1977

The Tax Consequences of Distributions from Retirement Plans

Chris Downs

Follow this and additional works at: http://scholarship.law.edu/lawreview

Recommended Citation
Available at: http://scholarship.law.edu/lawreview/vol26/iss2/4

This Comments is brought to you for free and open access by CUA Law Scholarship Repository. It has been accepted for inclusion in Catholic University Law Review by an authorized administrator of CUA Law Scholarship Repository. For more information, please contact edinger@law.edu.
COMMENTS

THE TAX CONSEQUENCES OF DISTRIBUTIONS FROM RETIREMENT PLANS

The substantial tax incentives for employers to establish private nondiscriminatory retirement plans has created a growth in the number of employees participating in private pension plans from an estimated 4 million employees in 1940, to 9.8 million in 1950, to between 23 and 30 million according to recent figures. By 1980, private pension plans are expected to cover 42 million employees. For any given employee, whether a participant in an individual, corporate, or self-employed retirement plan, the paramount concern is the amount of after-tax retirement benefit.

1. The favorable tax treatment granted qualified plans is considerable:
   Employers are permitted within certain constraints to deduct contributions made to these plans for participating employees whether or not the employees' interests are vested; earnings on the pension plan's assets are exempt from taxation; and covered employees are allowed to defer payment of tax on employer contributions made in their behalf until they actually receive the benefits.


3. Effective for taxable years beginning after December 31, 1974, three types of investment arrangements will qualify as individual retirement plans:
   (a) the individual retirement account (IRA) as described in I.R.C. §§ 219 (a)(1), 408(a);
   (b) the individual retirement annuity (IRAN) as described in I.R.C. §§ 219 (a)(2), 408(b); and
   (c) the qualified retirement bond as described in I.R.C. §§ 219(a)(3), 409.

   See also notes 69-71 infra.

4. Qualified corporate plans include those pension, profit-sharing, and stock bonus plans qualified under Internal Revenue Code sections 401 or 403. Under such plans, contributions by employers, employees, or both, are set aside in a separate fund held by a third party and invested. Sections 401 and 403 establish qualification rules which, if met by the plans, will result in special tax benefits: tax-free accumulation of earnings on a plan's investment funds, deduction of employer contributions, and favorable tax treatment upon the eventual distribution of funds to the employees and their beneficiaries. Section 415(c)(1) generally limits contributions to such plans to $25,000 or 25 percent of the participant's annual compensation. Benefits are limited to the lesser of $75,000 or "100 percent of the participant's average compensation for his high 3 years." I.R.C. § 415(b)(1).

5. Self-employed retirement plans include qualified pension or profit-sharing plans.
Although these deferred compensation plans vary in purpose and operation, each can provide for the distribution of periodic or lump sum payments. The taxation of periodic payments from qualified plans was one of the few provisions to remain unchanged by the Employee Retirement Income Security Act of 1974 (ERISA). Distributions of periodic payments from an employer's trust are taxed to the recipient as annuity payments under section 72 of the Internal Revenue Code. When an employee has made no contribution and has no other basis in the trust, all payments are taxed as ordinary income when distributed. Should the recipient have a basis in the trust by virtue of his contributions, taxation of the payments depends upon how fast the basis is recovered.

Admittedly the taxation of a periodic distribution presents no computational difficulties. It is only after leaving these shallow waters for the area of alternative lump sum distribution calculations that the depths of obfuscation are entered. To describe how, and under what circumstances, a lump sum distribution may be made, Congress has enacted a provision in excess of 3,000 words about as many as were required for the original provisions of the United States Constitution. To borrow one author's observation of a
code section added by ERISA, "[a]lthough the language of the section . . . is neither as felicitous nor as memorable as the ringing phrases of the Constitution, it will provide tax and pension experts with a text which will require nearly as much scholarly exegesis and which is susceptible to nearly as many subtle disputations."

ERISA allows the recipient of a lump sum distribution to take advantage of capital gain and special income averaging treatment, rather than the ordinary income taxation levied on periodic payments. Whether the distribution is made to the participant, or his trustee, executor, or beneficiary, the election to receive 10-year averaging treatment on a substantial portion of the distribution allows for meaningful tax planning.

I. LUMP SUM DISTRIBUTION TAXATION PRIOR TO ERISA

Under the Revenue Act of 1942 distributions from a qualified pension plan in excess of those amounts contributed by the employee were taxed as ordinary income. That portion of the distribution which constituted a return of employee contributions was simply a nontaxable return of capital. If the retirement benefits under the plan were paid out in one lump sum, that is, within one taxable year, on account of the employee's death or separation from his employer's service, certain exceptions to ordinary income taxation were provided to avoid the imposition of progressive tax rates in the year of the distribution. Under these circumstances the net benefits distributed were taxed as gain from the sale of a capital asset held for more than six months. This special taxation of lump sum distributions avoided the problem of income bunching at a time when the concept of income averaging was not yet recognized in tax legislation.

With the enactment of the Self-Employed Individual Tax Retirement Act of 1962, Congress offered additional tax incentives for retirement planning by providing that lump sum distributions under "Keogh" (HR-10) plans

11. Ch. 619, § 162, 56 Stat. 862.
12. INT. REV. CODE OF 1939, ch. I § 165(b), 53 Stat. 47 (now I.R.C. § 402). The amount actually distributed was taxed as an annuity under the predecessor of the current section 72.
16. See note 5 supra.
would be taxed as ordinary income, subject to five-year forward averaging. Taxing such distributions as though they were taken into income over a five year period minimized taxes by avoiding the high tax brackets otherwise resulting from bunching income in a single taxable year.

However, these exceptions to the general rule that retirement benefits should be taxed under annuity rules were open to abuse. The capital gains treatment of lump sum distributions from qualified plans allowed employees to receive deferred compensation at tax rates far more favorable than income currently received. Under the Tax Reform Act of 1969, Congress sought to modify this favorable capital gains treatment insofar as it applied to amounts representing employer contributions—amounts which would otherwise have been taxed as ordinary income. Given a lump sum distribution from a qualified plan, employer contributions for the plan years after 1969 were to be taxed as ordinary income subject to a special seven-year income averaging. Those employer contributions prior to 1969 were to be taxed as long-term capital gains. That portion of the distribution representing appreciation, interest, or dividends on the amounts accumulated continued to be given long-term capital gains treatment.

Though this partial substitution of income averaging for capital gains treatment was to provide a method of taxation more aligned with the purposes of deferred income taxation, the 1969 Act failed to meet other policy objectives. For example, the distinction between common law employees and the self-employed was retained. Common law employees were entitled to both capital gains and ordinary income treatment, while self-employed individuals received distributions wholly taxable under the 1962 Act as ordinary income. Also, although common law employees were provided an income averaging period of seven years, the self-employed were permitted only a five-year forward averaging period. In addition, the regulations proposed under the 1969 Act were excessively complex. Lump sum distributees were unable to determine their taxes because accountants and tax attorneys were refusing to attempt the computations. One of the major difficulties under the prior law was determining what portion of a lump sum distribution from a defined benefit plan represented benefits accruing prior to 1969 and what portion represented benefits accruing after 1970. This and other considerations served as the impetus for the ERISA amendments revising the taxation of lump sum distributions.

II. DEFINING A LUMP SUM DISTRIBUTION

A lump sum distribution is a distribution or payment to a recipient of the entire amount standing to the credit of an employee under a qualified corporate or Keogh plan. Such amount includes both employer and employee contributions made under the plan plus income earned on the account. The payment must be completed within a single taxable year and must be payable by reason of the employee's

(1) death,
(2) attainment of age 59½ or older,
(3) separation from service, or
(4) disablement.

