

The Estate Planner

By Lewis J. Saret*

Retirement Benefits in the Context of Estate Planning—Part II: Income Taxation of Retirement Benefits

Introduction

Generally

This is the second in a series of columns that address retirement benefits in the estate planning context. The first column in this series discussed the minimum required distribution rules that apply to qualified retirement plans and individual retirement accounts (herein jointly referred to as “QRPs”).¹

This column focuses on the income taxation of QRP payments where the participant or account owner has basis associated with his/her QRP interest, which is important because of its economic impact on the QRP beneficiary. Future columns will discuss aspects of the income taxation of retirement benefits that are not covered in this column, including lump-sum distributions, qualified rollovers from one plan to another and income in respect of a decedent, as well as tax issues associated with naming trusts as beneficiaries of QRPs, including both the application of minimum required distribution rules as they apply to trusts named as beneficiaries of QRPs and the income taxation of trusts that receive QRP benefits, and Roth IRAs.

Deferral of income taxation is the primary attraction for QRPs for most participants. As discussed in more detail below, taxation of income earned by QRP assets is generally deferred until such income is distributed to the QRP beneficiaries. This deferral benefits participants by allowing them to earn investment income on assets that would otherwise have been paid in taxes on a current basis.²

This column first discusses the income taxation of QRP distributions in general terms and then focuses



CCH

a Wolters



Lewis J. Saret is Of Counsel to the law firm of Moore & Bruce, LLP, and may be reached by e-mail at lewis.saret@gmail.com.

on the income taxation of retirement benefits where the QRP participant or IRA owner (hereinafter both participants of QRP and IRA account owners will be referred to as “participants” for the purpose of convenience, unless otherwise noted) has basis in such QRP or IRA.

Income Taxation—Generally

QRP distributions are taxable as ordinary income to participants or their beneficiaries under Code Sec. 72.³ As a general matter, however, assets must actually be distributed to the participant in order to trigger income taxation. In other words, the constructive receipt doctrine does not apply to QRP and, therefore, the unrestricted right to withdraw assets from the QRP, by itself, will not trigger income taxation.⁴

Notwithstanding the foregoing, under certain circumstances a “deemed” distribution may occur, which then triggers taxation of such deemed distribution. To illustrate, the following types of transactions may trigger a taxable deemed distribution:

- Pledging an IRA as security for a loan⁵
- Assignments, pledges or transfers of IRAs⁶
- Certain prohibited transactions with an IRA⁷
- IRA acquisitions of collectibles⁸
- Certain deemed distributions arising out of loans for QRP, other than IRAs, to plan participants⁹
- Converting a traditional IRA into a Roth IRA¹⁰

Example 1. Darwin dies in 2011 and his entire estate consists of one IRA with a \$10 million balance at Darwin’s death. To pay the estate tax of \$1.75 million (*i.e.*, \$10,000,000 (gross estate) – \$5,000,000 (estate tax exemption) = \$5,000,000 (taxable estate) × 35% (tax rate) = \$1,750,000 (estate tax)), Darwin’s son, Einstein, who is serving as personal representative of Darwin’s estate and is the beneficiary of Darwin’s IRA, borrows \$2 million from Big Bank, which is secured by Einstein’s inherited IRA from Darwin. Here, when Einstein pledges the IRA to secure the loan with Big Bank, this triggers a deemed distribution from the IRA.

3.8-Percent Medicare Surtax

To help finance the recent healthcare reform legislation, Congress enacted Code Sec. 1411, which imposes a 3.8-percent surtax on passive investment income of certain taxpayers for tax years beginning on or after January 1, 2013. Code Sec. 1411 applies

to net investment income of individuals when their modified adjusted gross income exceeds certain thresholds. These thresholds are \$125,000 for a married person filing separately, \$200,000 for an unmarried individual, or \$250,000 for a married couple filing jointly.

Although QRP distributions are not directly subject to the 3.8-percent Medicare surtax, such distributions may indirectly trigger taxation under Code Sec. 1411, because they increase the participant’s modified adjusted gross income.

Example 2. Julius and his wife, Cleopatra, have modified adjusted gross income for 2013 of \$220,000, including \$150,000 of interest and dividends. Here, Julius and Cleopatra are not subject to the 3.8-percent Medicare surtax because their modified adjusted gross income is below the \$250,000 threshold for married couples.

