest in his or her accrued benefit attributable to employer contributions and forfeitures until the participant has completed five years of service with the sponsoring employer, when the participant must be 100 percent vested. This type of vesting is referred to as cliff vesting. However, a defined benefit plan may instead adopt a graded vesting schedule under which the participant must be entitled to at least a 20 percent vested interest in his or her accrued benefit after three years of service, and an additional 20 percent for each year of service until the participant has seven years of service, when he or she must be 100 percent vested in his or her accrued benefit.

A defined contribution plan may provide that a participant is not entitled to any vested interest in his or her accrued benefit attributable to employer contributions and forfeitures until the participant has completed three years of service with the sponsoring employer, when he or she must be 100 percent vested. On the other hand, a defined contribution plan may adopt a graded vesting schedule under which the participant must be entitled to at least a 20 percent vested interest in his or her accrued benefit after two years of service, and an additional 20 percent for each year of service until the participant has six years of service, when he or she must be 100 percent vested in his or her accrued benefit. If a plan requires two years of service before a participant is eligible to participate in the plan, the participant must be 100 percent vested in his or her accrued benefit when he or she becomes a participant in the plan.

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70 Code §§ 411(a), (d)(3).
More rapid vesting is required in a top-heavy plan. Under a cliff vesting schedule, 100 percent vesting must occur after three years of service. Under graded vesting, a participant must be at least 20 percent vested in his or her accrued benefit after two years of service, with an additional 20 percent required for each year of service until the participant has six years of service, when he or she must be 100 percent vested in his or her accrued benefit.74 TRA 2001 applies the top-heavy vesting schedules to matching employer contributions for plan years beginning after 2001.75

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74 Code § 416(b).
75 Code § 411(a)(12), added by TRA 2001 §§ 633(a)(1), (2).