In determining eligibility for lump sum distribution treatment, the Code makes an important distinction between "common law employees" and the "self-employed" or "owner employees." An owner employee or self-employed person is one who is either a sole proprietor or, in the case of a partnership, a person who owns more than 10 percent of either the capital interest or profit of the partnership. A common law employee is any employee other than a self-employed person. For example, a nurse who is employed by a doctor doing business as a sole proprietorship would be a common law employee of the sole proprietorship. This classification of employees is critical, for it determines whether a recipient will qualify for a lump sum distribution on account of the employee's "separation from service." If an employee had been a self-employed individual or an owner employee at any time during his participation in a qualified corporate plan, he may be ineligible for lump sum distribution treatment on account of separation from service. Congress felt it necessary to maintain this eligibility distinction because of the perceived differences in employee status. For the many

21. A distribution will not fail to be a distribution of the balance to the credit of an employee when some additional amount is distributed in a subsequent taxable year on account of an employer's contribution for the employee's last year. See Rev. Rul. 1969-1 C.B. 131. For additional guidelines regarding the "balance to the credit of the employee," see Proposed Treas. Reg. § 1.402(e)-2(c), 40 Fed. Reg. 18,804 (1975).
23. Id. § 401(c)(3).
24. See Ray, Tax Aspects of the Pension Reform Act of 1974, 3 FORDHAM URB. L.J. 161, 166 n.17 (1975). For purposes of the definition of a lump sum distribution the term "employed" includes an individual who is an employee within the meaning of I.R.C. § 401(c)(4).
owner employees who are sole proprietors, there is no concept for "separation from service" comparable to the termination of common law employees.26

An owner employee under a Keogh plan is entitled to a lump sum distribution prior to age 59½ only if it occurs on account of his death or disability.27 Any premature distribution to owner employees prior to age 59½ is subject to an income tax penalty equal to 10 percent of the amount distributed. This penalty is in addition to the amount of income tax otherwise payable upon early distribution.28 ERISA left intact an additional penalty against premature distributions to owner employees by providing that no contributions can be made to the plan on the employee's behalf for the period of five taxable years following the year in which the premature distribution was made.29

There is a special problem concerning eligibility for lump sum distribution treatment that is of some consequence to estate planners. If a given lump sum distribution is to be made to more than one recipient, except a payment or distribution to two or more trusts, it will only qualify as a lump sum distribution if the entire amount distributed is included in the income of the employee with respect to whom the payment had been made.30 Thus, if a distribution of employee benefits is made to the surviving spouse and children after the death of the employee, the distribution cannot be treated as a lump sum distribution. The same disqualification occurs when estate planners deliberately make qualified plan benefits payable to the children in the event the spouse predeceases the employee.

III. Computing the Tax on Lump Sum Distributions

Generally speaking, distributions from individual retirement plans are taxed as ordinary income, subject only to the general income averaging provisions of Code section 1301. This contrasts with the new tax treatment of lump sum distributions made with respect to an employee from a qualified corporate or Keogh plan. Under ERISA, such lump sum payments may be taxed in part as capital gains and in part as ordinary income. That part of the taxable amount of the distribution which is attributable to the employee's

27. I.R.C. § 402(e)(4)(A). For a definition of disability for a self-employed individual, see id. § 72(m)(7), under which a self-employed person is considered disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or to be of long-continued and indefinite duration.
28. Id. § 72(m)(5)(B).
29. Id. § 401(d)(5)(C).
participation in the plan prior to January 1, 1974, is deemed long-term capital gain and taxed along with any other capital gains the taxpayer may report for the taxable year. Another tax, referred to as the “separate tax,” is imposed at ordinary income rates upon that part of the taxable portion of the distribution attributable to post-1973 participation. The impact of this separate tax at ordinary income tax rates may be mitigated by an election to use a 10-year income averaging provision. The objective, as with previous income averaging devices, is to minimize taxes by treating this portion of the distribution as though it were spread out over a 10-year period, thus avoiding the high tax brackets produced by income bunching. When computing the tax on the ordinary income portion, a special “minimum distribution allowance” is provided to minimize taxes on small distributions.

Prior to allocating the distribution between the capital gain and ordinary income portions, the taxpayer must first determine what amount of the distribution is taxable. That portion of the distribution which represents the amount contributed to the plan by the employee is subtracted out, such an amount being a nontaxable return of basis. A second amount to be subtracted from the distribution is the net unrealized appreciation attributable to any part of the distribution consisting of securities of the employer corporation. The amount remaining, referred to in the Code as the “total taxable amount,” is that portion of the distribution made up of employer contributions and income earned on the account.

For purposes of the above computation the proposed regulations describe the net amount contributed by a participant of a qualified plan as those amounts actually contributed by the employee plus any amount “considered contributed” by an employee. Constructive contributions would include amounts contributed by an employer to the extent such amounts were includible in the employee’s gross income, any premiums paid by the employer for current life insurance protection that are reported as income by

31. The 1976 Act provides that a distributee may elect to have the capital gain portion of the distribution treated as ordinary income for which the 10-year forward averaging election may be made. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1512, 90 Stat. 1520. More complete treatment of the averaging election and its implications is provided at pp. 331-34 infra.
32. For a discussion of the minimum distribution allowance, see p. 326 infra.
34. Id. § 402(e)(4)(D)(ii). See also pp. 339-42 infra.
36. See I.R.C. § 72(f).
the employee, and any death benefits payable under Code section 101(b) by reason of the employee's death. The sum total of these contributions is reduced by any previous distribution to the employee that was excluded from gross income as a return of employee contributions.

After determining the total taxable amount of the lump sum distribution, the taxpayer must allocate this amount between capital gains and ordinary income. No portion of the distribution will be taxed with income averaging treatment unless the taxpayer-recipient formally elects to have the ordinary income portion of the distribution taxed in accordance with the special 10-year forward averaging rule. If the taxpayer does not so elect, the ordinary income and capital gain portions of the distribution are determined in the following manner: the total taxable amount is multiplied by a fraction, the numerator being the number of calendar years of employee participation in the plan prior to 1974, and the denominator being the total number of years of active participation in the plan. The amount so determined is taxed as long-term capital gains; the balance as ordinary income received in the year of distribution.

A. Minimum Distribution Allowance

Should the taxpayer elect to have the 10-year forward averaging provision apply, a "minimum distribution allowance" may reduce the total taxable amount for the purpose of computing tax on the ordinary income portion of the distribution. This allowance does not reduce the total taxable amount for capital gains purposes. Intended to minimize tax on relatively small distributions, the allowance is available to reduce total taxable amounts of less than $70,000. The amount of the allowance is one-half the total taxable amount to the extent that the total taxable amount does not exceed $20,000—the maximum allowance thus being $10,000—less 20 percent of the total taxable amount in excess of $20,000. The allowance is thus

37. See Treas. Reg. § 1.72-16(b) (1964). The premium paid for current life insurance protection is treated as a constructive contribution by the employee because it is to be included in gross income. See Rev. Rul. 74-7, 1955-2 C.B. 228-29 for a table of amounts to be included.

38. The proposed regulations classify employee contributions according to the time period made. For those made prior to January 1, 1975, additional computations are required. See Proposed Treas. Reg. § 1.402(e)-2(d)(2)(ii)(B), 40 Fed. Reg. 18,808 (1975). There seems to be no apparent policy reason for selecting the January 1, 1975 date other than accommodating those taxpayers using a calendar taxable year.