Example 3. Same facts as Example 2, except that Cleopatra also takes a \$100,000 distribution from her IRA. Julius and Cleopatra are now subject to the Medicare surtax because their modified adjusted gross income now exceeds the \$250,000 threshold for married couples. As a result, they will pay the 3.8-percent surtax on the amount by which their \$320,000 modified adjusted gross income exceeds the \$250,000 threshold, or \$70,000 (*i.e.*, \$320,000 – \$250,000). Therefore, their Medicare surtax will equal \$2,660.

Return of Basis: After-Tax Investment

Although QRP distributions are generally taxable as ordinary income to the participant or to the beneficiaries who receive the distribution, such distributions are nontaxable to the extent that they represent a recovery of the participant’s “investment in the contract” or in other words, the participant’s basis in the QRP account.¹¹ For this purpose, “investment in the contract” generally constitutes the plan assets on which the participant has already paid income tax.¹² The purpose of this rule is to avoid such assets being taxed more than once.

Determination of Aggregate Basis Amount. Generally, participants will have a zero (\$0.00) basis in their QRP interests. However, under certain circumstances, participants will have a positive

basis. The following discussion describes how to ascertain the basis amount for QRP interests and IRA interests, which are determined using slightly different methods.

Non-IRA QRPs. A participant's investment in a non-IRA QRP generally equals (a) total participant contributions to the plan, less (b) previous nontaxable recoveries of such contributions.¹³ For this purpose, participant contributions to the QRP are generally those contributions previously taxed to the participant or made from the participant's after tax income, and therefore generally include participant contributions (1) included in taxable compensation, (2) withheld from taxable compensation, or (3) contributed to the plan from the participant's personal funds.¹⁴

For non-IRA QRPs, a participant's basis in his/her QRP interest (*i.e.*, investment in the contract) includes the following:

- **Designated Employee Contributions.** Amounts the participant's employer specifically designated as employee contributions that are taxable to the participant.¹⁵
- **Contributions Elected by the Participant.** Contributions made at the participant's election, other than certain (1) nontaxable cash or deferred contributions under 401(k) plans; (2) certain employer matching contributions for employees who are not self employed; and (3) contributions under certain one-time irrevocable elections.¹⁶
- **Payments on Nonqualified QRP Loans.** Payments on plan loans that are not qualified residential loans or qualified five-year loans.¹⁷
- **Contributions of Nontaxable Income.** Participant contributions that would not have been taxable to the participant if such payment had been paid directly to the participant,¹⁸ such as contributions to nonresident aliens that are nontaxable because such payments are for services performed outside the United States.¹⁹
- **Contributions to QRPs Providing Life Insurance.** Life insurance premiums paid by the QRP that are included in the participant's taxable compensation with certain exceptions. For this purpose, a participant's taxable compensation generally includes premiums paid from funds contributed by the employer or paid from funds earned by the plan. Here, the participant must allocate this deemed contribution amount to the plan program providing the life insurance.²⁰

- **Certain contributions of federal government employees and certain retirement benefits from the Railroad Retirement Board.** [Code Secs. 72(r), 86(d)(4).]
- **Rollovers.** A participant investment rolled over from another qualified plan in a trustee-to-trustee transfer if the participant's plan is a defined contribution plan under Code Sec. 401(a).²¹

Caution. Certain amounts are generally not treated as a participant's investment in the contract. These include certain employer contributions that employees agree to not take in cash and that are not taxable to the participant,²² certain employer contributions made while the participant was an expatriate that would have been nontaxable foreign earned income if paid directly to the participant,²³ and the participant's own contributions that the participant deducted on his/her own tax return in certain years.²⁴

Generally, for non-IRA QRPs and for purposes of determining the investment in the contract, plan programs within an employer-provided retirement plan are separate programs of interrelated contributions and benefits that are not interrelated with contributions and benefits under any separate program.²⁵ The importance of this distinction is that participants will have a different basis for different separate programs. Therefore, this allows participants to pick and choose different separate programs with different basis amounts when taking QRP distributions.

Traditional IRAs. For traditional IRAs, the owner's basis includes the following:

- Nondeductible IRA contributions²⁶
- Excess IRA contributions not returned by the due date of the owner's tax return²⁷
- Certain contributions of qualified reservist distributions²⁸
- Rollovers of after tax investments in the contract from another QRP²⁹

Planning Pointer. Participants must file Form 8606, *Nondeductible IRAs*, when they make nondeductible contributions to an IRA, effectuate a Roth IRA conversion, or receive any distribution from an IRA in which the participant has a positive basis in such IRA.³⁰ Therefore, to determine a participant's basis in his/her IRA,

the participant may look at his most recent Form 8606.

