KNOWING THE INS AND OUTS OF RETIREMENT DISTRIBUTIONS

By
Pamela D. Perdue
Summers, Compton, Wells & Hamburg

I. Introduction

Studies show that the vast majority of individual wealth now resides in retirement plans. While the options for receiving distributions of those funds out of a qualified retirement plan in a tax-favored manner have been reduced over the years, the issues and strategies for best tailoring distributions, particularly from an IRA, to best suit the needs and desires of the distributee and his/her family, while also attempting to minimize the tax implications, have only increased and become more complex.

II. Occasions Allowing Distributions from Qualified Plans

Since the majority of retirement assets will arise from a qualified plan, rather than an Individual Retirement Account (IRA), it is necessary to first know what occasions will permit distributions from the various types of qualified plans.

A. Profit-Sharing Plans

A profit sharing plan allows for more distribution flexibility than any other qualified plan. This is because a profit sharing plan may be drafted to allow for in-service distributions (i.e., distributions to an employee who remains employed and participating under the plan) upon many different occasions. That is, unlike other plans which may be subject to restrictions on the ability to make distribution prior to the employee's termination of employment, attainment of the plan's normal retirement age or plan termination, a profit sharing plan may be drafted to allow distribution while an employee remains employed.

Specifically, a profit sharing plan may be drafted to allow distribution after a fixed number of years (i.e., after contributions have been in the plan for at least two years [See Rev. Rul. 71-295, 1971-2 C.B. 184], the attainment of a stated age, or upon the occurrence of a stated event such as layoff, illness or disability. [Treas. Reg. § 1.401-1(b)(1)(ii)] The plan may also allow in-service withdrawals upon the occurrence of a bona fide hardship. [See Rev. Rul. 71-224, 1971-1 C.B. 124]

B. Money Purchase Plan

Previously, a money purchase plan was not allowed to provide for in-service withdrawals prior to the time the participant attained the plan's normal retirement age. [See former Treas. Reg. § 1.401-1(b)(1)(i)] However, the PPA (that is, the Pension Protection Act of

2006) amended the statute to provide that a pension plan will not be deemed to violate the qualification requirements merely because it allows an in-service distribution provided the employee has attained age 62. [IRC Section 401(a)(36)] The provision applies for distributions in plan years beginning after December 31, 2006. Conforming amendments have been issued at Treas. Reg. §1.401(a)-1(b)(1)(i). However, in order to take advantage, the plan must specifically allow for such distributions.

C. Section 401(k) Plans

Contrary to the general rules discussed above which allow in-service withdrawals under a profit sharing plans, employee elective contributions may generally <u>not</u> be distributed in-service but rather, are subject to very restrictive withdrawal rules. This means that even where the Section 401(k) plan is actually a feature of a profit sharing plan, as most are, the participant's own contributions are subject to much more restrictive distribution rules than those that apply to the employer contributions under the underlying profit sharing portion of the plan. Specifically, distributions attributable to an employee's Section 401(k) contributions (including both before-tax and now Roth after-tax contributions) may not be made before the participant's retirement, death, disability, severance from employment, attainment of age 59 1/2, (but only if the plan so provides) or, hardship, (again, but only if the plan so provides). [IRC § 401(k)(2)(B)]

In the case of a Roth 401(k) account under a Section 401(k) plan, in addition to the Roth after-tax contributions not being restricted by income limits, (as is the case with the Roth IRA), participants under a Roth 401(k) also have the possibility that distributions will be tax free, and not just tax-deferred if made after age 59 ½ or as a result of the individual's death or disability (as defined in the statute) provided the participant has participated in the Roth for at least 5 years. [IRC Section 402A(d)] Like regular before-tax contributions, Roth contributions are subject to the same limitations and restrictions on distributions as apply to a participant's before-tax contributions and further are required to be fully vested when made just as is the case with a participant's before-tax contributions.

D. Defined Benefit Plans

1. General Restrictions

The same rules that apply to money purchase plans apply equally in the case of a defined benefit plan so that, post PPA (<u>i.e</u>., the Pension Protection Act of 2006), such plans may be drafted to allow in-service distributions to a participant who has attained age 62. [IRC Section 401(a)(36)] While the vast majority of small defined benefit plans will simply terminate when distributions become necessary to be made to the owner of the plan sponsor, such a provision could be important in situations involving more than one owner.

2. Top 25 Restrictions

Special nondiscrimination rules will sometimes prevent a highly compensated participant in a defined benefit plan from receiving a lump sum distribution. This is because restrictions designed to prevent a highly compensated employee from receiving a distribution of virtually all of the plan's funds and leaving little or nothing to provide benefits to the plan's non-highly compensated participants impose restrictions such that annual payments from a defined benefit plan to one of the top 25 highly compensated participants under a defined benefit plan cannot exceed the annual value of a single life annuity unless generally, after making the lump sum distribution, the plan would still have assets equal to or greater than 110% of the value of current liabilities. [Treas. Reg. Section 1.401(a)(4)-5(b)]

Understandably, this can prove to be a significant problem in a small defined benefit plan. For example, where a defined benefit plan was established primarily to provide benefits for the older owners so that the younger family members could take over the benefits, precluding that older owner from taking a lump sum distribution may significantly upset those plans.

While IRS guidance sets forth a mechanism ostensibly allowing for lump sum distribution to an IRA followed by collateralization and an agreement to repay the excess should the plan terminate before the required funding level has been achieved, in reality, the mechanism does not work. This is because the mechanism, set forth in Revenue Ruling 92-76, 1992-2 CB 76, requires that the IRA contain 125% of the amount in excess of the annual single life annuity amount. However, it does not work because the remedy was constructed based upon the restrictions as they used to apply—not as the restrictions currently apply.

For example, if the lump sum value is $1,000,000 and annual single life annuity payments (i.e., the amount that the plan would be free to distribute to the restricted employee each year) is $100,000, the excess amount in the first year is $900,000. This means that in order to allow a lump sum distribution subject to the collateralization requirement and thus, the amount that must be held by the IRA as collateral is 125% of $900,000 or $1,125,000, more than the actual lump sum value received.

However, if enough prior planning is done, there may in fact be a satisfactory solution available to allow the highly compensated to receive a lump sum distribution. In the original planning for the ultimate transfer of ownership, the parties should consider establishing, not just the defined benefit plan, but a tag along defined contribution plan as well.

Example: Leslie is a restricted employee and participant under the Widget defined benefit plan. Leslie is also a participant in the Widget Section 401(k) plan. Leslie is retiring and wants to obtain a lump sum distribution from the defined benefit plan, but, as a restricted employee, is generally limited by the plan's funded status to instead receiving annual payments equal to the amount that would be received under a single life annuity.

In order to avoid this result while still satisfying the early termination restrictions, prior to receiving the distribution, Leslie proposes to enter into a written agreement with the plan administrator agreeing to the repayment of the restricted amount in the event repayment is required in accordance with the regulations. The IRA provider will agree to hold the IRA subject to the restriction agreement such that the account will be essentially segregated into an unrestricted portion and a restricted portion. The IRA provider will then agree to hold the restricted portion for the benefit of the pension plan during the period of the required restriction. In addition, if the initial assets of the IRA do not have an initial fair market value of at least 125% of the restricted amount (as required under the regulations but as will almost never be the case with respect to the defined benefit lump sum amount alone), Leslie agrees to roll over sufficient assets from the Widget Section 401(k) plan to bring the fair market value of the IRA to at least 125% of the restricted amount as required by the regulations.

The arrangement will qualify for the collateralization/repayment exception set forth in Rev. Rul. 92-76. Further, the repayment agreement will satisfy the requirements of Rev. Rul.. 92-76 and will not violate the provisions of Treas. Reg. Section 1.401(a)(4)-5(b)(3). Moreover, the rollover of both the defined benefit plan distribution as well as of the amount from the defined contribution plan would each qualify as an eligible rollover. [See Private Letter Ruling 200606051 (November 18, 2005)]

[See attached Exhibit A for a Sample IRA Collateral Pledge Agreement]

III. Overall Penalty Structure

The Code imposes excise taxes on distributions that occur too early or too late or if the distribution is too small. Specifically, with respect to too early, distributions prior to age 59 ½ are subject to a 10% excise tax with respect to the amount includible in income subject to statutory exceptions. [IRC Section 72(t)]

At the other end of the spectrum, distributions that are delayed too long may incur a 50%

excise tax pursuant to the required minimum distribution requirements. [IRC Section 4974] As such, the time in which distributions may be received with flexibility and relatively without penalty is generally between 59 ½ and 70 ½. Further, complex rules mandate the rate of distributions to that distributions during a participant's lifetime are not too small.

IV. Tax Favored Options on Distribution from a Qualified Plan

A. Introduction

Over the last several years, the federal government has instituted more and more rules designed to push plan participants into one course of action when they receive a distribution: rollover to another tax-deferred vehicle.

This is reflected in the virtual elimination of the averaging rules, (that is, 10 and 5 year averaging) save for the grandfather rule available to certain older participants. This goal is similarly reflected in the direct rollover rules of Section 401(a)(31) and 402 which both allow a direct rollover of most plan distributions, whether partial or full, to another qualified plan or IRA and, starting from 2005, mandate that, absent an affirmative election, in the case of a distribution of amounts in excess of $1,000 but not more than $5,000, the plan must presume a default election of rollover, rather than a default election of distribution to the participant. [IRC Section 401(a)(31)(B)]

Nevertheless, there remain some planning issues and opportunities.

B. Grandfathered 10-Year Averaging Election

A participant born on or before January 1, 1936 who receives a lump sum distribution has a grandfathered right to elect 10 year averaging. [Tax Reform Act of 1986 § 1122(h)(5)].

The election is only available with respect to the taxable portion of a lump sum distribution.

A lump sum distribution means a payment within <u>one taxable year</u> of the entire balance under the plan that is payable because:

(i) the participant reached age 59 ½ , or

(ii) (ii) in the case of a participant other than a self-employed participant, the participant separated from the service of the employer, or

(iii) in the case of a self-employed participant, because the participant became disabled, or

(iv) because of the participant's death. [Former § 402(d)(4)].

In order for a payment to qualify as a lump sum payment, the participant must have been a participant in the plan for at least five taxable years before the taxable year in which the distribution occurs. [Former § 402(d)(4)(F)].

The participant's entire balance must be distributed within one taxable year of the recipient.

The participant can only make this election once after 1986.

The election may be made by the participant's estate or trust provided the employee had attained age 59 1/2. [Former § 402(d)(4)(B)] The election, if made, applies to all lump sum distributions received by the participant during the year. [Former § 402(d)(4)(B)(ii)] Because a lump sum distribution must constitute the balance to the participant's account under the plan, a participant <u>can not</u> rollover part of a lump sum distribution and 10-year average the remaining portion. [Former § 402(d)(4)(K)]

Moreover, care must be taken with the averaging rules and the following general rules observed:

1. all pension plans maintained by an employer are treated as a single plan, and

2. all profit sharing plans maintained by an employer are treated as a single plan, and

3. all stock bonus plans maintained by an employer are treated as a single plan.

[Former §402(d)(4)(C)]

If the distribution is due to death and there is more than one recipient, one or all of the recipients of a lump sum distribution can use the optional 10 year averaging computation.

Distributions from an IRA do not qualify for lump sum treatment.

The amount of the tax is determined as if 1/10th of the taxable portion of the distribution, reduced by a minimum distribution allowance, were paid to a single person for the year. The minimum distribution allowance is the lesser of $10,000 or 50% of the total taxable amount reduced by 20% of the amount by which the total distribution exceeded $20,000. The minimum distribution allowance could not exceed $10,000 and is completely phased out if the total taxable distribution is $70,000 or more. The tax that would be paid on that portion by a single person, assuming this amount was the sole taxable income for the year, is thus determined based upon the <u>1986 tax rates</u>. This amount is then multiplied by 10 to arrive at the lower rate. [I.R.C. § 402(d)(1)(B)].

> <u>Example</u>: Assume that Pat was born in 1934 and has participated in the Widget profit sharing plan for substantially more than 5 years. Pat receives a lump sum distribution from the plan equal to $150,000. If Pat elects to 10-year average, the total tax paid for the year of distribution would equal 24,570 (<u>i.e</u>., the 1986 tax rate on $15,000 if that were the entire taxable income for the year would be $2,457 x 10 = $24,570. Because of the size of the distribution, no minimum distribution allowance is available.

C. Rollovers

As indicated previously, the federal government's goal, as reflected in its policies, is to encourage virtually all participants receiving a distribution to roll over that distribution into another tax-deferred vehicle. This is reflected in the expansion of the various entities from which and into which distributions can be rolled. [See attached Exhibit B, Rollover Chart]

Specifically, any portion of the balance to the credit of an employee in a qualified plan that constitutes the amount that would otherwise be includible in gross income may be rolled over in a direct rollover to another qualified plan, IRA, a governmental Section 457(b) plan or to a Section 403(b) arrangement <u>other than</u>:

1. a distribution that is a series of substantially equal periodic payments (not less frequently than annually) made either over the life or life expectancy(ies) of the employee and a designated beneficiary or for a specified period of 10 years or more;

2. a required minimum distribution;

3. a hardship distribution, or

4. certain corrective distributions.

[IRC Section 402(c)(4); Treas. Reg. Section 1.402(c)-2, Q & A-4]

Notwithstanding the general rule limiting the maximum rollover amount to the taxable portion, a distributee may also roll over the after-tax amount to the extent that the taxable portion is rolled over and provided it is rolled over in a direct rollover to either a qualified trust or to a Section 403(b) arrangement that separately accounts for the rolled over amount and the earnings including the after-tax amount, or is rolled over to either an IRA or to individual retirement annuity (other than an endowment contract). [IRC Section 402(c)(2)]

Where a rollover is allowed and a direct rollover not required, a distributee also has the option to do an indirect rollover. Under an indirect rollover, rather than the plan making the rollover directly to the other eligible retirement plan, distribution is made instead to the distributee who then must contribute the amount to another eligible plan not later than the 60th day following the day on which the distributee received the property distributed. [IRC Section 402(c)(3)] The IRS may waive the 60 day requirement where the failure to waive the requirement would be against equity or good conscience including casualty, disaster or other events beyond the reasonable control of the individual subject to the requirement. [IRC Section 402(c)(3)(B)] However, use of the 60day option requires that the plan withhold 20% of the distribution for federal income tax. This means that if the distributee is to avoid taxation on the amount withheld, the distributee must find substitute funds to be used in order to keep the distribution whole on rollover.

A rollover can be made under this rule, not just by the participant, but by the participant's surviving spouse as well as by an alternate payee.

D. Rollover by Nonspouse Beneficiaries

Most recently, the Pension Protection Act of 2006 for the first time allows nonspouse beneficiaries the option of rolling over a death benefit to an IRA.

1. Statutory Provision

The PPA allows nonspouse beneficiaries to transfer amounts received from a qualified plan, governmental Section 457 plan or a Section 403(b) plan directly to an IRA. The transfer must occur as a trustee-to-trustee transfer. As such, no 60 day rollover option is available. The transfer must be made to an IRA "established for the purpose of receiving the distribution" which suggest that it must hold only the death benefits. Moreover, the distributee must be a designated beneficiary, as defined for purposes of IRC Section 401(a)(9)(E). The IRA is treated as an inherited IRA of the nonspouse beneficiary. To the extent provided in regulations, a trust may also qualify as a designated beneficiary. The IRA will be subject to the post death minimum required distribution requirements under Section 401(a)(9)(B) with the exception of the special spouse rules of subsection (iv). [IRC Section 402(c)(11)]

2. Titling the IRA

Notice 2007-7 provides that the IRA must be established in a manner that identifies it as an IRA with respect to a deceased individual and also identifies the deceased individual and the beneficiary, for example, "Tom Smith as beneficiary of John Smith." [Notice 2007-7, Part V, Q & A 13]

3. Permitted, but not Required—(Currently)

As currently interpreted by the IRS, plans are permitted, but not required to allow direct rollovers by nonspouse beneficiaries. That is, a plan is not required to offer a direct rollover of a distribution to a nonspouse beneficiary. [Notice 2007-7, Part V, Q & A 14] Note, however, that both Technical Corrections bills in the House and the Senate would each clarify, if enacted, that plans are required to permit nonspouse rollovers. [S. 1974, and H.R. 3361]

4. Treatment as Eligible Rollover Distribution For Limited Purposes Only

The Notice notes that Section 402(c)(11) provides that a direct rollover by a nonspouse beneficiary is a rollover of an eligible rollover distribution <u>only for purposes of Section 402(c)</u>. As such, the distribution is not subject to the direct rollover requirements of Section 401(a)(31), the notice requirements of Section 402(f) or the mandatory withholding requirements of Section 3405(c). Thus, in addition, if the amount distributed in actually received by the nonspouse beneficiary, the distribution is not eligible for rollover. [Notice 2007-7, Part V, Q & A 15]

5. Trust as beneficiary

PPA provides that to the extent provided in regulations, a trust may also qualify as a designated beneficiary. The Notice provides that a plan may make a direct rollover to an IRA on behalf of a trust where the trust is the named beneficiary of a decedent provided the beneficiaries of the trust meet the requirements to be designated beneficiaries within the meaning of Section 401(a)(9)(E). The IRA must be properly established and titled with the trust identified as the beneficiary. In such case, the beneficiaries of the trust are treated as having been designated as beneficiaries of the decedent for purposes of determining the distribution period under IRC Section 401(a)(9), if the trust meets the requirements of Treas. Reg. Section 1.401(a)(9)-4, Q & A-5, with respect to the IRA. [Notice 2007-7, Part V, Q & A 16]

6. Application of Required Minimum Distribution Rules

The Notice contains rules for determining the distribution period for the nonspouse beneficiary based upon whether the employee died before or after his or her required beginning date.

1. Participant dies <u>Before</u> his/her Required Beginning Date

Under the general rule, if the employee dies before his/her required beginning date, the required minimum distributions, for purposes of determining the amount eligible for rollover is determined under either the 5-year rule or the life expectancy rule. Under either rule, no amount is a required minimum distribution for the year in which the employee dies.

Under the five-year rule, no amount is required to be distributed until the fifth calendar year following the year of the employee's death. Thus, if the 5-year rule applies, for the first 4 years after the year the employee dies, no amount payable to the beneficiary is ineligible for direct rollover as a required minimum distribution. As such, the beneficiary is permitted to directly roll over the beneficiary's entire benefit until the end of the fourth year. However, under a special rule, the 5 year rule must apply to the IRA. On or after January 1 of the fifth year following the year in which the employee died, no amount payable to the beneficiary is eligible for rollover.

[Notice 2007-7, Part V, Q & A 17(a) & (b)]

If the life expectancy rule applies, in the year following the year of death and each subsequent year, there is a required minimum distribution. The amount not eligible for rollover includes all undistributed required minimum distributions for the year in which the direct rollover occurs and any prior year. Notice 2007-7, Part V, Q & A 17(c]

Under a special rule, if the participant dies before his/her required beginning date and the 5 year rule applies, the nonspouse beneficiary may determine the required minimum distribution under the plan using the life expectancy rule in the case of a distribution made prior to the end of the year following the year of death. However, in order to use this special rule, the required minimum distribution under the IRA to which the direct rollover is made must be determined using the life expectancy rule using the same designated beneficiary. [Notice 2007-7, Part V, Q & A 17(a) & (c)(2)]

2. Participant Dies On or After Required Beginning Date

If the employee dies on or after his/her required beginning date, then, for the year of the employee's death, the required minimum distribution not eligible for rollover is the same as the amount that would have applied if the employee were still alive and elected the direct rollover.

For the year after the year of the employee's death and subsequent years, the applicable distribution period is to be determined using Q & A-5 of Treas. Reg. Section 1.401(a)(9)-5. As is the case of death before the employee's required beginning date, the amount not eligible for rollover includes all undistributed required minimum distributions for the year in which the direct rollover occurs and any prior year, including years before the employee's death. [Notice 2007-7, Part V, Q & A 18]

3. Distributions after Rollover

After rollover to an IRA, the required minimum distribution rules apply to the inherited IRA. The rules for determining the required minimum distributions under the plan with respect to the nonspouse beneficiary also apply to the IRA. Thus, if the employee dies before his or her required beginning date and the 5-year rule applied to the nonspouse beneficiary under the plan making the direct rollover, the 5-year rule applies for purposes of determining the required minimum distributions under the IRA. If the life expectancy rule applied to the nonspouse beneficiary under the plan, the required minimum distribution under the IRA must be determined using the same applicable distribution period as would have been used under the plan if the direct rollover had not occurred. Similarly, if the employee dies on or after his/her required beginning date, the required minimum distribution under the IRA for any year after the year of death must be determined using the same applicable distribution period as would have been used under the plan if the direct rollover had not occurred. [Notice 2007-7, Part V, Q & A 19]

The application of these rules, particularly the carryover of the plan distribution rules to the IRA, raised considerable concern among practitioners and even in the press. In response, the IRS has attempted to clarify how the special rule works in conjunction with the basic carryover rule. The clarification is found in its Employee Plans News, Special Edition, February 13, 2007.

In its clarification, the Service notes that Notice 2007-7, Q & A-17(c)(2) describes a special rule constituting an exception to the general rule of Q&A-19. Under the special rule, if under a plan, the 5 year rule applies for determining the required minimum distribution, a nonspouse designated beneficiary may, nevertheless, treat the plan as using the life expectancy rule provided that the rollover to the IRA is made prior to the end of the year following the year of the participant's death. Thus, despite the plan provision requiring the use of the 5-year rule, the nonspouse designated beneficiary is permitted to treat the plan as using the life expectancy rule both for determining the amount eligible to rollover as well as for purposes of determining the required minimum distribution under the IRA, <u>but only if the rollover if made prior to the end of the year following the year of the participant's death</u>.

> <u>Example</u>: If a participant in a plan dies in 2007 before his required beginning date and under the plan, the 5-year rule applies, the participant's nonspouse beneficiary is permitted to roll over the deceased participant's entire account balance into an IRA in 2007 and take required minimum distributions from the IRA under the life expectancy rule. If the account balance is rolled over in 2008, the amount eligible for rollover must be reduced by the amount of the required minimum distribution for 2008, determined using the life expectancy rule. After 2008, the nonspouse designated beneficiary may still roll over funds from the plan, but would have to take required minimum distributions from the IRA under the 5-year rule. No amount can be rolled over after 2011.

E. Direct Rollover to a Roth IRA

Pre-PPA, the Code did not permit a distribution from a qualified plan to be rolled directly into a Roth IRA. Rather, the distribution would first have to be rolled into a traditional IRA and subsequently rolled into the Roth IRA.

The PPA eliminated this extra step, although not right away. Specifically, PPA amends IRC Section 408A(e) to allow distributions from a qualified plan, Section 403(b) annuity, and governmental 457 plans to be rolled over directly into a Roth IRA <u>subject to all current law rules and restrictions</u> including the need to include the amounts in income and the recognition of the modified adjusted gross income limitations. This provision is effective for distributions made after December 31, 2007. This means that distributions will no longer need to go through the intermediary step of rolling over first to a traditional IRA.

IRS guidance confirms that plans are <u>required</u> to allow a participant to elect a direct rollover to a Roth IRA. [Notice 2008-30, Q & A-4] However, the plan administrator is not responsible for assuring the distributee is eligible, under the modified adjusted gross income limitations in effect prior to 2010, to make a rollover to a Roth. [Notice 2008-30, Q & A-5]

In the case of a nonspouse beneficiary, the modified adjusted gross income and filing status of the beneficiary are used to determine eligibility to make a qualified rollover contribution to a

Roth IRA. A plan may, but is not required to permit rollovers by nonspouse beneficiaries and a rollover by a nonspouse beneficiary must be made by a direct trustee-to-trustee transfer. [Notice 2008-30, Q & A-7]

A surviving spouse who makes a rollover to a Roth IRA may elect either to treat the Roth IRA as his or her own or to establish the Roth IRA in the name of the decedent with the surviving spouse as the beneficiary. [Notice 2008-30, Q & A-7]

As is the case with other direct rollovers, an eligible rollover distribution paid to an employee or to the employee's spouse is subject to the 20% mandatory withholding. However, a direct rollover to a Roth IRA is not subject to mandatory withholding even if the distribution is includible in gross income. Also, a distribution that is directly rolled over to a Roth IRA by a nonspouse beneficiary is not subject to mandatory withholding. [Notice 2008-30, Q & A-6]

F. Making Use of Net Unrealized Appreciation

Another special rule may be available where a distribution includes securities of the employer. If a lump-sum distribution includes employer securities, the recipient may be eligible to defer the tax on the net unrealized appreciation in the securities. [IRC Section 402(e)(4)(B)] If the distribution does not constitute a lump-sum distribution, tax is deferred only on the net unrealized appreciation in securities of the employer corporation resulting from employee contributions other than deductible employee contributions. However, this provision is not available where the distribution is rolled over. [IRC Section 402(e)(4)(A)]

Where the securities are received as part of a lump-sum distribution, the taxpayer may elect, however, to instead include the net unrealized appreciation in current taxable income. [IRC Section 402(e)(4)(B)]

"Net unrealized appreciation" means the excess of the market value of the securities at the time of distribution over the cost or other basis of the securities to the trust. [Treas. Reg. § 1.402(a)-1(b)(2)(i)] That is, the net unrealized appreciation is the increase in the value of the securities while held by the qualified plan. The plan is required to advise the recipient of the value of the net unrealized appreciation at the time of distribution.

The determination as to whether the distribution constitutes a lump-sum distribution is made by applying essentially the same rules that apply for purposes of the ten-year averaging election. However, the five years of participation requirement need not be satisfied.

If the employer securities are paid directly to the participant and the remainder rolled into an IRA, this will not preclude lump sum treatment for purposes of this rule. [See for example, Private Letter Ruling 9721036]

If this election is made, on the sale or exchange of employer securities with tax-deferred net unrealized appreciation, any gain is treated as long-term capital gains up to the amount of the net unrealized appreciation. This means that it is taxed as long-term capital gains without regard to how long the securities were held by the taxpayer. Any gain in excess of the amount of the net unrealized appreciation is long-term or short-term gains, depending on how long the taxpayer held the securities after distribution. [Treas. Reg. § 1.402(a)-1(b)(1)]

If the election is not made, and instead, the employer securities are rolled over to an IRA or to another qualified plan, the use of the net unrealized appreciation is lost forever. Subsequent distributions will be subject to ordinary income.

However, the decision to elect to take advantage of the net unrealized appreciation is not a no brainer given the option to rollover, sell the stock tax-deferred inside an IRA and allow the proceeds to accumulate for potentially decades before required distributions are made. Moreover, when using the net unrealized appreciation, the amount subject to ordinary income, the 10% early distributions excise tax may apply in the year of distribution with respect to the taxable basis of the employer securities.

V. Distributions from IRAs

A. Taxation Generally—Non-Roth

The general rule is that distributions from an IRA are included in gross income in accordance with the rules of Section 72. [IRS Section 408(d)(1)] For this purpose, the following rules apply:

1. all IRAs are treated as a single contract;

2. all distributions during any taxable year are treated as 1 distribution, and

3. the value of the contract, income on the contract, and investment in the contract are to be computed as of the close of the calendar year in which the taxable year begins.

[IRS Section 408(d)(2)]

The owner of an IRA is deemed to have a zero basis in the IRA and thus, except for any nondeductible contributions, the distribution is fully includible in income.

With respect to any nondeductible contributions made to the IRA, however, (other than Roth contributions), the portion constituting the non-Roth nondeductible contribution constitutes a return of the owner's basis and thus is returned tax-free. The portion of any distribution that constitutes a tax-free return of contributions is determined in accordance with the rules of Section 72. [IRC Section 408(d)(1)] For this purpose, all individual retirement plans are to be treated as one contract and all distributions during a taxable year are to be treated as one distribution. [IRC Section 408(d)(2)] This means that all distributions during the taxable year are to be aggregated and treated as one distribution both for purposes of reporting the distribution as well as for purposes of determining the nondeductible portion of a distribution. This rule precludes a taxpayer from treating any particular IRA from which withdrawals are made as containing only nondeductible contributions. The value of the contract, income on the contract and investment in the contract is to be computed as of the close of the calendar year in which the taxable year begins. [IRC Section 408(d)(2)(C)] However, for this purpose, the value of the contract is to be increased by the amount of any distributions during the calendar year. [IRC Section 408(d)(2), flush sentence]

To determine the nontaxable portion of a distribution, Notice 87-16, 1987-1 CB 446 provides that the following formula is to be applied:

$$\frac{\text{Total Nondeductible Contributions}}{\text{Total IRA Account Balance} + \text{Distribution Amount} + \text{Outstanding Rollover}} \times \text{Distribution Amount}$$

[Notice 87-16, 1987-1 CB 446, Part III]

This means that the portion of the distribution attributable to the return of nondeductible contributions is that portion of the year's total distributions that bears the same ratio to the total amount of the taxable year's distributions as the amount of nondeductible contributions held in all IRAs as of the end of the taxable year (excluding any Roth amounts) bears to the total balance of all IRAs as of the end of the taxable year (again, excluding Roth contributions).

<u>Example</u>: Assume Pat makes the following contributions:

	Deductible	Nondeductible
1984	$2,000	$0
1985	$2,000	$0
1986	$2,000	$0
1987	$1,000	$1,000
1988	$1,000	$1,000
1989	$0	$2,000
1990	$0	$2,000

$8,000 $6,000

On October 31, 1992, Pat receives a distribution of $5,000. At the end of the year, the total IRA account balance is $12,500. There are no outstanding rollovers. The portion of the distribution which is <u>not</u> includible in gross income for 1992 is calculated as follows:

$$\frac{\$6,000}{\$12,500 + \$5,000} \quad \text{x} \quad \$5,000 = \quad \$1,714.30$$

$1,714.30 of the $5,000 distribution consists of a return of basis. The remainder is includible in the individual's income.

On June 30, 1993, Pat receives a distribution of $3,000. No additional contributions are made in 1993 and the total IRA account balance on December 31, 1993 is $10,875. There are no outstanding rollovers. The total nondeductible contributions made to any IRA must be reduced by the portion of prior distributions attributable to return of nondeductible contributions, in this case $1,714.30. Thus, the reduced nondeductible contribution balance equals $6,000 minus $1,714.30, or $4,285.70. The portion of the distribution which is not includible in gross income for 1993 is calculated as follows:

$$\frac{\$4,285.70}{\$10,875 + \$3,000} \quad \text{x} \quad \$3,000 = \quad \$\$926.64$$

Thus, $926.64 of the $3,000 distribution consists of return of basis and the remainder is includible in the individual's income.

[Notice 87-16, 1987-1 CB 446, Part III]

The term "outstanding rollover" means for this purpose any amount distributed by an IRA within 60 days of the end of the taxable year, not rolled over to another IRA by the end of the year, but rolled over in the following year to another IRA before the 60 days end. [Notice 87-16, 1987-1 CB 446, Part III]

Because an individual may not designate a particular distribution as being from a segregated or particular nondeductible IRA, the same rules apply where the individual has made contributions to multiple IRAs

> Example: Assume Pat has two IRAs and has made a total of $6,000 of nondeductible IRS contributions. Pat takes a $300 distribution from IRA B on October 10, 1989. On December 11, 1989, Pat receives $7,000 from IRA A. There has not been any earlier distribution from either IRA. As of December 31, 1989, Pat has not yet rolled any amount into another IRA and thus, the year-end valuation does not include the distribution. On January 30, 1990, Pat rolls over $7,000 to another IRA. The year-end valuation of the accounts show the following:

IRA A	IRA B = $23,000
$3000	$20,000

> The amount removed from IRA A and rolled over on January 30, is, of course, not included in the valuation as of December 31, 1989, nor is the $300 distributed from IRA B and not rolled over later. To calculate the taxability of the 1989 distribution that was not rolled over (the $300), the "outstanding rollover" (the $7,000) must be added back to the denominator of the fraction used to determine the portion of the distribution attributable to the basis. The portion of the distribution attributable to basis is thus calculated as follows:

$$\frac{\$6{,}000}{\underset{\text{(IRA Account Balance + Outstanding Rollover)}}{(\$23{,}000 + \$7{,}000)} + \underset{\text{(Distribution)}}{\$300}} \times \$300 = \$59.41$$

[Notice 87-16, 1987-1 CB 446, Part III, Q & A D-7]
Roth IRAs

Planning Note: In order to keep the nondeductible contributions as large a percentage as possible during the year of a planned withdrawal, clients should be discouraged from rolling over large qualified plan distributions during the year of a planned or actual withdrawal from an IRA including nondeductible contributions.

B. Taxation—Roth IRA

Contributions to a Roth IRA are made on an after-tax basis with any subsequent distribution being-tax free provided that the distribution constitutes a "qualified distribution". [IRC Section 408A(d)] Further, a qualified distribution is not subject to the 10% early distributions tax of Section 72(t). [Treas. Reg. Section 1.408A-6, Q & A 5(a)]

Qualified Distribution

A qualified distribution means a payment that is:

(1) made on or after the date on which the individual attains age 59 ½,

(2) made to a beneficiary (or to the estate of the individual) on or after the death of the individual,

(3) attributable to the individual being disabled (within the meaning of Section 72(m)(7)), or

(4) a qualified special purpose distribution.

[IRC Section 408A(d)(2)]

A qualified special purpose distribution means any distribution to which Section 72(t)(2)(F) applies, <u>i.e</u>., certain first time home purchases.

However, in no event will a payment constitute a qualified distribution if it is <u>made within the five-year period beginning with the first tax year for which the taxpayer made a contribution to any Roth IRA.</u> [IRC Section 408A(d)(2)(B)] This means that in order to qualify for the special rules excluding the interest from income, the payment must be made after a five-year holding period.

Tacking for 5 Year Rule for Inherited IRA

In the case of an inherited Roth IRA or where the surviving spouse treats the Roth IRA as his/her own, the five-year holding period includes the period previously held by the decedent. [Treas. Reg. Section1.408A-6, Q & A 7(a)]

Taxation of Distributions Not Qualifying As Qualified Distributions

With respect to distributions that do not constitute qualified distributions, the distribution is includible in the taxpayer's gross income to the extent that the distribution, when added to all previous distributions from the taxpayer's Roth IRAs (whether or not qualified distributions) reduced by the amount of those prior distributions that were previously includable in gross income, exceeds the taxpayer's contributions to all of the taxpayer's

Roth IRAs. [Treas. Reg. Section 1.408A-6, Q & A 4] Thus, the taxpayer is generally allowed to recover his/her contributions before taxable earnings are treated as distributed.

Where the distribution does not constitute a qualified distribution, the 10% early distributions tax of Section 72(t) applies to amounts includible in income unless one of the exceptions is otherwise applicable. [Treas. Reg. Section1.408A-6, Q & A 5(a)] In addition, the early distributions tax will apply to a distribution that does not constitute a qualified distribution even though not then includible in income if it is allocable to a conversion contribution, if made prior to the close of the five-year holding period. [IRC Section 408A(d)(3)(F)] For purposes of applying the tax, only the amount of the conversion contribution includible in gross income as a result of the conversion is taken into account. [Treas. Reg. Section 1.408A-6, Q & A5(b)]

Ordering Rules

In order to determine whether an amount distributed from a Roth IRA is allocated to regular contributions, conversion contributions or earnings, Roth IRA distributions are subject to special ordering rules so that distributions are treated in the following order:

1. regular contributions including regular annual Roth contributions, rollovers from other Roth IRAs and Roth accounts;

2. conversion contributions on a first in first out basis, and

3. earnings.

[IRC Section 408(d)(4)(B); Treas. Reg. Section 1.408A-6, Q & A 8]

All distributions from all Roth IRAs made during the tax year are aggregated. [Treas. Reg. Section 1.408A-6, Q & A 9(a)]

Who Can Make Annual Roth Contributions

Only those individuals whose adjusted gross income does not exceed specified limits may make annual Roth contributions. Contributions to a Roth IRA may be made even after the taxpayer attains age 70 1/2 . [IRC Section 408A(c)(3)(C)(D)(4)]

In the case of an individual with a modified adjusted gross income in excess of the applicable amount, the contribution the individual can make to a Roth is phased out. For 2007, the phase out occurs between $99,000 and $114,000 for single taxpayers, between $156,000 and $166,000 for married individuals filing jointly and between $0 and $10,000 for married individuals filing separately. For 2008, the phase out occurs between

$101,000 and $116,000 for single taxpayers, between $159,000 and $169,000 for married individuals filing jointly and between $0 and $10,000 for married individuals filing separately.

For this purpose, a taxpayer's modified adjusted gross income is essentially the same as the adjusted gross income used to determine the amount of deductible contributions that can be made to a traditional IRA by a person who is an active participant in a plan except that any conversion income is not taken into account. [IRC Section 408A(c)(3)(C)(i)] For years after 2004, and solely for purposes of the $100,000 limitation applicable to conversions, required minimum distributions are also not included in modified adjusted gross income solely for that purpose. [Treas. Reg. Section 1.408A-3, Q & A 6]

Roth Conversions

Individuals who (1) have modified adjusted gross income not in excess of $100,000 and (2) are not married filing a separate return may convert amounts from a traditional IRA to a Roth IRA. [Treas. Reg. Section 1.408A-4, Q & A 1(a)] The taxpayer must include the untaxed amount on conversion in income. The conversion is treated as a rollover and most of the normal rollover rules apply. [Treas. Reg. Section 1.408A-4, Q & A 1(a)] However, the one-rollover-per-year limitation of Section 408(d)(3)(B) does not apply.

Prior to 2008, a taxpayer could only convert amounts from either a traditional IRA, SEP or SIMPLE IRA into a Roth IRA. After 2007, taxpayers can also rollover amounts from the following plans directly into a Roth IRA provided that the rollover otherwise complies with the applicable rules:

1. a qualified pension, profit sharing or stock bonus plan;

2. a tax-sheltered annuity plan, that is, a Section 403(b) annuity, or

3. a deferred compensation plan of a state or local government (Section 457).

[IRC Section 408A(e), as amended by the Pension Protection Act of 2006]

Pre-2010 Conversion MAGI Limits

Conversions can only be made, however, for years <u>prior</u> to 2010, where the individual's modified adjusted gross income is $100,000 or less. [IRC Section 408A(c)(3)(B); Treas. Reg. Section 1.408A-4, Q & A 2]

Conversions Beginning in 2010

Beginning in 2010, conversions of a traditional IRA can be made without regard to an individual's modified adjusted gross income.[IRC Section 408A(c)(3)(B), as amended by the Tax Increase Prevention and Reconciliation Act]

Special Tax Inclusion Rule for 2010 Conversions

Under a special rule, unless the taxpayer elects not to have this special rule apply, any amount required to be included in gross income for the taxable year beginning in 2010 shall be included ratably over the 2-year period beginning with the first taxable year beginning in 2011. [IRC Section 408A(d)(3)(A)(iii)]

Taxation in the case of a Failed Conversion

In the case of a failed conversion, for example, where the conversion is made but the adjusted gross income exceeds the threshold amount and is not timely corrected, the contribution will be treated as a regular contribution to a Roth IRA subject to the following:

1. a 6% excise tax per year for any excess amount not withdrawn;

2. the distributions from the traditional IRA are includible in gross income, and

3. the 10% early distributions tax may apply to any distribution.

Correction of a failed conversion means moving the converted amount (plus earnings from the date of the conversion) into a traditional IRA by the due date (including extensions) for the individual's tax return for the year during which the conversion to the Roth IRA was made.

Note, however, that any required minimum distribution due for the year cannot be converted. [Treas. Reg. Section 1.408A-4, Q & A 6(a)]

Recharacterization

A taxpayer may recharacterize a contribution made to one type of IRA by either having it transferred, in a trustee-to-trustee transfer, to another type of IRA or by transferring the assets between two IRAs at a single financial institution. [IRC Section 408A(d)(6)]

Importantly, the rules allow recharacterization with respect to all or any portion of an

IRA conversion. With respect to earnings or losses on recharacterization, with respect to contributions made after 1999, the net income attributable to a contribution that is distributed as a returned contribution pursuant to Section 408(d)(4) or recharacterized in accordance with Section 408A(d)(6) is to be determined by allocating to the contribution a pro rata portion of the actual earnings and losses of the IRA during the period the IRA held the contribution. This means that the net income may be a net loss. [IRC Section 408A(d)(6)(B)(i); Notice 2000-39, 2000-30 IRB 132]

A recharacterization must be made on or before the due date (including extensions) of the individual's return in which the original IRA contribution was made. [IRC Section 408A(d)(6)(A)] However, the six month automatic extension rule applies provided that the taxpayer's return was timely filed and the taxpayer takes appropriate corrective action within the six month period. [See Instructions to Form 8606; Announcement 99-57, 1999-24 IRB 50]

Some *Considerations In Deciding Whether to Convert*

1. <u>Does the taxpayer need the IRA funds for living expenses</u>---one of the greatest benefits of the Roth is the ability to avoid the lifetime required minimum distribution provisions; those who do not need the IRA assets for living and who would prefer to leave IRA assets to another generation should consider conversion;

2. <u>Are there assets outside or the IRA with which to pay the conversion taxes</u>—where there are assets sufficient to pay the taxes due on conversion outside of the IRA, this allows for greater IRA tax-free accumulation;

3. To take advantage of tax benefits that might otherwise be loss in a particular year;

4. For estate tax purposes and benefits

4. To avoid other tax implications, for example, the possible income limits at which Social Security becomes taxable.

Planning Opportunities

Take Advantage of Tax Diversification

Because qualified distributions from a Roth IRA are already tax paid, no penalty applies with respect to distributions that qualify as qualified distributions. This makes it much more feasible to access Roth IRAs for emergencies. While, ideally, these accounts should be saved for retirement when needed, should an emergency arise, Roth IRA accounts provide a much more tax advantageous way in which to reach funds.

Thus, even where an individual cannot clearly determine that a Roth IRA may be the most advantageous, from a tax perspective, of the two IRAs, a Roth IRA may be desirable to be established simply for tax diversification.

Moreover, distributions from traditional IRAs may well accelerate the time at which Social Security benefits become taxable for individuals whose compensation exceeds certain limits.

Roll Over Large Qualified Plan Distributions to a Roth

This can be done beginning in 2010 without regard to the individual's modified adjusted gross income and before, in the case of a business owner that has control over the amount of his compensation.

By rolling over to an IRA and paying taxes currently, the amounts in the Roth IRA wont be treated as income with respect to a decedent for estate purposes.

Moreover, if the funds will not be needed during the individual's lifetime, since a Roth IRA is not subject to the required minimum distribution rules for lifetime distributions, the individual can designate, for example, his/her children as the beneficiaries, via separate accounts, and allow the children to stretch out distributions over their life expectancies.

C. Wash Sale Rules apply to IRAs

Code Sec. 1091(a) prohibits the recognition of losses from the so called "wash sales" of stocks and securities. Specifically, that Section provides that in the case of a loss sustained from the sale or disposition of stocks or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after said date, the taxpayer has acquired or entered into a contract to acquire substantially identical stock or securities, no deduction is allowed under Code Section 165. An exception is available where the taxpayer is a dealer in stock or securities and the loss is sustained in a transaction made in the ordinary course of business.

In Rev Rul 2008-5, 2008-3 IRB , the IRS addressed whether this rule applies equally where the acquisition following the sale or disposition by an individual taxpayer, is made by the taxpayer's IRA (including a Roth). The IRS concludes that the prohibition applies equally in such a situation. Specifically, the revenue ruling concludes that the loss on the sale by the individual taxpayer is disallowed under Code Sec. 1091 . However, the taxpayer's basis in the IRA or Roth IRA is not increased, the ruling holds, by virtue of Code Sec. 1091(d)

VI. Dealing with the Required Minimum Distribution Requirements

A. Introduction

The required minimum distribution rules are designed to ensure that the benefits associated with allowing a tax-qualified retirement plan are actually used for retirement, rather than estate planning purposes. As such, these rules generally mandate the latest date by which distribution must begin. Absent the need for the funds for current living, in an ideal world, the taxpayer's desire is to defer distribution as long as possible in order to take advantage of the tax-deferred build-up available in an IRA or qualified plan. (Note, that with the advent of the Roth IRA, this may now be accomplished in some situations since the Roth IRA is not subject to the Pre-Death Minimum Distribution Requirements discussed below).

Note: Required minimum distributions may not be rolled over to an IRA or to another qualified plan.

B. Lifetime Distributions

Distribution from a qualified plan or a traditional IRA are generally required to commence not later than the participant's "required beginning date". The definition of "required beginning date" will depend upon whether the plan is a qualified plan or an IRA, and, in the case of a qualified plan, whether the individual is or is not a 5% owner.

In the case of all participants in a qualified plan other than 5% owners with respect to the plan year ending in the calendar year in which the employee attains age 70 1/2, the "required beginning date" means April 1 of the calendar year following the later of:

(i) the calendar year in which the employee attains age 70 1/2, or

(ii) (except in the case of a 5% owner as described above), the calendar year in which the employee retires.

In the case of a 5% owner, subject to certain grandfather provisions, the "required beginning date" means April 1st of the calendar year following the calendar year in which the employee attains age 70 1/2 without regard to whether the participant has terminated employment.

An individual is treated as a 5% owner if the employee is a more than 5% owner of the employer with respect to the plan year ending with or within the calendar year in which the individual attains age 70 1/2.

Once distributions have begun to a 5% owner, determined in accordance with this definition, distribution must continue, even if the participant ceases to be a 5 percent owner in a subsequent year.

[IRC §401(a)(9)(C)(i) and (ii)]

Note, that the year in which the participant attains age 70 1/2 is the first year for which a distribution is required. This means that, although the participant has until April 1 of the following year to satisfy this distribution requirement, if distribution is not made in the 70 1/2 year, two distributions will need to be made in the year following the year of attainment of age 70 1/2, i.e., the first by April 1 and the second (i.e., the one actually attributable to that year), not later than December 31. In the case of a large total retirement benefit where the minimum required distribution for each year is apt to be large, this bunching of two distributions may not be desirable.

In the case of a traditional IRA, that is, a non-Roth IRA, the required beginning date means April 1 of the calendar year following the calendar year in which the individual attains age 70 1/2. [I.R.C. §401(a)(9)(C)(i)]

In the case of a Roth IRA, however, no pre-death minimum distribution requirements apply.

C. Post Death Required Minimum Distributions

1. Distributions Treated as Having Begun (Death After Required Beginning Date)

Where distribution are treated as having begun prior to the employee's death but the employee's entire interest had not been distributed prior to death, the plan must provide that the remaining portion of the employee's interest will be distributed at least as rapidly as under the method of distribution then being used as of the date of death. [IRC §401(a)(9)(B)(i)].

After the year of the participant's death, a plan will satisfy this requirement if, where the participant has a designated beneficiary, distribution is made over the longer of: (i) the remaining life expectancy of the participant's designated beneficiary or (ii) the remaining life expectancy of the employee. [Treas. Reg. §1.401(a)(9)-5, Q & A 5] If the participant does not have a designated beneficiary, (including where the beneficiary designated is the participant's estate or a charity) distribution must be made over the participant's remaining life expectancy. [Treas. Reg. §1.401(a)(9)-5, Q & A-5] This means the life expectancy of the employee using the age of the employee as of the employee's birthday in the calendar year of the employee's death and reduced by one for each subsequent calendar year.[Treas. Reg. §1.401(a)(9)-5, A-5(c)(3)]

However, if the spouse is the sole beneficiary, the applicable distribution period during the spouse's lifetime is the spouse's annually recalculated life expectancy. Once the surviving spouse dies, any remaining benefits must be paid out over the spouse's remaining life expectancy using the age of the spouse in the calendar year of the spouse's death reduced by one for subsequent calendar years. [Treas. Reg. §1.401(a)(9)-5, A-5(c)(2)]

Participant Survived by Designated Beneficiary. If the Participant dies on or after the date distributions begin and there is a designated beneficiary, the minimum amount that will be distributed for each distribution calendar year after the year of the Participant's death is the quotient obtained by dividing the Participant's account balance by the longer of the remaining life expectancy of the Participant or the remaining life expectancy of the Participant's designated beneficiary, determined as follows:

(1) The Participant's remaining life expectancy is calculated using the age of the Participant in the year of death, reduced by one for each subsequent year.

(2) If the Participant's surviving spouse is the Participant's sole designated beneficiary, the remaining life expectancy of the surviving spouse is calculated for each distribution calendar year after the year of the Participant's death using the surviving spouse's age as of the spouse's birthday in that year. For distribution calendar years after the year of the surviving spouse's death, the remaining life expectancy of the surviving spouse is calculated using the age of the surviving spouse as of the spouse's birthday in the calendar year of the spouse's death, reduced by one for each subsequent calendar year.

(3) If the Participant's surviving spouse is not the Participant's sole designated beneficiary, the designated beneficiary's remaining life expectancy is calculated using the age of the beneficiary in the year following the year of the Participant's death, reduced by one for each subsequent year.

No Designated Beneficiary. If the Participant dies on or after the date distributions begin and there is no designated beneficiary as of September 30 of the year after the year of the Participant's death, the minimum amount that will be distributed for each distribution calendar year after the year of the Participant's death is the quotient obtained by dividing the Participant's account balance by the Participant's remaining life expectancy calculated using the age of the Participant in the year of death, reduced by one for each subsequent year.

2. Distributions Not Treated as Having Begun (Death Before Required Beginning Date)

Where the employee dies before distributions are treated as having begun, that is, where the employee or traditional IRA owner dies before his/her required beginning date, distribution must be made in accordance with one of three rules.

If the plan neither specifies which rule applies nor allows the beneficiary to elect which rule applies, then which rule is applicable is determined based upon whether the employee has a designated beneficiary.

The first, the 5 year rule, requires that the entire interest must be distributed within 5 years after the death of the employee without regard to whom or what entity the distribution is made. [IRC §401(a)(9)(B)(ii); Treas. Reg. §1.401(a)(9)-3, Q & A-1(a)]. That is, the employee's entire interest must be distributed as of December 31 of the calendar year which contains the fifth anniversary of the date of the employee's death. [Treas. Reg. §1.401(a)(9)-3, Q & A-2].

Another method, (the life expectancy rule), requires that any portion of an employee's interest payable to (or for the benefit of) a designated beneficiary, be distributed, commencing within one year of the employee's death, over the life of such beneficiary (or over a period not extending beyond the life expectancy of such beneficiary) using the Single Life Table of Treas. Reg. Section 1.401(a)(9)-9, Q & A-1. [Treas. Reg. §1.401(a)(9)-3, Q & A-1(a)] This method is only available if the employee has a designated beneficiary. If the employee has a designated beneficiary but the spouse is not the sole designated beneficiary then distributions must begin by December 31 of the calendar year immediately following the calendar year in which the employee died.

If the employee dies before distributions begin and there is a nonspouse designated beneficiary, the employee's entire interest is required to be distributed over the life of the designated beneficiary using the beneficiary's age as of the beneficiary's birthday in the calendar year immediately following the calendar year of the employee's death. For subsequent years, the applicable divisor (distribution period) is reduced by one each calendar year. [Treas. Reg. Section 1.401(a)(9)-5, Q & A-5(c)(1)]

The final method is available only if the sole designated beneficiary is the employee's surviving spouse. In such case, distributions must commence on or before the later of: (i) December 31 of the calendar year immediately following the calendar year in which the employee died or (ii) December 31 of the calendar year in which the employee would have attained age 70 ½. [Treas. Reg. §1.401(a)(9)-3, Q & A-3(b)]. Under this method, the surviving spouse essentially steps into the shoes of the employee but using the employee's age 70 ½ date as the focal point.

Where the spouse is the sole designated beneficiary, the distribution period during the spouse's life is the spouse's single life expectancy using the spouse's birthday for each distribution calendar year after the calendar year of the employee's death up through the calendar year of the spouse's death. [Treas. Reg. Section 1.401(a)(9)-5, Q & A-5(c)(2)] This means that the spouse's life expectancy is inheritently recalculated each year thus providing for a longer distribution period and therefore, shorter required distributions.

D. Planning Opportunities

Marry a Younger Spouse

Generally, the required minimum distribution during the participant's lifetime is determined based upon a table constructed based upon the individual participant's life expectancy plus a beneficiary who is 10 years younger. As can be easily seen, if the participant has a large account and does not need the funds in the plan or IRA, the strategy is to reduce the greatest extent possible, the amount required to be distributed. This in turn means being able to have the greatest possible denominator.

Where the sole designated beneficiary is however, the participant's spouse, the required minimum distributions can be determined using the joint and last survivor life expectancy table that takes into consideration both parties actual ages. This allows for the spreading out of the payments over longer periods and thus, smaller required minimum distribution amounts.

In addition, where the spouse is the designated beneficiary, on the death of the participant, as an alternative to receiving the minimum distributions from the plan, the spouse could take the distribution from the plan and roll it into the spouse's own IRA. In this way, the spouse could treat the IRA as his/her own and name a beneficiary whose life expectancy will be used to further defer distribution. Further, because the IRA would be treated as the spouse's rather than the taxpayer's, the spouse has the additional advantage over what would be the case if the money remained in the qualified plan of delaying distribution until the spouse attains age 70 ½ . Where the spouse is younger than the taxpayer, this technique may prove a substantial advantage.

On death, have older Beneficiaries Disclaim

The determination of a participant's designated beneficiary is made based upon the beneficiaries designated as of the date of the employee's date of death who remain designated as of September 30 of the calendar year following the calendar year of the employee's death. [Treas. Reg. §1.401(a)(9)-4, A-4(a)] If more than one designated beneficiary exists, the general rule is that the designated beneficiary is deemed to be, for purposes of calculating the required minimum distribution, the designated beneficiary with the shortest life expectancy, i.e, the oldest designated beneficiary.

If the oldest beneficiary does not need the funds, or other options exist, consider having the oldest beneficiary disclaim entitlement to any benefits before the applicable September 30.

Use Separate Accounts

As indicated above, if more than one designated beneficiary exists, the general rule is that the designated beneficiary is deemed to be, for purposes of calculating the required minimum distribution, the designated beneficiary with the shortest life expectancy. One way to avoid this result is by the use of separate accounts.

Specifically, if an employee's interest under a defined contribution plan is divided into separate accounts, the required minimum distribution rules separately apply to each separate account under the plan. While separate accounts can be established at any time, either before or after the employee's required beginning date, they are recognized for purposes of determining required minimum distributions only after the later of the year of the employee's death (whether before or after the required beginning date) and the year the separate accounts are established. However, the applicable distribution period is determined disregarding the other beneficiaries of the employee's benefit only if the separate account is established no later than the last day of the year following the calendar year of the employee's death. [Treas. Reg. §1.401(a)(9)-8, Q & A-2]

Separate accounts means separate portions of an employee's benefit reflecting the separate interests of an employee's beneficiaries under the plan as of the date of the employee's death. The separate accounting must allocate all post-death investment gains and losses, contributions, and forfeitures, for the period prior to the establishment of the separate accounts on a pro rata basis in a reasonable and consistent manner. However, once established, the separate accounts can provide separate investments for each separate account. [Treas. Reg. §1.401(a)(9)-8, Q & A-3]

Stretch the IRA

The current required minimum distributions rules allowing a beneficiary to take distribution basically over his/her lifetime allows an IRA to be stretched out over the maximum possible period to both allow for maximum tax deferred accumulation and reduction of taxes. For the individual who does not need the funds in an IRA for on-going living expenses, stretching the IRA can be a significant benefit.

> <u>Example</u>: Leslie has an IRA valued at $500,000. At age 70 ½. Leslie begins taking required minimum distribution based upon the Uniform Lifetime Table. The first year's required minimum distribution is $18,248. Similar distributions are made until Leslie's death. However, because the account has also continued to earn tax-deferred earnings, on death, Leslie's IRA is worth $590,000. Leslie's sole beneficiary is Leslie's grandchild Pat who is age 28. Pat can simply cash out the IRA and accept a significantly smaller inheritance or Pat can stretch out the IRA. If Pat accepts the stretch option, Pat must begin taking distributions in the year following the year of Leslie's death based upon Pat's own life expectancy.

The stretch option becomes even more valuable where the beginning IRA is a Roth IRA and therefore, no lifetime required minimum distributions are required to be taken.

VII. <u>Early Distributions Tax</u>

A. Generally

While the required minimum distribution rules are there to prevent individuals from using tax-deferred amounts for estate planning purposes rather than for retirement, the early distributions tax of Section 72(t) is in the Code in order to prevent individuals from receiving tax-preferred retirement income too early and for non-retirement purposes. As such, Code Section 72(t) generally imposes a 10% excise tax on retirement income includible in income which is paid before attainment of age 59 ½. [IRC Section 72(t)] The 10% excise tax is in addition to any taxes otherwise due and applies unless taxation is avoided by rolling the amount into another eligible tax-deferred vehicle such as an IRA.

Note that if a participant in a qualified plan does not elect a direct rollover, and thus, becomes subject to the 20% federal income tax withholding requirement, and then subsequently rolls over the distribution actually received within the 60 day rollover period, the 10% early distributions penalty will nevertheless apply with respect to the 20% withheld and not received if the participant is under age 59 ½. [Moon v. United States, 97-2 USTC ¶ 50,668 (Fed. Cl. 1997)]

B. Exceptions

Notwithstanding the general rule, the early distributions tax is subject to a number of exceptions, not all of them available to both qualified plans and IRAs and not all of them particularly useful.

1. Distributions made to a beneficiary (or to the estate of the employee) on or after the death of the employee;

2. Distributions attributable to the employee's being disabled as defined in Section 72(m)(7) (this means that the individual 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 be of long-continued and indefinite duration);

3. Distributions that are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life or life expectancy of the employee or the joint lives or joint life expectancies of the employee and the employee's designated beneficiary; in the case of a qualified plan, payments must begin after the employee separates from service;

4. Dividends paid with respect to stock of a corporation that are described in Section 404(k);

5. Distributions made on account of a levy under Section 6331 on the qualified retirement plan;

6. Distributions made to the employee (other than distributions described in one of the other exceptions) to the extent such distributions do not exceed the amount allowable as a deduction under Section 213 to the employee for amounts paid during the taxable year for medical care (determined without regard to whether the employee itemizes deductions for such year)

7. Distributions to qualified reservists called to active duty; in the case of a qualified plan, this exception is also available in the case of qualified plans, the provision applies with respect to elective deferrals.

Exceptions only available to Qualified Plans

8. Distributions made to an employee after separation from service after attaining age 55;

9. Payments to an alternate payee pursuant to a QDRO.

Exceptions only available to IRAs

10. Distributions to unemployed individuals for health insurance premiums;

11. Distributions for higher education expenses, and

12. Distributions for first home purchase

[IRC Section 72(t)(2)]

C. Age 55 Exception

Originally, this exception was only available where the participant's separation from employment was "on account of early retirement.” However, this requirement was subsequently removed by a Technical Corrections Act. As a result, a distribution made after the employee has separated from service for the employer maintaining the plan provided such separation from service occurred during or after the calendar year in which the employee attained age 55 will qualify for this exception. [Notice 87-13, 1987-1 CB 432, Q&A-20] This means that in order to take advantage of this exception, the employment termination must have occurred no earlier than the year the individual reached age 55.

Further, the legislative history indicates that the exception will continue to apply even if the individual returns to employment, for either the same or a different employer.[1986 Act Conf. Rep. at II-456; 1986 Act Blue Book] However, the Service will likely scrutinize situations where the employee returns to work to ensure that there was, in fact, a true separation from service.

D. QDRO Exception

A distribution made to an alternate payee is exempt from the early distributions excise tax, without regard to the age of the alternate payee, provided the distribution is made pursuant to a QDRO. [IRC Section 72(t)(2)(C)] A distribution made incident to a divorce, but not made pursuant to a QDRO, will not qualify for this exception.

This exception is only available in the case of amounts received from a qualified plan. This is because IRAs are not subject to the QDRO rules, since they are also not subject to the federal anti-alienation requirement. This means that if the receiving spouse rolls the proceeds into an IRA, distributions from that IRA would not then qualify for the exception from the 10 percent tax for payments made pursuant to a QDRO.

E. Substantially-Equal-Payments Exception

In order to qualify for this exception, payments from a qualified plan must begin after the employee separates from service.. [IRC Section 72(t)(3)(B)] Further, payments must be made in substantially equal periodic payments, at least annually, over the life or life expectancy of the employee or over the joint lives or joint life expectancies of the employee and the employee's designated beneficiary. [IRC Section 72(t)(2)(iv)]

The series of payments will be deemed to be substantially equal periodic payments if made in accordance with one of three alternative methods known as the required minimum distribution method, the fixed amortization method, and the fixed annuitization method.

Under the required minimum distribution method, payments will be treated as satisfying the substantially equal payment requirement if the annual payments are determined in a manner that would be acceptable for purposes of the required minimum distribution required under Section 401(a)(9). In making this calculation, the life expectancy tables to be used are either the single-life expectancy table in Treasury Regulation § 1.401(a)(9)-9, Q&A-1, the joint and last survivor table in Treasury Regulation § 1.401(a)(9)-9, Q&A-3, or the Uniform Lifetime table contained in those regulations and affixed to the revenue ruling. Whichever table is used initially must continue to be used in each following year. [Rev. Rul. 2002-62, § 2.01(a)].

Under the fixed amortization method, payments will be treated as satisfying the substantially equal payment requirement, if the amount to be distributed annually is determined by amortizing the participant's account balance over a number of years equal to the life expectancy of the account owner or the joint life and last survivor expectancy. The interest rate used for this purpose must not be more than 120 percent of the federal mid-term rate (determined in accordance with Section 1274(d) for either of the two months immediately preceding the month in which the distribution begins). [Rev. Rul. 2002-62, § 2.02(c)]. Again, the life expectancy tables to be used reflect the change in the tables under the new regulations issued under Section 401(a)(9). The account balance, the number from the chosen life expectancy table, and the resulting annual payment are determined once for the first distribution year, and the annual payment is the same amount in each succeeding year.

Under the final alternative, that is, the fixed annuitization method, the amount to be distributed annually is determined by dividing the participant's account balance by an annuity factor (the present value of an annuity of $1 per year beginning at the taxpayer's age attained in the first distribution year and continuing for the life of the taxpayer). The annuity factor is to be derived using the mortality table specified in Appendix B of Revenue Ruling 2002-62 and an interest rate determined in the same manner as specified for purposes of the fixed amortization method. [Rev. Rul. 2002-62, § 2.01(c)]

> Example : Assume that Chris is a participant in an individual account plan that operates on a calendar year. Chris would like to start receiving distributions starting in 2003. Chris will celebrate his fiftieth birthday in January 2003. Chris would like to begin receiving distributions, but avoid the 10 percent excise tax. Assume the following:
>
> The account balance as of December 31, 2002 (the relevant date), is $400,000. 120 percent of the federal mid-term rate for the appropriate month is 4.5 percent and, when applicable, this is the interest rate that will be used for calculations. Distributions will be over Chris' life only and, when applicable, single-life expectancy will be used for calculations.

After the issuance of its prior guidance in Notice 89-25, [Notice 89-25, 1989-1 C.B. 662]. the Service had made it clear in a series of private letter rulings that the substantially equal periodic payment exception was not incompatible with the use of annual recalculation. After the issuance of its most recent guidance on the exception in the form of Rev. Rul. 2002-62, [Rev. Rul. 2002-62, 2002-42 IRB 710] it was unclear whether annual recalculation would continue to be allowed without running afoul of the exceptions. However, in a series of private letter rulings, the Service has confirmed that, subject to satisfaction of certain requirements, the exception will not be lost as a result of the use of annual recalculation. [See Private Letter Rulings 200432021, 08/06/2004; 200432023, 08/06/2004; 200432024, 08/06/2004]

Required Minimum Distribution Method: For 2003, the annual distribution amount ($11,695.91) is calculated by dividing the account balance as of December 31, 2002 ($400,000), by the single-life expectancy (34.2) obtained from Q&A-1 of Treasury Regulation § 1.401(a)(9)-9 when age 50 is used ($400,000 ÷ 34.2 = $11,695.91). For subsequent years, the annual distribution amount is determined by dividing the account balance as of December 31 of the prior year by the single-life expectancy obtained from the same single-life expectancy table using the age attained.

Fixed Amortization Method: For 2003, the annual distribution amount is calculated by amortizing the account balance ($400,000) over a number of years equal to Chris' single-life expectancy (34.2) at a rate of interest equal to 4.5 percent. If an end-of-year payment is calculated, then the annual distribution amount in 2003 is $23,134.27. Once the annual distribution amount is calculated, the same amount will be distributed in subsequent years.

Fixed Annuitization Method: For 2003, the annual distribution is equal to the account balance ($400,000) divided by the cost of an annuity factor that would provide one dollar per year over Chris's life beginning at age 50 (that is, the actuarial present value of an annuity of one dollar per year payable for the life of a 50-year-old). The age 50 annuity factor (17.462) is calculated based on the mortality table in Appendix B of Revenue Ruling 2002-62 and an interest rate of 4.5 percent. The annual distribution amount is calculated as $400,000 ÷ 17.462 = $22,906.88. Once an annual distribution amount is calculated under this method, the same amount will be distributed in subsequent years. [See Internal Revenue Service, FAQs regarding Rev. Rul. 2002-62]

Revenue Ruling 2002-62 provides a one-time election pursuant to which a participant may switch methods from either the fixed amortization method or the fixed annuitization method to the required minimum distribution method. A change in method will usually result in significantly smaller payouts. Once the change is made, the required minimum distribution method must be followed in all subsequent years. Any subsequent change will be treated as a prohibited modification for purposes of Section 72(t)(4). [Rev. Rul. 2002-62, § 2.03(b)]

If, as a result of following one of the allowable methods, an individual's assets in a covered plan are depleted, the failure to continue receiving substantially equal periodic payments as a result of this depletion will not trigger the 10 percent excise tax, nor be treated as a modification in the series of payments. [Rev. Rul. 2002-62, § 2.03(a)]

With respect to the exception for substantially equal periodic payments, the rules contain a recapture provision. If the series of payments are modified after commencement (other than by reason of death or disability) and the modification occurs (1) before the close of the five-year period beginning with the date of the first payment and after the employee attains age 591/2 or (2) before the employee attains age 591/2, the taxpayer's tax for the first taxable year in which the modification occurs is increased by an amount equal to the tax that (but for the exception) would have been imposed plus interest for the deferral period. [IRC Section 72(t)(4)] Essentially, then, no modifications can occur until the later of the date the taxpayer reaches age 591/2, or the completion of five years of payments. "Deferral period" means the period beginning with the taxable year in which (without regard to the exception) the distribution would have been includable in gross income and ending with the taxable year in which the modification occurs.

> Example : Chris begins receiving payments under the substantially-equal-payments exception at age 50. Chris elects, at age 58, to receive the remaining amount in a lump sum. Because Chris has modified the series of payments and has not reached age 591/2, the recapture tax applies.

> Example : Chris begins receiving payments at age 56 and changes the method of distribution prior to age 61. Again, the recapture tax would apply, since Chris has modified the election prior to the close of the five-year minimum period.

F. TEFRA § 242(b)(2) Elections

The early distributions tax also does not apply in the case of a distribution made pursuant to a TEFRA § 242(b)(2) election. [HR 841, 99th Cong., 2d Sess. II-457 (1986)] The TEFRA election allowed participants to elect, prior to January 1, 1984, that their benefits be distributed in accordance with provisions that complied with the pre-TEFRA rules even after the enactment of TEFRA.

G. Disability Exception

The penalty does not apply in the case of a distribution that is attributable to the participant's being disabled as defined in Section 72(m)(7). The tax court has provided some insight on what constitutes disability, for this purpose, in a case heard pursuant to Section 7463 and therefore, lacking precedential value. While the case cannot be cited as precedent, it provides insight to taxpayers as to how a court might apply the definition.

In Coleman-Stephens v. Commissioner, [Coleman-Stephens v. Comm'r, TC Summ. Op. 2003-91 (2003)}] the court noted that the regulations provide that an individual is considered disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. The court noted that the taxpayer was unable to continue in her employment, despite an attempt to return to a comparable position. As such, the court concluded that she was unable to engage in any substantial gainful activity. Despite the Service's arguments to the contrary, the court also concluded that the taxpayer's disability was of indefinite duration because the evidence supported an inability to predict when, if ever, she would be able to return to work.

H. Distributions from an IRA for Health Insurance Premiums

Distributions from an individual retirement plan to an individual after separation from employment will not be subject to the 10% excise tax if the individual has received unemployment compensation for 12 consecutive weeks under a Federal or State unemployment compensation law by reason of the separation. Further, the distributions must be made during a taxable year during which such unemployment compensation is paid or the succeeding taxable year. Further, the distributions must not exceed the amount paid during the taxable year for insurance described in Section 213(d)(1)(D) with respect to the individual and the individual's spouse and dependents (as defined in Section 152, determined without regard to subsections (b)(1), (b)(2) and (d)(1)(B) thereof). The exception does not apply to any distribution made after the individual has been employed for at least 60 days after the original separation from employment. [IRC Section 72(t)(2)(D)]

I. Higher Education Expenses

The 10% excise tax does not apply to certain payments from an IRA for higher education expenses. The exception is available provided that the distributions do not exceed the qualified higher education expenses of the taxpayer for the taxable year. [IRC Section 72(t)(2)(F)]

The term "qualified higher education expenses" means qualified higher education expenses (as defined in Section 529(e)(3)) for education furnished to: (1) the taxpayer, (2) the taxpayer's spouse, or (3) any child (as defined in Section 152(f)(1)) or grandchild of the taxpayer or the taxpayer's spouse, at an eligible educational institution (as defined in Section 529(e)(5)).

The amount of any qualified higher education expenses for any taxable year are to be reduced as provided in Section 25A(g)(2).

[IRC Section 72(t)(7)]

J. First Time Home Purchase

Distributions from an IRA which are qualified first-time homebuyer distributions are not subject to the early distributions excise tax. [IRC Section 72(t)(F)]

The term "qualified first-time homebuyer distribution" means any payment or distribution received by an individual to the extent such payment or distribution is used by the individual before the close of the 120th day after the day on which the payment or distribution is received to pay qualified acquisition costs with respect to a principal residence of a first-time homebuyer who is the individual, the spouse of such individual, or any child, grandchild, or ancestor of such individual or the individual's spouse.

"Qualified acquisition cost" means the costs of acquiring, constructing, or reconstructing a residence. The term includes any usual or reasonable settlement, financing, or other closing costs.

For purposes of this exception, the term “first-time homebuyer” means any individual if:

(1) such individual (and if married, such individual’s spouse) had no present ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which this provision applies, and

(2) subsection (h) or (k) of subsection 1034 (as in effect on the day before the date of the enactment of this provision) did not suspend the running of any period of time specified in Section 1034 (as so in effect) with respect to such individual on the day before the date the distribution is applied.

Date of acquisition means the date on which a binding contract to acquire a principal residence is entered into, or on which construction or reconstruction of such a principal residence is commenced.

[IRC Section 72(t)(8)]

EXHIBITS

The attached two Exhibits are Reprinted with permission from: Qualified Plans: Forms, Notices, and Supplementary Materials, by Pamela D. Perdue, (ALI-ABA, publisher) © 2007; www.ali-aba.org/BK48.

The Exhibits are as follows:

Exhibit A	Sample IRA Collateral Pledge Agreement
Exhibit B	Rollover Chart

EXHIBIT A

IRA RESTRICTED ACCOUNT AND
PLAN REPAYMENT AGREEMENT

This IRA Restricted Account and Plan Repayment Agreement ("Agreement") is entered into this ____ day of ___________, 20__ by and among ________________("Participant"), The XYZ National Bank ("Custodian"), the ABC Defined Benefit Pension Plan and Trust ("Pension Plan") and the ABC Company ("ABC").

W I T N E S S E T H:

WHEREAS, _______________ ("Participant") is a participant in the Pension Plan and is entitled to receive, and has elected to receive a distribution of his/her entire vested benefit under the Pension Plan, and

WHEREAS, the Participant is also a highly compensated employee, as defined for purposes of Section 414(q) of the Internal Revenue Code as well as one of highest paid 25 such highly compensated employees and is therefore a "Restricted Employee," as that term is defined for purposes of Treasury Regulation Section 1.401(a)(4)-5(b)(3)(ii), with respect to the Pension Plan, and

WHEREAS, Participant has elected to receive a lump sum distribution of his vested benefit under the Pension Plan and the Plan Administrator of the Pension Plan has approved payment of such, subject to satisfaction of the conditions and terms set forth herein, and

WHEREAS, one such condition requires that, in order for the Participant as a Restricted Employee to receive a distribution from the Pension Plan in excess of the limits of Treas. Reg. Section 1.401(a)(4)-5(b)(3)(i), prior to receipt or deemed receipt of a distribution from the Pension Plan, the Participant must enter into a written agreement with the Pension Plan to secure the repayment to the Pension Plan of any amount received which is determined to be necessary for the distribution of assets on plan termination to satisfy the nondiscrimination requirements of Section 401(a)(4) of the Internal Revenue Code, (the "Restricted Amount"), and

WHEREAS, the benefit to be received by the Participant from the Pension Plan may be insufficient to satisfy the required security necessary under this Agreement to secure the repayment to the Pension Plan of the Restricted Amount but whereas the Participant is also a participant in the ABC 401(k) Plan and Trust ("401(k) Plan") and is also entitled to receive a distribution, in one lump sum payment, of his/her entire vested account under the Section 401(k) Plan, and

WHEREAS, pursuant to the provisions of said Section ____ of the Pension Plan and Treasury Regulation Section 1.401(a)(4)-5(b), the Participant may become liable to the Pension Plan for a sum equal to the Restricted Amount, as determined by the Plan's actuary and to this end, the Participant has agreed to secure the performance of his obligations under this Agreement by pledging to the Pension Plan said amount and securing that pledge in accordance with this Agreement.

NOW THEREFORE, in consideration of the foregoing and the mutual covenants and conditions contained herein, the receipt and sufficiency of which is hereby acknowledged, it is hereby agreed among the parties as follows:

1. The Participant hereby agrees to repay to the Pension Plan the Restricted Amount in the event that the Pension Plan should terminate and repayment becomes necessary to satisfy the nondiscrimination requirements of Internal Revenue Code Section 401(a)(4). The Restricted Amount shall mean the excess of the accumulated amount of distributions made to the Participant over the accumulated amount of the Participant's nonrestricted limit. The Participant's nonrestricted limit means the payments that could have been distributed to the Participant, commencing when distribution commenced to the Participant, had the Participant received payments in the form described in Treasury Regulation Section 1.401(a)(4)-5(b)(3)(i)(A) and (B). The term "accumulated amount" means the amount of a payment increased by a reasonable amount of interest from the date the payment was made (or would have been made) until the date for the determination of the Restricted Amount. Absent manifest errors, the actuary's determination of all such amounts shall be binding and conclusive on all parties to this Agreement and those claiming under them.

2. The Custodian agrees to maintain an IRA in the name of the Participant and to invest the assets, for bookkeeping purposes, in two separate portions: the first to consist of those assets listed on Exhibit A constituting the assets pledged as security to the Pension Plan by the Participant (i.e., 125% of the Restricted Amount and sometimes referred to herein as the restricted portion) and the second consisting of all other assets of the IRA (i.e., the unrestricted portion).

3. All references to sections of the Internal Revenue Code and to other published guidance shall be interpreted to include as well any additional or substitute provisions adopted thereunder.

4. In order to secure the obligations set forth above in compliance with Section ____ of the Pension Plan and in accordance with both Treasury Regulation Section 1.401(a)(4)-5(b)(3) and Revenue Procedure 92-76, the Participant hereby agrees as follows:

(a) Participant hereby agrees to roll over his/her entire lump sum distribution from the Pension Plan into an Individual Retirement Account ("IRA") to be held by the Custodian.

(b) Participant agrees to the repayment from the IRA to the Pension Plan of the Restricted Amount, as then determined by the Plan's actuary, in the event that the Plan Administrator of the Pension Plan shall determine that such repayment is necessary for the distribution of assets on termination of such plan in order to satisfy the requirements of Section 401(a)(4) of the Internal Revenue Code or is otherwise necessary to satisfy any applicable requirement of the Internal Revenue Code.

(c) Participant hereby pledges, as security to the Pension Plan in order to secure the repayment, assets equal to 125% of the Restricted Amount, said assets to consist of the Participant's distribution from the Pension Plan to be rolled into the IRA and, to the extent necessary, all or a portion of the Participant's distribution from the Section 401(k) Plan also to be rolled into the IRA maintained with the Custodian sufficient to satisfy the 125% requirement.

(d) The amount of the security, i.e., 125% of the Restricted Amount, shall not be distributable to the Participant, or to anyone whose interest arises under the Participant, except upon written certification, authorization and direction of the Plan Administrator of the Pension Plan to the Custodian. The Pension Plan shall provide to the Custodian copies of such documents as it shall reasonably and in good faith require in order to verify the proper Plan Administrator of the Plan and shall keep the Custodian advised as to any changes in the position of Plan Administrator.

(e) In the event that, during the term of this Agreement, the value of the pledged assets securing the repayment, determined on a fair market basis, shall drop below 110% of the Restricted Amount, this Agreement shall automatically be extended to such other assets of the IRA sufficient to increase the value of the pledged assets to 125% and the Agreement shall have the same force and effect with respect to said additional assets as if they were originally the subject of this Agreement. In the event, however, that insufficient assets then remain in the IRA to increase the value of the assets to 125%, the Participant hereby agrees to cause so much of his/her distribution from the 401(k) Plan to be deposited into the IRA so that the amount of the Restricted portion of the IRA held by the Custodian shall equal at least 125% of the Restricted Amount. In the event that the Participant shall fail at anytime to timely satisfy this security requirement, this Agreement shall be deemed terminated and the Plan Administrator shall certify, authorize and direct the Custodian to repay to the Pension Plan the Restricted Amount.

(f) In order to ensure that sufficient assets remain available to the Pension Plan at all times to ensure compliance with this Agreement, the Participant shall notify the Plan Administrator of the Pension Plan, in writing, no later than 10 days prior to any withdrawal from the IRA which would decrease the value of the assets in the IRA, taking into account both assets in the restricted as well as the unrestricted portion, below 150% of the Restricted Amount.

(g) In the event that required minimum distribution payments should be required to be distributed from the IRA while this Agreement remains in force and effect, distribution shall be made first from the unrestricted portion of the IRA and, only after the unrestricted portion is fully exhausted, from the restricted portion. If, however, required minimum distribution payments cause the fair market value of the restricted portion of the IRA to fall below 110% of the Restricted Amount, the Participant, or his/her beneficiaries, as applicable, shall cause additional amounts to be deposited into the IRA to bring the aggregate fair market value of the restricted portion to 125% of the Restricted Amount. In the event that the Participant, or the Participant's beneficiaries, shall fail at any time to timely satisfy this security requirement, this Agreement shall be deemed terminated and the Plan Administrator shall certify, authorize and direct the Custodian to repay to the Pension Plan the Restricted Amount.

(h) With respect to that portion of the IRA consisting of assets in excess of 125% of the Restricted Amount, if any, the Participant shall have full and unrestricted access to such amounts subject, however, to the requirement to notify the Plan Administrator of the Pension Plan at least 10 days prior to any withdrawal that would leave less than 150% of the Restricted Amount in the IRA.

4. The Custodian hereby agrees that in the event that it shall be notified, in writing, by the Plan Administrator of the Pension Plan, that said Pension Plan is terminating and that pledged assets are necessary for the distribution of assets on plan termination, or that the Agreement is to be treated as terminated or null and void, the Custodian shall promptly pay to the Plan a sum equal to the Restricted Amount, as determined by the Pension Plan's actuary. In such case, the Plan Administrator of the Pension Plan shall submit a written statement to the Custodian of all such sums due to the Pension Plan. The Custodian may conclusively rely upon the accuracy of the statement signed by the Plan Administrator of the Pension Plan and shall have no affirmative duty to investigate the accuracy of said amounts.

5. The Custodian agrees to release the restricted portion of the IRA only in accordance with written directions signed by the Plan Administrator of the Pension Plan. Provided, however, on each ________________until the termination of this Agreement, amounts in excess of 125% of the Restricted Amount, as required to be held as security, shall be transferred from the restricted portion to the unrestricted portion of the IRA.

6. In the event the Plan Administrator notifies the Custodian in writing that the Pension Plan is terminating prior to satisfaction of a condition that would allow termination of this Agreement (as set forth in Treasury Regulation Section 1.401(a)(4)-5(b)), or that this Agreement is terminated or to be treated as null and void, then, upon written declaration and demand of the Plan Administrator delivered to the Custodian, the Custodian shall immediately endorse, negotiate or take such other steps as shall be necessary to immediately pay the amount of the claim, as set forth in the Notice, directly to the Pension Plan.

7. Notwithstanding the fact that some of the assets are restricted as provided herein, the entire value of the lump sum distribution, as and when rolled over to the IRA, shall be reflected for all federal and state, and if applicable, local tax purposes as if the Participant received the distribution, unrestricted, so that the Participant shall be solely responsible for any and all federal, state or local income taxes attributable to said distribution.

8. If for any reason, the Custodian pays any part or all of any claim of the Pension Plan directly or indirectly to the Pension Plan, the parties hereto agree that in no event shall the Custodian be liable to any party to this Agreement for such action or for any payment made to the Pension Plan in good faith. The Participant and ABC Company agree to indemnify and hold harmless the Custodian and its successors, assigns, representatives, agents, employees, officers and directors from and against any claims, liabilities or causes of action, including without limitation, the expenses in connection therewith, including reasonable attorneys' fees, arising under this Agreement, other than claims against the Custodian due to the Custodian's willful or negligent failure to perform.

9. In the event of the Participant's death while this Agreement remains in force and effect, the Custodian shall nevertheless continue to hold the funds constituting the IRA for the benefit of the beneficiary designated by the Participant under the same terms and conditions set forth in this Agreement.

10. The release of the security pledged under this Agreement by the Custodian shall be made only upon receipt of a written certification from the Plan Administrator of the Pension Plan, who, for this purpose, must be other than the Participant, that: (a) the Pension Plan has not been terminated, (b) one of the conditions under the law allowing for the release of this claim has been fully and completely satisfied, and (c) the Participant is no longer obligated to repay any amount to be released.

11. In the event that Congress should provide by statute, or the Treasury Department or the Internal Revenue Service should provide by regulation or ruling, or similar publication of general pronouncement and public guidance, that the limitations provided for in Section _____of the Plan and in Treasury Regulation Section 1.401(a)(4)-5(b) are no longer necessary in order for the Pension Plan to meet the requirements of a qualified defined benefit pension plan under the then Internal Revenue Code, this Agreement shall terminate and be of no further force or effect. In such case, the Plan Administrator shall so advise the Custodian in writing.

12. This Agreement shall inure to the benefit of and be binding upon the heirs, successors, assigns, representatives, executors and/or successor in interest of the parties hereto.

13. Any notice, offer or demand required or permitted to be given under this Agreement by one party to another may be made or given either by delivering the same to such other party personally, or by mailing the same by United States mail, certified, postage prepaid, return receipt requested, to such other party at the following addresses:

Custodian ____________________________
____
____

Participant ____________________________
____
____

Plan ____________________________
____
____
____

copy to:__________________, Esq.
____
____
____

Plan Sponsor ____________________________
____
____

or to such other address as any party hereto may later designate, notice of which is to be given in the manner provided hereinabove.

14. This Agreement, to the extent not governed exclusively by federal law, shall be construed in accordance with the laws of the State of ____________________, without regard, however, to any of its conflict of laws that might require resolution under any other state's laws.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed by their duly appointed representatives.

____
Participant

The ABC Defined Benefit Pension Plan
by__________________________
Administrator

THE XYZ NATIONAL BANK
by____________________________
Print Name:__________________
Title:________________________

ACCEPTED AND AGREED

____
Participant's Spouse

THE ABC COMPANY
by____________________________
Print Name:__________________
Title:_________________