39. I.R.C. § 402(e)(4)(B). The election is made by filing IRS Form 4972 as part of the taxpayer's income tax return.

40. Id. § 402(a)(2).

41. Id. § 402(e)(1)(D).

42. The minimum distribution allowance for a $50,000 total taxable amount would
phased out on a gradual basis so that total taxable amounts equal to or in excess of $70,000 qualify for no minimum distribution allowance. The total taxable amount less any allowance is the amount upon which tax on the ordinary income portion of the distribution is computed.

B. The Initial and Actual Separate Taxes

Prior to computing the actual separate tax applied to the ordinary income portion, the taxpayer must make the intermediary calculation of the "initial separate tax." Again, this series of calculations results in the tax on the ordinary income portion and does not affect the computation of tax on the capital gains portion. The initial separate tax is computed as follows: disregarding all other income, the total taxable amount of the lump sum distribution, less any minimum distribution allowance, is divided by 10 to accommodate the 10-year forward averaging provision. The amount so determined is multiplied by the income tax rate applicable to unmarried, non-head of household individuals. That amount is then multiplied by 10 to arrive at the initial separate tax. The effect of this computation is simply to spread the entire distribution in equal amounts over 10 years, apply the unmarried individual rate to those 10 equal amounts, and accumulate the total potential tax under those conditions. Note that any amount eventually receiving capital gains treatment is still included in the total taxable amount for the purpose of computing the initial separate tax.

After arriving at the initial separate tax, the taxpayer may then determine the separate tax—the actual tax levied on the ordinary income portion of the distribution. To eliminate the tracing problems encountered under the

---


44. Selection of a 10-year figure was made simply to reflect that individuals usually live about 10 years following retirement at age 65. See H.R. Rep. No. 807, supra note 18, at 148.

45. The tax so determined is reduced by two amounts: (1) the federal income tax paid with respect to previous lump sum distributions for which 10-year forward averaging was elected, and (2) that portion of the tax attributable to the value of annuity contracts distributed (a) as part of the current lump sum distribution, or (b) during the current or preceding five taxable years of the recipient since 1973. See I.R.C. § 402(e)(2)(A), (B).

46. Although the ordinary income portion is included in the recipient's gross income, I.R.C. § 62(11) allows a deduction from gross income for the ordinary income portion taxed under section 402(e). This deduction assures that the ordinary income portion is taxed only under the separate tax provision. No deduction from gross income is allowed for the capital gain portion beyond that provided under section 1202 because the capital gain portion is not subject to the separate tax.
1969 Act, ERISA provides that the ordinary income portion of the distribution is that fractional part of the distribution attributable to the length of active plan participation after December 31, 1973. The ordinary income portion is thus determined by multiplying the total taxable amount, less any minimum distribution allowance, by a fraction, the numerator of which is the number of calendar months of active participation in the plan after December 31, 1973, and the denominator of which is the total number of months of active participation.\footnote{The actual separate tax is determined by applying this fraction to the initial separate tax.\footnote{This amount represents the actual tax liability on the ordinary income portion of the distribution.} The actual separate tax is determined by applying this fraction to the initial separate tax.\footnote{This amount represents the actual tax liability on the ordinary income portion of the distribution.}} The actual separate tax is determined by applying this fraction to the initial separate tax.\footnote{This amount represents the actual tax liability on the ordinary income portion of the distribution.}

\section*{C. Capital Gains Treatment}

Regardless of whether the averaging election is made with respect to the ordinary income portion, capital gains treatment is accorded that portion of the total taxable amount attributable to pre-1974 plan participation. The capital gains portion is determined by multiplying the total taxable amount, \textit{not} reduced by any minimum distribution allowance,\footnote{Proposed Treas. Reg. § 1.402(e)-2(d)(3)(ii), 40 Fed. Reg. 18,809 (1975). See also \textit{Cain, Sanchez, Hauver & Wood, The Pension Reform Act of 1974: Taxation of Distributions}, 7 \textit{THE TAX ADVISOR} 32, 36 (Jan. 1976).} by the same fraction used in determining the separate tax on the ordinary income portion.\footnote{I.R.C. § 402(e)(1)(B) defines the "amount of tax" as:\footnote{See Kopple & Veenhuis, \textit{An Analysis of Lump-sum Distributions After the Pension Reform Legislation}, 42 J. Tax. 2 (1975) for discussion of this treatment.} an amount equal to the amount of the initial separate tax for such taxable year multiplied by a fraction, the numerator of which is the ordinary income portion of the lump sum distribution for the taxable year and the denominator of which is the total taxable amount of such distribution for such year.\footnote{I.R.C. § 402(a)(2). The proposed regulations clarify that the numerator and denominator of this fraction should also be expressed in terms of months of participation. See Proposed Treas. Reg. 1.403(a)-2(e)(3)(i), 40 Fed. Reg. 18,811 (1975).} The amount of capital gains so determined is included in the distributee’s gross income. Tax on that portion is computed under Code sections 1 and 1201 in the same manner that tax is computed for all capital gains. Note that the capital gain portion is included in the distributee’s regular tax computation along with other income whereas the separate tax on the ordinary income portion is computed without regard to any other income. One may only speculate on the reason for this difference but it does seem consistent with the apparent policy of providing special treatment only to the ordinary income portion of the distribution.
D. Illustration

Because these statutory rules are complex, an illustration of the computational steps may prove helpful. Assume that a recipient, age 61, receives a lump sum distribution in cash of $55,000 on January 1, 1980 after participating in his employer's pension plan from January 1, 1971 to December 31, 1979. The employee's participation thus involved three pre-1974 years and six post-1973 years. The pension plan is a qualified plan to which the employee made no contributions.

1. **Separate tax on ordinary income portion**

   (Total taxable amount = $55,000.)

   Minimum distribution allowance: $10,000 - $7,000 (20% of the distribution over $20,000, or $35,000) = $3,000.

   Initial separate tax: 10% × $52,000 ($55,000 - $3,000) = $5,200

   $5,200 taxed at an unmarried individual's tax rate = $942.00

   10 × $942 (yearly tax rate) = $9,420

   initial separate tax = $9,420.

   Ordinary income portion: $55,000 × 6 (post-1973 years)

   \[ \frac{9 \text{ (total years of participation)}}{9} = $36,667. \]

   Separate tax on the ordinary income portion:

   \[ \frac{$9,420 \text{ (initial separate tax)}}{6 \text{ (post-1973 years)}} \times \frac{\$36,667 \text{ (ordinary income portion)}}{\$55,000 \text{ (total taxable amount)}} = $6,280, \text{ or} \]

   \[ \frac{$9,420 \text{ (initial separate tax)}}{6 \text{ (post-1973 years)}} \times \frac{9 \text{ (total years of participation)}}{9} = $6,280 \text{ (taxed at recipient's regular rate)}. \]

2. **Tax on the capital gain portion.**

   Capital gain portion: $55,000 × 3 (pre-1974 years of participation)

   \[ \frac{9 \text{ (total years of participation)}}{9} = $18,333 \text{ (taxed as capital gain)}. \]

   One immediate result of this proration is to render as capital gains rather than ordinary income those distributions actually attributable to benefits accrued prior to December 31, 1973. More important is the fact that the ordinary income portion of the distribution is determined only by the ratio...
of plan years before and after December 31, 1973 and not by any percentage amount of actual contributions in the years after December 31, 1973. This method of allocation provides an additional benefit because contributions are generally greater in the later years of an employee’s participation when his salary is at a higher level. The method of computation, therefore, will often allocate to pre-1974 years, and tax as capital gains, amounts actually contributed after December 31, 1973.51