Inherited IRAs. For an inherited IRA, any basis in the IRA due to nondeductible contributions held by a decedent passes to the decedent's beneficiaries. However, unless the beneficiary is the decedent's spouse, the beneficiary cannot combine this basis with any basis the beneficiary has in his/her own traditional IRA or in other traditional IRAs inherited from other decedents.³¹ In contrast, the decedent's spouse may elect to treat an IRA inherited from the deceased spouse as the surviving spouse's own IRA or roll it into his/her own IRA. In this case, the surviving spouse just adds the basis of the deceased spouse's IRA to the basis of his/her own IRA.

Caution. If a beneficiary takes a distribution from both an inherited IRA with a basis and his/her own traditional IRA with a basis, the beneficiary must complete a separate Form 8606 to determine the taxable and nontaxable portions of such distributions.³²

Taxation of Distribution from Non-IRA QRP with Basis—Generally. Generally, Code Sec. 72 provides that distributions from non-IRA QRPs in which the participant has basis are deemed to include proportionate amounts of basis to the recipient as the total basis (*i.e.*, the investment in the contract) bears to the total account balance.³³

The specific rules that apply to calculate taxable and nontaxable distributions exceed the scope of this column. However, there are certain key facets of this analysis that planners should be aware of, which are discussed below.

Aggregation. Because there is no aggregation rule as there is for IRAs, different non-IRA QRP plans are treated as separate plans for purposes of the calculation of taxable income and nontaxable return of basis. This differs from the IRA aggregation rule, which is discussed below.

Split Distributions. Sometimes participants split their distributions between rollovers and distributions outright to the participant. In such cases, such split distributions are treated as two separate distributions as opposed to a single distribution per Notice 2009-68.³⁴ However, it should be noticed that this position conflicts with Reg. §31.3405(c)-1, Q&A 6.

Example 4. David retires from Goliath Corporation. His 401(k) plan contains \$1 million, of which \$200,000 represents David's basis. David rolls over \$800,000 to the plan of Samson Corporation, David's new employer and simultaneously withdraws the remaining \$200,000. If the rollover to the Samson plan and the \$200,000 distribution are considered two distributions, then the distribution to David of \$200,000 only carries out \$40,000 of basis (*i.e.*, $\$200,000 / \$1,000,000 \times \$200,000 = \$40,000$), which is the position taken by Notice 2009-68.³⁵ However, if this transaction is treated as one distribution, then David can allocate \$200,000 of basis to the \$200,000 distribution to David, resulting in that payment being nontaxable while the rollover to Samson's plan defers the tax on the funds that David has rolled over.³⁶

Special Treatment of Employee Contributions. Some QRPs maintain separate accounts for some or all of the employee's contributions and earnings thereon. Such plans may allow or require the participant to take distributions on only those separate account balances. In such cases, the participant may compute his/her investment in the account as if it were a separate plan program even if it does not technically qualify as a separate plan program.³⁷ Here, the participant may take an immediate distribution of his/her contribution and related earnings, which may consist primarily of nontaxable returns of the participant's investment in the plan and then take out the remainder in the form of taxable annuity payments in future years.

Planning Pointer. This provision is advantageous to participants because they generally will have a higher basis in their employee contribution account. Therefore, by drawing on such accounts the participant can minimize the tax hit from a plan distribution.

Partial Rollover. There are several different ways in which a participant may take a partial rollover, each with different tax consequences. This section discusses some of these ways to illustrate the issues involved.

Partial Direct Rollover and Partial Distribution of Remainder. If a participant directs his/her plan to roll over part of his/her account to a traditional

IRA and distribute the remainder then, as discussed above, IRS Notice 2009-68 treats this transaction as two separate distributions. Each distribution then carries out a proportionate amount of basis.

Example 5. Ben has \$300,000 in the Franklin Corporation QRP, of which \$100,000 represents Ben's investment in the plan. Ben directs the QRP to distribute out \$100,000 to him and to roll over \$200,000 to a traditional IRA. Here, \$66,667³⁸ of the \$100,000 distribution to Ben is taxable, and \$33,333 is a return of basis.

