

CHAPTER 14 – Annuities & Employment Retirement

During the client's employment phase savings and compensation benefits are accrued - for payment at or after retirement (or at death).

This can occur with (1) individual income deferral accumulations (e.g., an IRA), or (2) employer qualified retirement plans, etc.

In permitted situations these accumulations can be accrued on a “pre-tax basis” (i.e., currently deducted or excluded from gross income, then with a zero tax basis for the account assets).

Deferred/Retirement Benefits - Examples

- 1) Commercial annuities – individually purchased (for life or a term).**
- 2) Qualified pension & profit-sharing plans (& annuity distributions at retirement/death).**
- 3) Nonqualified executive deferred compensation arrangements.**
- 4) Stock options-ISOs & nonqualified options.**
- 5) Individual retirement accounts (IRAs), including “Roth” IRAs.**
- 6) Death benefit only plans from the employer.**

Retirement & Taxation of Deferred Payments p.2

After retirement various deferred employment related benefits may be paid on a periodic basis.

For income tax purposes critical issues will be:

(1) the timing of the recovery of *any* cost basis,
and

(2) the amount of includible gross income. In the qualified (§401) retirement plan context (where contributions were all made on a pre-tax basis) the entire distribution often will be includible in payee's gross income.

Annuity Payment Options

– Traditional Annuity p.3

At the time annuity payments commence payments can be made for:

- 1) Term certain
- 2) One life annuity
- 3) Two life annuity (e.g., joint and survivorship). Note: Retirement Equity Act.

Amounts might be withdrawn before annuity payments commence. What income tax treatment? Cf., life insurance policy borrowings

Gross Income Inclusion of Annuity Income p.4-5

Code §72 provides for determining:

- (1) the “investment in the contract” and
- (2) the “expected return” to create “exclusion ratio” for each payment received. §72(b).

Therefore, the same portion of each future payment is included in gross income.

Is this approach actuarially sound? What are other options for tax basis recovery in the annuity context? Allow tax basis recovery first?

See §72(d) for qualified plan distributions & tax basis recovery. Cf., §72(b).

Additional income tax elements

- 1) What is a “refund feature”? What is the tax impact of a “refund feature”? See Code §72(c)(2) requiring an adjustment. P. 14.**
- 2) What if the annuitant dies prior to end of life expectancy period? See Code §72(b)(3) enabling an income deduction (on last income tax return for individual) for the unrecovered tax basis. P. 6.**
- 3) What if the annuitant outlives the life expectancy period? See Code §72(b)(2) re inclusion of the entire amount after all tax basis has been recovered. P. 6.**

Required Minimum Distribution Rules (RMD)

P. 10. What is the purposes of the “required minimum distribution” (RMD) rules (starting at 70½, subject to certain exceptions)?

How determine the required distribution?

What if successor owners receive benefits – what is the required payout period?

Note exception (described in Notice 2009-9, p.13) re RMD waiver for the year 2009 (only).

Why?

Estate Tax Inclusion?

p.13

Code §2039 requires inclusion in the gross estate of the value of the survivorship interest under an annuity contract.

Prior distributions: Client may previously have received annuity payments and, if accumulated (after income tax) additional inclusion of that net amount in gross estate (under Code §2033).

Estate Tax Inclusion of the Annuity – Code §2039

1) For a one-life annuity on the life of decedent – no residual value and no asset transfer occurs at the time of death.

2) For a joint & survivor annuity – what is the value of survivor benefits in the gross estate? And, who contributed to obtaining those survivorship benefits? See Code §2039(b).

P. 16. Is a marital deduction available? P.16.

Death: §2056(b)(7)(C). Lifetime: §2523(f)(6).

Tax basis step-up at death (under Code §1014)?

No - an IRD item. Code §691; when distribute?

Any Limit on Retirement Plan Accumulations?

- 1) Previously a dollar limit – p. 16; previously an excise tax on distributions above \$112,500 (as indexed). A “tax on success”?
- 2) Presently no limit on accumulations.
- 3) Prior Obama proposed limit – maximum annuity providing annual benefit of \$210,000 (payable on J&S annuity, starting at age 62); see p. 16, fn. 24.

Should a limit apply? Is the deferral valuable?

Maximize contributions & avoid creditors?

Qualified Retirement Plan Benefits

p.15-16

What are the payout options at retirement?

What is the relevance of the Retirement Equity Act? See Code §401(a)(11). P.16.

Is a (gift tax) marital deduction available, including a QTIP election? See Code §2523(f)(6).

If donee spouse dies first: See Code §2523(f)(6) (D), (p.18), re estate tax. No §2044 inclusion.

Community Property Law Applications p.18

Community property is a local law concept – therefore ownership is defined by applicable state law. But, what about when the property interest (the qualified plan benefit) is defined by federal law (ERISA)?

Allard v. Frech (and PLR 9018002, p.19, pre-REA) that under Texas law the non-employee spouse has a community property interest in the employee spouse's qualified plan benefits. Cf., Ablamis case (9th Cir, p.22) re federal preemption & non-participant spouse has no interest at death.

Boggs v. Boggs, U.S. Sup. Ct.

P.23

Facts: He was employee; 1st wife died; 2nd wife survives and 2nd wife asserts right to all plan benefits (to detriment of 1st marriage children).

ERISA preempts community property rights – with result that 2nd spouse is entitled to all plan benefits (& not part to his 1st marriage children with 1st spouse deceased)? Is the ERISA objective to benefit the surviving spouse?

Dissent (p.32): ERISA does not preempt (& nullify) community property law rights.

Necessity of a Proper Beneficiary Designation

Egelhoff case (p.44) – designation of ex-spouse as beneficiary under plan – not changed after divorce, but state law provided for revocation of designation on divorce; No, US Sup. Ct. says ERISA preemption here & pay ex-spouse).

Kennedy case (2009) (p. 44) – even a waiver of benefits by the ex-spouse does not preclude payment to ex-spouse if designation document is not changed as of death of employee.

What is the plan administrator to do?

Unintended Beneficiary Designation

Is other relief available?

Use a common law proceeding to enforce contractual intent re agreed rights, after benefits inadvertently received by former spouse?

Kensinger case, p. 45

Plan administrator is not involved in this proceeding.

Executive Deferred Compensation p.46

Nonqualified deferred compensation.

Deferral during lifetime is to be accomplished consistent with requirements specified in Rev. Rul. 60-31, i.e., contractual, unsecured benefits & not funded (including funds not in escrow).

Note, “rabbi trust” option (p.47) – no security interest; cf., “secular” trust option.

What relevance of Code §409A (re: vesting & income recognition)?

Deferred Compensation and Estate Tax p.48

Gross estate inclusion for the amount receivable under a non-qualified deferred compensation arrangement. Code §§2033, 2039.

Rabbi trust proceeds? If and when paid?

Distribution is “income in respect of a decedent” under Code §691 to the recipient.

How direct this asset to the beneficiaries?

What tax effect to private beneficiaries?

Direct the proceeds to charity?

Stock Options

Basic Issues

p.48

Types of stock options: ISOs and NSOs.

What value is includible in the gross estate?

Who should be the beneficiary?

Who should exercise the option?

What income tax treatment arises upon the disposition of (1) option or (2) option stock?

What is the capacity to borrow to enable the exercise of the options & stock purchase?

Do not let valuable options expire unexercised!

Incentive Stock Options

ISOs §422

p.49

Option grant at FMV & limit on grant amount.

No gross income inclusion either (1) at time of grant of option or (2) upon exercise.

Capital gains event when stock is subsequently sold (but two year holding period applies; waiver of holding period at death).

No ISO assignment during life, so no gifting opportunities. Inclusion of value in gross estate.

Basis step-up at death (see p.49)?

Nonqualified Stock Options

p.50

Value of option in the gross estate at death.

Transfer option by gift during lifetime? Gift to the extent of the value of the option right?

Death of optionee before exercise, income tax liability accrues to estate of employee.

Rev. Rul. 98-21 (p. 50) – completed gift only when the required services are performed to enable the exercise of the option.

See Rev. Proc. 98-34 (p.52) re valuation.

Individual Retirement Accounts

p.56

Sources of funds in an IRA?

- 1) Contributions;**
- 2) Rollovers**

**How designate the successor beneficiary to the
IRA?**

**Is this a testamentary disposition? No. See p.
57 & the Texas Estates Code provision.**

Individual Retirement Accounts, cont.

Rev. Rul. 92-47, p. 57.

Example: Entire lump sum balance is distributable to the decedent's child.

Distribution is IRD to the recipient.

No discount of the IRA value for the imbedded income tax cost – Kahn case, p.59.

Possible transfer of the account interest to charity? To achieve what objectives?

See IRA (only) rollover to charity. P.61.

The “Roth” IRA

p.62

No deduction at the time of contribution but no income inclusion upon subsequent withdrawal.
Transfer regular IRA balances into a Roth IRA account?

Death Benefit Only Plans

p.63

Benefit provided by employer only to survivor.

Does the employee have sufficient benefits to be connected with this plan? If so, apply a “retained life interest” analysis to the survivorship interest. §2038 (not §2039).

But, if no pre-death interest of the employee?

See, Levin case, p. 63. Power to alter, amend or revoke the interest of the spouse. Cf., DiMarco case, p. 69 & 71 (re gift tax), where not the controlling shareholder.

Social Security Benefits

p. 72

Social security survivorship benefits not includible in the estate of the deceased (employee) spouse.

But, Social Security benefits do terminate at time of death.

What treatment of survivor's benefits? No gross estate inclusion.