IV. SPECIAL RULES REGARDING LUMP SUM DISTRIBUTIONS

In addition to modifying the general description and taxation of lump sum distributions, ERISA authorized a number of special rules regarding what constitutes a lump sum distribution, who can elect the special 10-year forward averaging treatment, and what additional amounts must be taken into account when computing the actual tax. These rules may be summarized as follows:

(1) Aggregation of plans rule—In order to determine whether the entire amount standing to the credit of an employee in a single tax qualified plan has been distributed, all trusts forming part of the plan must be combined and treated as a single trust, all pension plans must be aggregated with all other pension plans maintained by the employer, and all profit-sharing plans must be aggregated with all other profit-sharing plans maintained by the employer.52 However, aggregation is not required among different kinds of plans, i.e., a profit-sharing plan need not be aggregated with a pension plan. This permits distributions to a participant in separate taxable years from pension and profit-sharing plans of a single employer. In certain cases such staggered distribution will result in a lower total tax.53

(2) Six-year look back rule: aggregation of distributions—Given an election by the taxpayer of the 10-year forward averaging applied to the ordinary income portion of his lump sum distribution, when computing the separate tax the recipient must add to the total taxable amount the sum of the total taxable amount of all lump sum distributions since 1973 for which the taxpayer has previously elected 10-year averaging, and the value of all annuity contracts distributed to him since 1973, whether or not part of a lump sum distribution.54 Although distributions from any tax-qualified plan are considered under the six-year look back rule, only those distributions

52. I.R.C. § 402(e)(4)(C).
54. I.R.C. § 402(e)(2).
received during the current year and during the five preceding taxable years are required to be aggregated. In the case of a distribution under an annuity contract, the taxable amount of such a distribution shall be deemed to be the current actuarial value of the contract determined on the distribution date.55

(3) Election of lump sum treatment—The 10-year averaging of the ordinary income portion of the lump sum distribution is only available to the recipient if he makes a formal election to do so.56 Only an individual, estate, or trust may elect to have the special 10-year averaging rule apply.57 Corporations or partnerships cannot elect this tax treatment.

(4) Minimum period of service—Where the employee himself is to receive the lump sum distribution, he may not elect to have the special 10-year forward averaging rule apply unless he has been a participant in the plan for five or more taxable years before the taxable year in which the distribution is made.58

(5) Single election after age 59 1/2—Only one election for 10-year forward averaging may be made with respect to any participant after he has attained age 59 1/2, but the proposed regulations do provide that such an election is revocable within the period of limitations for the year in which the election was made.59 This is important because in some cases, a participant may decide to revoke an election made in a previous year when he later receives a lump sum distribution from a different plan.

V. THE EFFECT OF ELECTING 10-YEAR FORWARD AVERAGING

Whether an election to report the ordinary income portion of a distribution under the forward averaging provision will result in a lower total tax must be determined on a case-by-case basis. Because the distribution is treated

55. Id. The effect of the six-year look back rule is examined more closely in the text at pp. 332-33 infra.
57. The general rule of section 402(e)(4)(B) is that the "taxpayer" is required to make the election. The party required to make the election in the case of a lifetime distribution to two or more trusts should logically turn upon whether the income of such trusts is taxable to (1) the employee, as is true in the case of certain grantor trusts established by the employee, or (2) the trusts, or trust beneficiaries taxable on trust income. In the later case presumably the trustee will make the election.
Kopple & Veenhuis, supra note 49, at 5.
as if received over a 10-year period, and then is taxed as if it were the only income of the recipient, the income averaging provision may result in a lower total tax than if the entire distribution were taxed as capital gains. But when a taxpayer's tax liability is offset by credits or reduced by deductions, as in the year of a large loss, the taxpayer may not want to elect 10-year averaging since such election would impose a tax on income already sheltered.

When a taxpayer elects 10-year averaging for a lump sum distribution, the averaging applies to all such distributions received in the same taxable year. As previously noted, under the six-year look back rule, the value of all annuity contracts distributed to the recipient during the current or previous five years since 1973 must be aggregated and included in the total taxable amount at current actuarial value. In other words, given a previous distribution in the form of an annuity, an election to use 10-year averaging in the current year is an election to treat all annuity contracts distributed during the look back period as lump sum distributions. The annuity is given such treatment to ensure that concurrent distributions of cash and other property in multiple distributions will qualify as distributions of the credit balances of all the participating employee's accounts and thus be deemed lump sum distributions. The effect of such requirements is to impose some rather unfavorable tax consequences upon the recipient of multiple distributions.

It should first be noted that the same provision that requires the inclusion of annuities also provides that any tax imposed by virtue of their inclusion in the total taxable amount is to be deducted from the tax on the lump sum distribution. Thus the current actuarial value of the annuity is itself not subject to taxation. However, the net effect is not a wash. The effect of

60. For example, a taxpayer in the 50 percent tax bracket who receives a lump sum distribution of $100,000 would pay at least $25,000 in capital gains tax but only $20,900 under 10-year forward averaging.
61. I.R.C. § 402(e)(2).
62. Under I.R.C. § 402(e)(4)(A), which defines a "lump sum distribution," any distribution of an annuity contract from a qualified plan is treated as a lump sum distribution.
64. I.R.C. § 402(e)(2)(b). The committee reports and the proposed regulations indicate that the tax attributable to the annuity is computed by subtracting the pro rata portion of the minimum distribution allowance from the value of the annuity and then computing a tax on the remaining value by taxing 10% of this value and multiplying it by ten.

Cain, Sanchez, Hauver, Wood, supra note 47, at 38.
taking the annuities into account when determining the separate tax is to inflate the ordinary income portion of the distribution, thus causing it to be taxed at higher rates. The credit allowed for the inclusion of the annuity does not completely compensate for the increase resulting from higher rates being applied to the total amount.

The aggregation of annuities under an election to use 10-year averaging imposes additional burdens. Generally, a periodic distribution of an annuity contract is taxed in the year in which it is received by the recipient, and is taxable only to the extent of the excess of each payment over the employee's investment in the contract. When the distribution of an annuity contract is required to be included in the total taxable amount for the purpose of 10-year forward averaging, however, the annuity is included at the current actuarial value of the contract, a value that includes employee contributions. Thus the recipient is subject to three disadvantages: (1) the value of the annuity contract included in the taxable amount is not reduced by the amount of employee contributions; (2) the inclusion of the annuity for purposes of computing the separate tax causes the non-annuity portion of the distribution to be taxed at a higher rate; and (3) in some cases, the inclusion of annuity contracts will reduce the minimum distribution allowance otherwise available.

Because of this potentially unfavorable taxation due to aggregation of multiple lump sum distributions and distributions under annuity contracts, the taxpayer should do his best to avoid multiple distributions during any six-year period. Given an expected lump sum distribution during a look back period, the recipient, if he has the option, may avoid the aggregation rules by electing to receive periodic payments from a trust. For tax planning purposes, given a lump sum distribution for which 10-year averaging is not elected, previously distributed annuities need not be aggregated under the six-year look back rule. Although the look back rule may persuade the dis-

65. I.R.C. §§ 403(a)(1), 72(m).
66. Id. § 402(e)(2). Under proposed regulation 1.402(e)-2(c)(1)(ii)(F), the actuarial value of an annuity contract is the greater of (1) the cash value on the date of distribution, without regard to any loans under the contract, or (2) the amount determined under IRS tables contained in Publication No. 861, entitled “Annuity Factors for Lump Sum Distributions.”
68. Because the minimum distribution allowance is only available if the total taxable amount is less than $70,000, the inclusion of annuity contract values may have the effect of relinquishing this deduction. See Anderson & Rollins, Tax Consequences of the Various Distribution Options from a Qualified Corporate Plan, 15 Tax. for Accountants 4, 7 (1975).
tributee to forego the averaging election, ERISA nevertheless provides several distribution options deserving independent consideration.

VI. THE TAXATION OF VARIOUS DISTRIBUTION OPTIONS

A. Distributions From Individual Retirement Accounts (IRA)

Proceeds from an individual retirement account, an individual retirement annuity, or a qualified retirement bond are generally included in the gross income of the recipient and are fully taxable in the year distributed. Because contributions to such accounts, annuities, or bonds are made with tax-deferred dollars, and because the income of the account is not taxed as earned, the employee's basis in such an account is zero. If an annuity contract is distributed from an individual retirement account and the annuity contract qualifies as an individual retirement annuity, the distribution is not included in income when received but taxed under section 72. Again, the employee's basis in the annuity contract is zero.

Because Congress intended that the savings accumulated in an individual retirement account or contributions made to a retirement annuity were to be

69. An individual retirement account is generally a domestic trust created or organized by a written instrument for the exclusive benefit of an individual or his beneficiaries. Contributions to such accounts are usually made in cash, except for tax-free rollover contributions which may include property. For any single year such contribution may not exceed an amount equal to 15 percent of the individual's compensation includible in his gross income or $1,500, whichever is less. The balance in an individual retirement account generally may be invested in any assets that are acceptable investments for a qualified plan. The assets within the plan can accumulate earnings tax free until they are distributed, at which time the distributions are included in the gross income of the recipient. For additional requirements, see I.R.C. §§ 219, 408(a).

70. Retirement savings may also be invested in annuity contracts called individual retirement annuities. An individual retirement annuity means an individual retirement annuity contract, an individual joint and survivor annuity contract (on the lives of the owner and his spouse), or an individual endowment contract issued by an insurance company under which the annual premiums do not exceed $1,500. For additional requirements, see id. §§ 219, 408(b).

71. This is another type of investment in which deductible employee retirement savings can be placed. Amounts may be invested annually in bonds issued by the federal government providing for the accumulation of interest until the time of redemption. For additional requirements, see id. §§ 219, 409(a).

72. I.R.C. § 408(d)(1). There are a number of exceptions to the general rules of taxability of distributions from an individual retirement account, annuity, or bond. These exceptions pertain to rollover contributions and to the timely withdrawal of excess contributions. See id. §§ 408(d)(4), 409(b)(3). In addition, the transfer of an individual's interest in an individual retirement account, annuity, or bond to his former spouse under a divorce decree or under a written instrument incident to the divorce is not taxable. Id. § 408(d)(5).

73. Id. § 408(d)(2).
used for retirement purposes, distributions from such accounts or annuity plans prior to age 59 1/2 (or disablement) are penalized by imposing an additional 10 percent nondeductible income tax upon the amount distributed.\textsuperscript{74} This policy also applies when benefits are retained in accounts beyond the maximum age for payout. In the event sufficient payments are not timely made from the retirement account or annuity, then an excise tax is imposed upon the amount of the under-distribution.\textsuperscript{75}

Upon the redemption of a retirement bond, the entire proceeds are included in the gross income of the taxpayer in the year redeemed, if redeemed between the ages of 59 1/2 and 70 1/2.\textsuperscript{76} In the event the registered owner does not redeem the bond prior to age 70 1/2, he must include in his gross income for that taxable year the amount of the proceeds he would have received if the bond had been redeemed prior to age 70 1/2.\textsuperscript{77} Again, this is a codification of congressional intent that the amounts invested for retirement be used for retirement purposes.

An additional incentive to encourage the recipient to receive his amounts ratably over the period of his retirement is the fact that distributions from a retirement account or annuity are not eligible for capital gains treatment or the special 10-year averaging rules applicable to lump sum corporate or Keogh plan distributions. However, income averaging is available for distributions from any of the three forms of individual plans under the general income averaging rules provided in section 1301. Finally, for purposes of estate and gift taxation, those amounts invested in individual retirement accounts, annuities, or retirement bonds are excluded from taxation under sections 2039(c) and 2517 to the extent contributions to those plans were deductible for income tax purposes.

\textbf{B. Tax-free Rollover of Distributions}

For those employee plan participants who wish to change employers, yet continue to defer taxation upon their already vested benefits, certain rollover provisions may be used. Under ERISA, an employee who receives a lump sum distribution from a qualified pension, profit-sharing, stock bonus, or annuity plan may reinvest (rollover) on a tax-free basis that portion of the distribution not consisting of employee contributions into another plan, retirement account, annuity, or bond.\textsuperscript{78} Such rollover provisions make em-
ployee benefits portable, that is, able to be carried by the employee from one employer to another. Even though the benefits are distributed directly to the employee, as long as the distribution is properly reinvested within 60 days of receipt the tax remains deferred. Because the receipt of the benefits is actual and not merely constructive, the rollover provisions are akin to the tax deferral obtained by reinvestment of proceeds acquired by virtue of an involuntary conversion of property under Code section 1033 or reinvestment of proceeds from the sale of a residence under section 1034.\textsuperscript{79}

When determining the amount which can be rolled over, all employee contributions must be excluded.\textsuperscript{80} In the event that the distribution includes property other than cash, the employee contributions must be withdrawn first from the cash element of the distribution and then, as necessary, from the other property.\textsuperscript{81} Whether the transfer is to an individual retirement account or to a second qualified plan, when the rollover consists of property other than money, the "same property rule" applies and the actual property itself must be transferred.\textsuperscript{82}

ERISA created two basic types of rollovers. The first is merely a means of altering the funding medium for an individual retirement plan. Any amount received from an individual retirement account and paid into another individual retirement account, annuity, or bond within a 60-day period is not included in the recipient's gross income for the year in which it is received.\textsuperscript{83} Since there is no requirement that the entire amount in an individual retirement plan be withdrawn and reinvested to qualify for this type of tax-free rollover, it is possible to diversify an existing plan by partial withdrawal and reinvestment.\textsuperscript{84} This tax-free rollover is not available, however, if there was a prior tax-free rollover of an amount received from another account or annuity within three years of the date of the current distribution.\textsuperscript{85}

The second type of rollover created by ERISA involves lump sum distributions from plans qualified under sections 401(a) and 403(a). As initially enacted, a distribution from an employee's trust fund under section 401(a) or employee annuity under section 403(a) would only qualify for a tax-free

\textsuperscript{80} I.R.C. §§ 402(a)(5)(B), 403(a)(4)(B).
\textsuperscript{81} Id. §§ 402(a)(5)(C), 403(a)(4)(C), 408(d)(3). \textit{See also Colby, supra} note 79, at 7.
\textsuperscript{82} I.R.C. §§ 402(a)(5)(C), 403(a)(4)(C), 408(d)(3).
\textsuperscript{83} Id. § 408(d)(3)(A)(i).
\textsuperscript{84} See Colby, \textit{supra} note 79, at 7.
\textsuperscript{85} I.R.C. § 408(d)(3)(B). This limitation obviously places a premium on well-planned IRA diversifications.
rollover if it was a lump sum distribution. Thus, several requirements faced an employee desiring to roll over his benefits into the qualified plan of a successor employer: (1) the entire distribution had to be made within a single year and consist of the whole credit balance in the employee's account, (2) the employee must have been a plan participant for five or more taxable years, and (3) the distribution must have been made after the employee had attained age 59½ or made on account of the employee's separation from service, death, or disablement. Subsequent to the enactment of ERISA, it was recognized that a significant number of employees failed to meet these requirements, and thus were unable to take advantage of the rollover provisions when, for example, an employer terminated a plan and distributed benefits even though the participants continued to work for the same employer. Such a problem would arise when an employer corporation was acquired by, became a subsidiary of, or was merged into another corporation. A 1976 amendment to ERISA extended tax-free rollover treatment to those distributions which would have been a lump sum distribution but for having been made on account of a plan termination or a complete cessation of contributions under the plan. Thus, if an employee of a subsidiary corporation, or a corporation which is a member of a controlled group of corporations, receives a distribution in connection with the liquidation, sale, or other means of terminating the parent-subsidiary or controlled group relationship, the distribution could be treated as if made on account of plan termination and thus be rolled over.