Distribution of Entire Account Followed by Partial Rollover. If a participant directs the QRP to distribute the entire plan balance to him/her and then the participant rolls over part of that balance within 60 days of the distribution, a special rule applies. Here, Code Sec. 402(c)(2) provides that pretax assets are deemed rolled over first.³⁹

Therefore, this method yields a different result than if the participant directs a partial direct rollover from the QRP combined with a partial distribution, which is discussed above. Here, the participant is able to have basis distributed out to him/her first and other QRP assets rolled over to a traditional IRA.

Example 6. Same facts as Example 5 except that Ben withdraws his entire QRP balance, of \$300,000, and then within 60 days of the

distribution, rolls over \$200,000 to a traditional IRA. Here, Code Sec. 402(c)(2) deems all of the pre-tax assets to be rolled over to the IRA and associates a return of basis of \$100,000 with Ben's net distribution, causing that distribution to be tax-free (*i.e.*, \$100,000

Figure 1.

Step 1: Determine Total basis in traditional IRAs.

+	Total basis of owner in all traditional IRAs for at end of tax year.
+	Nondeductible contributions to traditional IRAs for current tax year. ¹
=	Total basis in traditional IRAs of owner.

Step 2: Determine the value of all traditional IRAs as of December 31 of the tax year ("Year End Account Value").

+	Value of all traditional IRAs as of December 31 of tax year. ²
+	Distributions from all traditional IRAs during tax year.
+	Amounts of Roth IRA conversions during the tax year.
=	Adjusted value of all traditional IRAs as of December 31 of tax year.

Step 3: Determine basis percentage.

+	Product of Step 1: total basis in tradition IRAs of owner.
÷	Product of Step 2: adjusted value of traditional IRAs as of December 31 of tax year.
=	Basis percentage.

Step 4: Nontaxable portion of IRA distributions.

+	Product of Step 3: basis percentage.
x	Total IRAs distributions during tax year other than Roth IRA conversions.
=	Nontaxable IRA distributions other than Roth IRA conversions.

Step 5: Nontaxable portion of IRA distributions.

+	Product of Step 3: basis percentage.
x	Total amount of traditional IRAs converted into Roth IRAs.
=	Nontaxable IRA distributions converted into Roth IRA.

Step 6: Nontaxable portion of IRA distributions.

+	Total IRA distributions including Roth IRA conversions.
-	Product of Step 4: Nontaxable IRA distributions other than Roth IRA conversions
-	Product of Step 5: Nontaxable IRA distributions converted into Roth IRA
=	Taxable IRA distributions including Roth IRA conversions.

¹ Form 8606 factors out any contribution made from January 1 through April 15 of the year following the tax year, which may have been included in the basis numbers.

² Note that such distributions do not include distributions that are rolled over into another traditional IRA because such rolled-over amounts are included in the year end balances.

(distribution) – \$100,000 (return of basis) = \$0 (taxable distribution)).

Taxation of Distributions from IRAs with Basis.

Similar to non-IRA QRP, distributions from traditional IRAs are taxable only to the extent that they exceed basis. However, distributions from IRAs are different from non-IRA QRP distributions in that an aggregation rule applies to IRA distributions. Specifically, owners of two or more IRAs must generally aggregate the investments in all of their IRAs to determine the taxable and nontaxable portions of their IRA distributions.⁴⁰ In addition, all distributions during the year are treated as one single distribution.⁴¹ Also, because Roth IRA conversions are treated as distributions of the rolled over traditional IRA, the aggregation rules applicable to IRAs also apply to any Roth IRA conversions during the tax year.

For purposes of the aggregation rules, the following types of IRAs must be aggregated:⁴²

- Traditional IRAs
- Individual retirement annuities
- SEP IRAs
- SIMPLE IRAs
- However, the following types of IRAs are not aggregated:
 - Inherited IRAs are only aggregated with other inherited IRAs held as a beneficiary of the same decedent
 - Roth IRAs are not aggregated⁴³
 - IRAs of spouses are not aggregated with the other spouse's IRAs. In other words, each spouse only aggregates his/her own IRAs

The formula used by Form 8606, *Nondeductible IRAs*, for determining the taxable portion of IRA distributions is as outlined in Figure 1.

ENDNOTES

* Mr. Saret gratefully acknowledges the assistance of David Perry, Esq., with the preparation of this column.

¹ See Lewis J. Saret, *The Estate Planner, Retirement Benefits in the Context of Estate Planning—Part I: Minimum Required Distributions*, TAXES, Nov. 2011, at 15.