In the event the distribution is received by one who was an "employee" as defined in section 401(c)(1) (a partner or other self-employed participant in an HR-10 plan) at any time when contributions were made on his behalf, then the distribution may not be rolled over into a successor employer's employee trust or annuity plan that qualifies under section 401(a) or 403(a). Such "tainted" distributions can be rolled over into an individual retirement plan which may be in the form of an individual retirement plan.

86. See H.R. Rep. No. 1020, 94th Cong., 2d Sess. 2 (1976), describing the requirements for tax-free rollover treatment prior to April 8, 1976.
87. Id. at 3.
89. I.R.C. §§ 402(a)(5)(A)(i), 403(a)(4)(A)(i). Because in some cases it may be difficult to fix the date when a complete discontinuance of contributions occurs, special rollover rules now determine the time of plan termination. Under a profit-sharing or stock bonus plan, a complete discontinuance of contributions shall be deemed to occur on the day the plan administrator notifies the Internal Revenue Service that all contributions have been discontinued. Id. § 402(a)(6)(A).
90. Id. § 402(a)(6)(B)(1).
91. Id. §§ 402(a)(5), 403(a)(4).
retirement account, annuity, or qualified retirement bond. However, this account cannot subsequently be rolled over into another employer’s qualified plan.\(^9\)

If for any reason an employee is unable to roll over his lump sum distribution into a successor employer’s plan within the 60-day period, he may place his distribution into an individual retirement account set up as a conduit to facilitate a transfer between plans. The subsequent distribution from the conduit account is tax-free on the condition the amount received is paid into the new employer’s qualified plan within the following 60-day period.\(^9\)

Such transfers are not without risk, however. For instance, to preserve the tax-free status of the distribution out of the conduit IRA back into a qualified plan, the distribution must consist of the entire amount in the IRA. Furthermore, the amount distributed must be attributable solely to the previous rollover from the prior plan to the conduit IRA. In short, the previous rollover must be kept intact and never supplemented with additional current IRA contributions.\(^9\)

Once tainted with such contributions, the distribution’s tax deferred status is lost and the distribution cannot subsequently be rolled over into another qualified plan. Any subsequent distribution from the tainted IRA will be taxed as ordinary income, because the amounts so distributed are neither eligible for capital gains treatment nor the special averaging rules applicable to distributions from qualified plans.\(^9\)

For these reasons, contributions to be rolled over should always be maintained in a separate IRA. The taxpayer should also recognize that a distribution from a conduit account does not qualify for the estate and gift tax exclusions under Code sections 2039(c) and 2517.

Aside from the change of employment situation, many employees will elect a lump sum distribution only to continue tax deferral by rolling over their benefits into an IRA. Such a rollover offers the beneficiary certain flexibility with regard to the timing of distributions and the mode of investment. Depending on the tax situation, it may be better for an employee to take a lump sum distribution, pay the tax, and invest the remainder in an annuity contract.\(^9\)

For example, one might find that upon retirement his securities

\(^9\) Id. §§ 408(d)(3)(A)(i) and (ii).
\(^9\) Id. §§ 402(a)(5), 408(d)(3)(A)(ii).
\(^9\) Id. § 408(d)(3)(A)(ii). See also McGovern, Transfer of Lump Sum Distributions into an Individual Plan Can Avoid Immediate Tax, 15 TAX. FOR ACCOUNTANTS 68, 69 (1975).
\(^9\) I.R.C. § 408(d)(1).
\(^9\) As an example, suppose a 65-year old single male who had one-fourth of his active participation in a noncontributory qualified plan after 1973 has the option to receive $4,000 per year for life, or a $40,000 lump sum distribution. Assume further that
portfolio includes several stocks upon which substantial losses remain unrealized. Such a recipient might elect to take the lump sum distribution and shelter the distribution from tax, offsetting the capital losses against the capital gains portion of the distribution.\textsuperscript{97}

C. Distributions of Employer Securities

Distributions of employer securities receive favorable tax treatment under ERISA. The term "securities of the employer corporation" means only those shares of stock or bonds and debentures issued with interest coupons or in registered form.\textsuperscript{98} When a lump sum distribution includes the securities of the employer corporation, the net unrealized appreciation of those securities is not included in the total taxable amount of the lump sum distribution.\textsuperscript{99} Any appreciation in the value of employer securities between the time the securities were allocated to the participant's account and the time of the distribution is not taxed at the time of the distribution.\textsuperscript{100} This provides a decided advantage over distributions of annuity contracts which must be aggregated at actuarial value when determining the total taxable amount.

Upon the eventual exchange of these securities by the recipient, their basis in his hands does not include the amount of unrealized appreciation at the time of distribution. This unrealized appreciation is taxed at the time of the exchange as long-term capital gains.\textsuperscript{101} Any gain in excess of this unrealized appreciation that is attributable to the holding period after distribution is taxed as long- or short-term capital gains depending on the period of time the taxpayer currently has a taxable income of $50,000, that there are no multiple distributions within the look-back provision, and that he could purchase an annuity contract that would pay him 10 percent of the purchase price each year for the remainder of his life. Given these circumstances an election to take the periodic payment option would yield an after-tax yearly retirement benefit of approximately $1500. An election to take a lump sum distribution, pay the tax, and purchase an annuity contract with the remainder would yield an after-tax retirement benefit of approximately $2,400, a 60% increase over the periodic payment option. See Cain, Sanchez, Hauver & Wood, \textit{supra} note 47, at 3-9.

\textsuperscript{97} McGovern, \textit{supra} note 94, at 71.
\textsuperscript{98} I.R.C. § 402(a)(3)(B). This definition would include the securities of a parent or subsidiary corporation of the employer.
\textsuperscript{99} \textit{Id.} § 402(e)(4)(D)(ii). Conversely, one would assume that any unrealized depreciation from the cost of employer securities originally credited to a participant's account would be debited out of the account prior to distribution. It is unclear whether a loss represented by such a debit would be recognized upon subsequent exchange of the securities.
\textsuperscript{100} Pursuant to Treas. Reg. § 1.402(a)-1(b)(2)(i) (1965), the amount of net unrealized appreciation in the distribution is the excess of the market value of such securities at the time of distribution over the cost or other basis to the trust.
\textsuperscript{101} Treas. Reg. § 1.402(a)-1(b)(1)(i) (1965).
the securities were held by the distributee. In the event a distribution of employer securities is not taxed as a lump sum distribution solely because the employee was not a plan participant for five or more taxable years, the net unrealized appreciation is still excluded from gross income. The appreciation is also excluded from the capital gains portion of a total distribution regardless of whether lump sum treatment is elected.

A review of the tax computation of lump sum distributions will clarify the advantages of rolling over appreciated employer securities. When allocating a lump sum distribution between the pre-1974 capital gains portion and the post-1973 ordinary income portion, with regard to the post-1973 portion, only that amount that exceeds employee contributions is taxable. If the cash or other property (employer securities) equals employee contributions there will be no tax on that portion of the distribution. Thus, if a retiring employee has an option to take part of his distribution in appreciated employer securities he should consider maximizing the amount of tax-free lump sum distribution by taking the greatest portion in employer securities, so that the total current value of employer securities reduced by the net unrealized appreciation, plus any cash distributed, equals the total amount of pre-1974 employee contributions.

102. Id. This holding period commences on the day of distribution. See Rev. Rul. 394, 1971-2 C.B. 211.
103. I.R.C. § 402(e)(4)(J). For the minimum period of service requirement, see id. § 402(e)(4)(H).
104. Id. §§ 402(a)(2), 402(e)(4)(D). The computation of the capital gain portion of the distribution is presented at pp. 328-29 supra.
105. The general rule provided in section 402(a)(1) stipulates that the amount actually distributed shall not include the net unrealized appreciation in securities of the employer corporation "attributable to the amount contributed by the employee."
106. See Anderson & Rollins, supra note 68. The article demonstrates how a retiring employee who wishes periodic payments may arrange for annuity payments and still take out all of his contributions tax free by making effective use of a distribution of employer securities. Given an election to receive cash or other property equal to his contributions, the employee may receive the balance in the form of an annuity contract. The distribution of an annuity contract is treated as a lump sum distribution, and, therefore, the recipient receives favorable tax treatment with respect to unrealized appreciation in employer securities attributable to both the employee and employer contributions. For example,

[The balance to the credit of Stan Wilson, upon his retirement in 1975, is $100,000. His contributions were $24,000. He has an option to take up to $50,000 in employer securities which have a basis to the trust of 60% of their present value. If he takes $40,000 of employer securities and a $60,000 annuity contract (for a total of $100,000), and if he makes the lump-sum distribution election, he will have no tax on the receipt of the employer securities. The total taxable amount is the amount of the distribution (without considering the annuity contract), $40,000; less net unrealized appreciation...]}
If the distribution of employer securities is in the form of a periodic payment rather than a lump sum distribution, only that portion of the net unrealized appreciation attributable to the amount considered contributed by the employee is excluded from the distributee's income. The favorable tax treatment with respect to the unrealized appreciation attributable to employer contributions is lost. This limitation is critical, for it greatly reduces the amount of tax-free distribution that is otherwise available with a lump sum distribution that includes employer securities.

The rollover of employer securities into a successor employer's plan or the employee's own IRA presents a number of problems. When an individual receives stock in a distribution from a qualified plan, the same stock received must be contributed to the successor employer's plan or individual retirement account to avoid taxation on the original distribution. If the former employer's stock is not readily marketable there arises the issue of whether the stock is a proper investment for the successor employer's plan. The tax advantage of excluding the net unrealized appreciation of employer securities from gross income appears to be lost with the rollover of these securities to a successor corporation's plan, because the tax advantage is only available to the securities of the employer corporation which ultimately makes the taxable distribution. Should the employee roll over his employer's stock into an IRA, he will again lose the tax advantage of the exclusion of unrealized appreciation from gross income, this time by virtue of section 408(d). This section gives the taxpayer a "zero" basis in his account, the proceeds being fully taxable to the individual when distributed.

Id. at 10.

109. In the hands of the successor employer's plan, the prior employer's stock may not be a "qualifying employer security" to which the partial exception from the "prudent man requirement" would apply. See Colby, supra note 79, at 9.
110. I.R.C. §§ 402(a)(3), 402(e)(4)(K). See also Colby, supra note 79, at 9. I.R.C. § 402(a)(5)(B)(ii) explicitly recognizes that transfers of property other than cash can be rolled over tax-free into a subsequent employer's qualified plan, thus maintaining at least the tax-deferral advantage. Assuming the section 404(a)(2) prudence requirement is met for purposes of rolling the securities into the new plan, it is submitted that the trustee's exchange of the former employer's stock for successor employer stock should not constitute a taxable event for the employee. Such an exchange would remove the non-employer stock taint upon subsequent lump sum distribution from that plan. Recognition of the tax-free status of the trustee's exchange is consistent with ERISA's rollover policy of portability and tax-deferral. Nevertheless, should the trustee's exchange be considered a taxable event, the absence of realization by the employee should be effective to defer actual tax liability until distribution.
Although a living employee may gain significant tax advantage from rolling over appreciated employer securities, the advantage may be lost if the distribution is on account of the employee’s death. A decedent’s securities would normally receive a step-up in basis to the asset value on December 31, 1976 under the new section 1014(d). However, section 1014(c) states that it shall not apply to property that constitutes a right to receive an item of income in respect of a decedent under section 691. The Internal Revenue Service has recently denied a step-up basis for appreciated securities distributed to a widow, holding that the net unrealized appreciation in the employer securities distributed to a deceased employee constituted a right to receive income in respect of a decedent as provided in section 691(a). On the subsequent sale of the securities, the gain attributable to such appreciation was taxable to the widow as long term capital gains. lump sum distributions of nonemployer securities receive the same treatment as cash distributions. Although such securities cannot be rolled over into the successor employer’s plan, the distributee may transfer the securities into an investment annuity currently characterized in the financial press as a “wraparound” annuity. The distributee may thus continue to defer taxes on all interest or dividends by “wrapping” the security around an annuity. A wraparound annuity resembles other annuities except the wraparound annuitant may determine the securities which fund the annuity.

D. Distribution of Life Insurance Benefits

When a life insurance contract is purchased as part of a qualified plan, that part of the premium paid by plan income or deductible employer con-

112. Rev. Rul. 125, 1975-1 C.B. 254. See also Rev. Rul. 297, 1969-1 C.B. 131. Although this ruling may be consistent with ERISA’s policy of according favorable treatment only to the employee, the ruling seems unduly harsh on the widow who would have shared in the advantage of tax deferral on the capital gain had the employee survived the distribution. Such an advantage would not accrue in the normal section 691 situation. Further, the federal revenue loss from allowing this step-up will continue to decrease after December 31, 1976 because the Tax Reform Act of 1976 allows step-ups only to the asset value on December 31, 1976 for assets owned by decedents dying after that date. In this sense, the IRS ruling effectively applies the 1976 Act retroactively.
113. See An Annuity for All Seasons, FORBES, May 1, 1976, at 86. However, there appears to be no reason why the Service would not consider the wraparound a taxable event for purposes of the unrealized appreciation.
114. Id. The companies currently offering the investment annuity allow a broad selection of securities that a customer can wraparound: listed over-the-counter stocks, corporate bonds, mutual funds, government securities, and all banking instruments.
Contributions to the plan is included in the gross income of the plan participant in the year paid.\footnote{115} Such payments are treated as constructive contributions by the employee.\footnote{116} At the death of an individual insured under a qualified plan, the cash surrender value of the contract immediately prior to death is treated as a plan distribution.\footnote{117} This distribution is taxable to the extent that it exceeds employee contributions, which are returned tax-free. Any amount payable in excess of cash surrender value is excluded from the beneficiary’s income under section 101 as life insurance proceeds payable by reason of death.

When payments are made under an endowment contract considered to be an individual retirement annuity, no deduction for retirement savings is allowed for that portion allocable to the cost of life insurance. Distributions from such endowment contracts are taxed as ordinary income to the extent attributable to retirement savings and are taxed as life insurance proceeds, exempt from gross income under section 101, to the extent attributable to life insurance. Thus, if the given contract has matured, the full value of the contract will constitute retirement savings and all amounts payable under the contract will be taxed as ordinary income.

VII. Federal Estate and Gift Taxation of Employee Benefits

Prior to the Tax Reform Act of 1976,\footnote{118} the distribution of employee benefits payable by reason of the death of the employee received markedly different tax treatment depending upon whether the distribution was made from an individual retirement plan or a qualified corporate plan. Under prior law, distributions from an individual retirement plan—taking the form of an individual retirement account, annuity, or bond—did not qualify for the estate tax exclusions under former section 2039(c) and were thus included in the gross estate.\footnote{119} The amount included in the gross estate was that portion of the distribution attributable to the decedent employee’s contributions. To add to the tax burden, those contributions made by the decedent’s former employer were considered made by the decedent, if made by reason of the decedent’s employment.\footnote{120} Distributions from HR-10 plans also did not benefit from the former section 2039(c) exclusion as any contri-
Contributions made on behalf of a decedent while he was a self-employed individual under the meaning of 401(c)(1) were considered to be employee contributions and were thus included in the decedent employee's gross estate.\(^{121}\) Such unfavorable treatment of distributions made by reason of an employee's death was consistent with the policy that employee retirement benefits be used during the period of the individual's retirement and not reserved for a testamentary disposition.

However, prior law did make an exception to this otherwise unfavorable tax treatment by providing special rules for annuities or other distributions paid out from plans qualifying under sections 401(a) or 403(a). That portion of the distribution paid out from a qualified plan attributable to employer contributions was excluded from the gross estate.\(^ {122}\) Again, the taxable amount was that portion attributable to the decedent employee's contributions but, with qualified corporate plans, contributions made by the decedent's former employer were not considered to have been contributed by the decedent.

With the Tax Reform Act of 1976, Congress has deemphasized the policy of discouraging testamentary dispositions by moving toward a policy of achieving tax parity for payments made to beneficiaries of a deceased employee. Under the new law, the value of an annuity receivable by a beneficiary under an individual retirement account, annuity, or bond, to the extent such payment was deductible for income tax purposes, is excluded from the decedent employee's gross estate.\(^ {123}\) This exclusion also covers HR-10 plans, to the extent payments to the plan were allowable as income tax deductions under section 404. However, the estate tax exclusion under each of these retirement plans is now limited to survivorship benefits in the form of an annuity or payments other than a lump sum distribution.\(^ {124}\)

\(^{121}\) Id. § 2039(c)(4).
\(^{122}\) Id. § 2039(c).
\(^{124}\) Id. § 2009(c)(3). The new Act also defines the term "annuity" as: "an annuity contract or other arrangement providing for a series of substantially equal periodic payments to be made to a beneficiary (other than the executor) for his life or over a period extending for at least 36 months after the date of the decedent's death."

Former section 402(e)(4)(A) included all distributions of annuities within the definition of lump sum distributions. The new Act, by providing for exclusion from gross estate of annuities other than lump sum distributions, thus places a premium on the types of distributions provided by the qualified plan. A plan allowing distribution of payments under an annuity over a 36-month period would appear to provide added significance to the executor's power to elect lump sum treatment. That election would include the annuity value in the gross estate but would allow the 10-year forward averaging treatment of the ordinary income portion of the distribution, or of the entire
The law of gift tax also applies to gifts indirectly made. Any transaction by which a property right or interest is gratuitously passed to or conferred upon another constitutes a taxable gift.\textsuperscript{125} Thus, when an employee has an option to take either a retirement annuity for himself alone or a smaller annuity for himself with a survivorship annuity payable to a beneficiary, an irrevocable election by the employee to take a reduced annuity with the survivorship feature would seem to result in a gift tax.

However, under prior law, as well as under the current code, section 2517 provided a gift tax exclusion for amounts paid out under a qualified plan by reason of an employee's death. Just as the estate tax exclusion was previously applied under section 2039, the amount exempt from gift tax was that portion of the survivorship annuity attributable to employer contributions.\textsuperscript{126} Thus, prior to 1976, the gift tax exclusion did not apply to transfers made pursuant to an IRA or payments made on behalf of a self-employed individual under an HR-10 plan, such payments being deemed attributable to employee contributions. Under the current Code, however, contributions made to an HR-10 plan, to the extent allowable as an income tax deduction under section 404, are now deemed to have been made by an employer so that the gift tax exclusion is available.\textsuperscript{127} The gift tax exclusion was further modified under the 1976 Act to include an annuity provided under an IRA.\textsuperscript{128}

Section 101(b) excludes from the gross income of the employee’s beneficiaries or estate an amount up to $5000 which is paid by the employer by reason of the employee’s death. But such employee death benefits will be included in gross income if immediately prior to his death the employee possessed a nonforfeitable right to receive the amount while living. Distributions from a nonqualified plan under which the employee possessed this nonforfeitable right to receive the amounts while living disqualify the beneficiaries from using the $5000 exclusion.\textsuperscript{129} This exclusion is also

\textsuperscript{125} See Treas. Reg. § 25.2511-1(c) (1965).
\textsuperscript{126} I.R.C. § 2517(b).
\textsuperscript{127} Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009(c)(4)(B), 90 Stat. 1520 (amending I.R.C. § 2517(b)).
\textsuperscript{128} Id. § 2009(c)(4)(A) (amending I.R.C. § 2517(a)).
\textsuperscript{129} I.R.C. § 101(b)(2)(B).
unavailable with regard to benefits attributable to joint and survivor annuities in the event any annuity payments were made prior to the employee's death.\textsuperscript{130}

VIII. Conclusion

The new method for taxing lump sum distributions from qualified corporate and Keogh plans must be viewed as one of the positive features of the Employee Retirement Income Security Act of 1974. The current availability of the special 10-year income averaging to both common law employees and the self-employed is a major step toward achieving tax parity for pension benefits. Whether the recipient is a beneficiary under a qualified corporate or Keogh plan, that portion of the lump sum distribution attributable to pre-1974 contributions may be taxed as capital gains, the allocations between capital gains and ordinary income in either case being made on the basis of the portion of time the employee was a participant prior to 1974 and after 1973. Only a single major distinction between common law employees and the self-employed has been retained and that is with respect to the qualification for lump sum distribution treatment. Common law employees may claim the special averaging treatment if the distribution is on account of their separation from service, even before age 59\(\frac{1}{2}\), whereas the self-employed, because of perceived differences in employment status, still may not elect such treatment.

This movement toward tax parity is also evident in the modification of the estate and gift tax provisions under the Tax Reform Act of 1976. Prior to the 1976 Act, distributions made under HR-10 plans established by self-employed individuals or distributions under individual retirement plans did not qualify for the estate or gift tax exclusions from the decedent employee's gross estate. Under current law, however, distributions from such retirement plans other than lump sum distributions, are excluded from the employee's gross estate to the extent contributions to the plan were allowable as income tax deductions under section 404.

Although the new method for taxing lump sum distributions has not made the required computations any less exacting, allocating the ordinary income and capital gains portions according to the participation period rather than to the actual amounts contributed avoids the onerous task of tracing distributed funds to either pre-1973 or post-1974 contributions. This, in conjunction with the liberalization of rollover provisions and the availability of the special income averaging provisions for the self-employed, offers evi-

\textsuperscript{130} Id. § 101(b)(2)(C).
dence that Congress has recognized the voluntary nature of private retirement plans. In this respect, the simplification of plan administration and the more equitable taxation of lump sum distributions provided by ERISA serve to advance congressional intent to broaden participation in employer financed retirement plans.

Chris Downs