² See Lewis J. Saret, *supra* note 1, at 15, 16–18, for an illustration of this principle.

³ Code Secs. 402(a), 408(d)(1).

⁴ Code Secs. 402(a), 408(d)(1).

⁵ Code Sec. 408(e)(4); Reg. §1.408-4(d)(2). *But see* LTR 200606051 (Nov. 18, 2005) (assignment of IRA assets to secure former employee's obligation to repay pension distribution under certain circumstances did not result in a deemed distribution to IRA owner under Code Sec. 408(e)(4)).

⁶ Code Sec. 72(e)(4)(A)(ii); Reg. §1.408-4(a)(2); *In re Coppola*, CA-5, 2005-2 USTC ¶50,503, 419 F3d 323 (2005).

⁷ Code Secs. 408(e)(2), 4975; Reg. §1.408-4(d)(1).

⁸ Code Sec. 408(m)(1).

⁹ Code Sec. 72(p)(2).

¹⁰ Code Sec. 408A(d)(3)(A); Reg. §408A-4, Q&A -1(c), -7.

¹¹ Code Sec. 72(b).

¹² For a detailed discussion of how to deter-

mine a taxpayer's basis in his QRP interest, see *Vorris J. Blankenship, Determining Taxpayer Investment in Retirement Plans and IRAs*, J. RETIREMENT PLANNING, Mar.–Apr. 2006, at 17.

¹³ Blankenship, *supra* note 12.

¹⁴ Code Secs. 72(c)(1), 72(f)(1), 403(c); Reg. §1.72-8(a)(1), (5).

¹⁵ Reg. §1.72-8(a)(1); Code Sec. 414(h); Reg. §1.401(k)-1(a)(2)(ii).

¹⁶ Code Sec. 72(f)(1); Reg. §1.402(a)(1)-1(d)(1).

¹⁷ Reg. §1.72(p)-1, Q&A 21.

¹⁸ Code Sec. 72(f)(2).

¹⁹ Code Sec. 872(a).

²⁰ Reg. §§1.72-16(b)(2), -16(b)(4), - 8(a)(1), 1.403(b)-1(c)(3).

²¹ Blankenship, *supra* note 12, at note 34. To qualify to receive the investment rollover, the plan must have agreed to account separately for both (1) the rolled-over investment, and (2) the amount rolled over in excess of investment. Code Secs. 402(c)(2)(A), 401(a)(31)(C)(i).

²² Code Secs. 401(k), 403(b), 402(g).

²³ Code Sec. 72(f).

²⁴ Code Sec. 72(o)(1).

²⁵ Reg. §1.72-2(a)(3)(i).

²⁶ Code Sec. 408(o).

²⁷ LTR 200904029 (Oct. 30, 2008).

²⁸ Code Sec. 72(t)(2)(G).

²⁹ Code Sec. 402(c)(2).

³⁰ See Form 8606, *Nondeductible IRAs*, General Instructions.

³¹ *Id.*; Code Sec. 1014.

³² *Id.*

³³ Code Sec. 72(e)(8)(A), (B), (5)(D).

³⁴ Notice 2009-68, IRB 2009-39, 423.

³⁵ *Id.*

³⁶ LTR 200926041 (Apr. 3, 2009) (IRS ruled that direct rollover of parties entire account balance from Plan X to Plan Y, other than after-tax contributions which were distributed directly to the participant, were treated as one distribution).

³⁷ Code Sec. 72(d)(2).

³⁸ The taxable amount is calculated as follows: [(\$300,000 (total account) – \$100,000 (Ben's investment in the plan) = \$200,000) / \$300,000 (total account)] x \$100,000 (distribution) = \$66,667.

³⁹ Code Sec. 402(c)(2); Reg. §§1.402, Q&A-1, Q&A-5(b); Reg. §1.402(c)-2, Q&A-8; LTR 9840041 (July 6, 1998).

⁴⁰ Code Sec. 408(d)(2); Notice 1987-1 CB 446.

⁴¹ *Id.*

⁴² Code Secs. 7701(a)(37), 408(k)(1), 408(p)(1); Notice 87-16, 1987-1 CB 446; IRS Form 8606, *Nondeductible IRAs*, and instructions thereto.

⁴³ Code Sec. 408A(d)(4)(A).

This article is reprinted with the publisher's permission from the TAXES—THE TAX MAGAZINE, a monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the TAXES—THE TAX MAGAZINE® or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH.