

LUMP SUM DISTRIBUTIONS UNDER THE TAX REFORM ACT OF 1976

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The revision of Internal Revenue Code section 2039¹ by the Tax Reform Act of 1976² expanded the sources from which distributions may qualify for estate tax exclusion; at the same time, it circumscribed the form of distribution that will be excluded.³ The resulting trade-off between income and estate tax benefits complicates the already difficult process of selecting among distribution options from a qualified pension plan.⁴ Because it is almost impossible to anticipate the optimum choice at the time an estate or pension plan is drafted, especially in the case of a pension plan where the document must accommodate a variety of interests, the planner must focus seriously on the problem of whom to designate as the ultimate decision-maker. Fiduciary liability under the Employee Retirement Income Security Act of 1974 (ERISA)⁵ and ambiguities in the language of section 2039, in the absence of regulations, intensify the complexities.

This article attempts to respond in a practical way to these issues. Part I describes the amendment to section 2039; Part II analyzes some of the competing interpretations of when the estate tax exclusion is available; Part III outlines the relative merits of lump sum distributions and other payment options; and Part IV offers and assesses some tentative approaches to immediate estate and pension planning problems.

I. THE AMENDMENT TO SECTION 2039

A. Eligible Distribution Sources

The amendments to section 2039 have expanded the distribution sources eligible for estate tax exclusion. Under section 2039(c), *Exemption of Annuities Under Certain Trusts and Plans*, amounts paid to a beneficiary other than the decedent's executor from specified retirement plans or programs are excludible from the decedent's estate in the proportion that contribu-

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¹ All references, unless otherwise identified, shall be to the Internal Revenue Code of 1954, as amended.

² Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 455.

³ As a general rule, survivor annuities are includible in the gross estate of the decedent. Section 2039(c) and (b) require the inclusion in the gross estate of the value of any annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement (other than insurance) if, under such contract or agreement (1) an annuity or other payment was payable to the decedent, or (2) the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period which cannot be ascertained without reference to his death or for any period which does not in fact end before his death. See S. SURREY, W. WARREN, P. MCDANIEL & H. GUTMAN, *FEDERAL WEALTH TRANSFER TAXATION* 442-43 (1977). Although I.R.C. § 2039 applies both to survivor annuities payable as an employee death benefit and to annuities that are not employment related, cases most often involve employment situations. *Id.*

⁴ "Qualified pension plan" or simply, "qualified plan" shall mean any plan or program from which distributions are, in appropriate circumstances, excludible under I.R.C. § 2039(c). Any account, annuity, or bond covered by I.R.C. § 2039(e) shall be referred to merely as an "IRA."

⁵ 29 U.S.C. §§ 1001 *et seq.* (Supp. IV 1974).

tions to the plan or program came from the employer. Prior to amendment, the exclusion was specifically denied to contributions on behalf of the self-employed, since the employer, for purposes of section 2039(c), was also the employee. The Tax Reform Act extends the exclusion to certain distributions from Keogh plans⁶ and, by adding new section 2039(e), from individual retirement accounts and individual retirement annuities.⁷ Except in the case of IRAs, the exclusion is still not available to payments or contributions under such programs made by or deemed to have been made by the decedent. However, for the first time, employer contributions to Keogh plans are deemed not to have been made by the decedent and therefore are afforded the exclusion.

B. Eligible Distribution Types

In addition to expanding the sources of distribution eligible for estate tax exclusion, the amended statute also eliminates the exclusion in all cases in which the otherwise qualifying distribution is receivable as a lump sum distribution. Specifically, section 2039(c) now provides that notwithstanding any other provision of law, for estates of decedents dying after December 31, 1976,

there shall be excluded from the gross estate the value of an annuity or other payment (*other than a lump sum distribution described*

⁶ Keogh plans, also known as H.R. 10 plans, are private pension or profit sharing plans established by an unincorporated proprietorship or partnership to cover its employees, including the self-employed proprietor or partner. Prior to the revision made by section 2009(c)(2) of the Tax Reform Act, I.R.C. § 2039(c) provided: "For purposes of this subsection, contributions or payments on behalf of the decedent while he was an employee within the meaning of section 401(c)(1) made under a trust or plan described in paragraph (1) or (2) shall be considered to be contributions or payments made by the decedent." The revised section substitutes the following sentence:

For purposes of this subsection, contribution or payments on behalf of the decedent while he was an employee within the meaning of section 401(c)(1) made under a trust or plan described in paragraph (1) or (2) shall to the extent allowable as a deduction under section 404, be considered to be made by a person other than the decedent and, to the extent not so allowable, shall be considered to be made by the decedent.

⁷ IRAs, see note 4 *supra*, are created with the tax-deductible contributions of an individual who receives compensation but who is not an "active participant" in his or her employer's plan. I.R.C. §§ 219, 408(a), 408(b), and 409. Under I.R.C. § 220, a so-called "spousal IRA" may be set up for or by such an employee's spouse, even though such spouse receives no compensation from an employer. "Rollover IRAs" are tax-free transfers of otherwise taxable distributions from certain qualified plans and other IRAs; they are governed by the provisions of I.R.C. §§ 402(a)(5) and (6), and 403(a)(4) and (5).

Section 2009(c)(1) of the Tax Reform Act added section 2039(e) to the Code. This provision provides an exclusion of the value of "an annuity receivable by any beneficiary (other than the executor) under (1) an individual retirement account described in section 408(a), (2) an individual retirement annuity described in section 408(b) or (3) a retirement bond described in section 409(a)."

Except in the case of rollover amounts, the subsection (e) exclusion extends only to amounts allowed under I.R.C. § 219 as a deduction for retirement savings.

Section 3(j)(i) and 3(a) of the Technical Corrections Bill, H.R. 6715, 95th Cong., 1st Sess. (1977), if enacted, would provide that annuities paid from spousal IRAs also may qualify for the estate tax exclusion.

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in section 402(e)(4), determined without regard to the next to the last sentence of section 402(e)(4)(A))⁸ receivable by any beneficiary (other than the executor) under

a section 401(a) trust (or contract purchased by such trust), a section 403(a) annuity plan, a section 403(b) plan, or the government-sponsored "Retired Servicemen's Family Protection Plan."⁹

To be excludible under section 2039(e) however, payments must take the form of an annuity, specifically defined for purposes of such subsection in the last sentence thereof as "an annuity contract or other arrangement providing for a series of substantially equal periodic payments to be made to the beneficiary (other than the executor) for his life or over a period extending for at least 36 months after the date of the decedent's death."

Notably, the subsection (e) definition of "annuity" differs from the pre-amendment description of an annuity. Pursuant to the regulations under section 2039, an annuity included any distribution that was not a single sum, whether paid within one taxable year or otherwise, *viz.*, "one or more payments, extending over any period of time. The payments may be equal or unequal, conditional or unconditional, periodic or sporadic."¹⁰ To be sure, if this definition still obtained for section 2039(e) purposes, the available distribution options under a subsection (e) annuity would be greater than those available under a subsection (c) lump sum distribution from a qualified plan. Some adjustment to accommodate the difference was therefore needed. No explanation, however, has been given as to why the payment structures applicable to subsection (e) are less liberal than are those in subsection (c). Perhaps new regulations will clarify the extent of the applicability of the new definition, and explain its purpose.

II. AVAILABILITY OF THE EXCLUSION

A. *Tax Benefit Theory or Liquidity Theory*

Putting aside for the moment a discussion of when the exclusion ought to be chosen and disregarding the question of who should be assigned the responsibility of electing the payment option under a qualified plan, consideration must be given to whether the mere payment as a lump

⁸ Emphasis supplied to indicate the words added by section 2009(c)(3) of the Tax Reform Act.

⁹ Paragraphs (1), (2), (3), and (4) of I.R.C. § 2039(c) read:

- (1) An employees' trust (or under a contract purchased by an employees' trust) forming part of a pension, stock bonus, or profit-sharing plan which, at the time of the decedent's separation from employment (whether by death or otherwise), or at the time of termination of the plan if earlier, met the requirements of section 401(a);
 - (2) A retirement annuity contract purchased by an employer (and not by an employees' trust) pursuant to a plan which, at the time of decedent's separation from employment (by death or otherwise), or at the time of termination of the plan if earlier, was a plan described in section 403(a);
 - (3) A retirement annuity contract purchased for an employee by an employer which is an organization referred to in section 170(b) (1)(A)(ii) or (vi), or which is a religious organization (other than a trust), and which is exempt from tax under section 501(a); or
- (4) Chapter 73 of title 10 of the United States Code.

¹⁰ Treas. Reg. §20.2039-1(b), T.D. 7416, 41 F.R. 14514 (1976).

sum automatically precludes the estate tax exclusion, or whether the exclusion remains available in the absence of an affirmative election—pursuant to section 402(e)(4)(B)¹¹—to apply the separate income tax made applicable to a portion of a lump sum distribution by section 402(e)(1).

The cause of the controversy is the language that extends the exclusion to distributions "other than a lump sum distribution described in section 402(e)(4)." This would seem to require that the (e)(4)(B) election must be made before the exclusion is lost, despite quasi-official statements discussed below indicating that the purpose of the exclusion was to relieve illiquid estates. The ambiguity is unresolved as of this writing.

The actual "description" of a lump sum distribution appears in section 402(e)(4)(A), which provides that the term "lump sum distribution" from plans that "qualify" under section 401(a) or 403(a) means "the distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient" in specified circumstances.¹²

Although perhaps only the foregoing description was considered by Congress, the reference in 2039(c) is, nevertheless, to "(e)(4)" as a whole, and technically, the (e)(4)(B) election is encompassed. This inclusion may have been intentional, in light of the fact that although a modifying phrase appears in section 2039(c) with respect to disregarding the next to the last sentence of section 402(e)(4)(A), no such qualifier was added in respect of (e)(4)(B). Further, there is no such thing as a "lump sum distribution described in section 402(e)(4)" in respect of distributions cited in paragraphs (3) and (4) of section 2039(c). Thus, for example, a distribution under a conventional section 403(b) contract will qualify for the section 2039(c) exclusion even if a single sum is paid. However, although gearing the exclusion to income tax treatment is consistent with the proposition that only payments that receive income tax benefits should be made to sacrifice the estate tax exclusion, it is inconsistent with the congressional report¹³ and

¹¹ I.R.C. § 402(e)(4)(B) provides, in pertinent part, that, except for an annuity contract, no amount may be treated as a lump sum distribution under subparagraph (A) "unless the taxpayer elects for the taxable year to have all such amounts received during such year so treated . . ." After the annuitant attains age 59 ½ only one such election may be made. The consequences flowing from this rule are discussed in Cook & Adkins, *Some Considerations in the Impact of ERISA on Estate Planning*, T.M.C.J. 76-11 (November 1976) [hereinafter Cook & Adkins]. It should be remembered that a self-employed individual who does not make an election under (e)(4)(B) cannot receive for income tax purposes capital gains treatment for any portion of the distribution, whereas for other individuals, such treatment is, in appropriate circumstances, automatic, unless under I.R.C. § 402(e)(4)(L) the individual makes an election to treat the entire distribution as ordinary income.

¹² Specifically, those circumstances are:

(i) on account of the employee's death, (ii) after the employee attains age 59½, (iii) on account of the employee's separation from service [but only if he or she is not self-employed within the meaning of section 401(c)(1)], or (iv) after the employee has become disabled [but only if he or she is self-employed].

I.R.C. § 402(e)(4)(A). The explanation of clauses (iii) and (iv) contains greater detail than need be reproduced here; instead, emphasis has been supplied to indicate the applicability of the clauses.

It should be noted, however, that section 402(e)(4)(H), which requires five years of service for the lump sum rules to apply, pertains to employees but not to their beneficiaries.

¹³ H.R. REP. NO. 95-1515, 94th Cong., 2d Sess. 624-25, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 4118, 4262-63 [hereinafter H. REP.].

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the General Explanation of the Act, issued after the Act was published,¹⁴ both of which suggest that the exclusion was offered because annuitants, as opposed to single sum recipients, would lack the wherewithal to pay estate tax.¹⁵ The congressional report in discussing the availability of the exclusion to distributions from an individual retirement account, states that "[g]enerally, the exclusion is to be available in situations where a liquidity problem might exist because the schedule of payments to be made from the account will not provide current funds to pay the estate tax."¹⁶

The General Explanation stated under the heading, "Reasons for Change":

The Congress, however believed that it is no longer appropriate to continue the estate tax exclusion with respect to amounts payable in a single lump sum under a retirement plan. Benefits paid in a lump sum will normally generate sufficient cash to cover the estate tax liability attributable to the inclusion of the benefits in the decedent's gross estate.¹⁷

The position manifested by Internal Revenue Service rulings does not lend support to this position. Specifically, the Service's view that the estate tax exclusion is lost where a binding duty exists to use plan proceeds for estate obligations can result in the paradoxical imposition of an estate tax on estates only when they lack liquidity.¹⁸

All things considered, unless and until the regulations are issued which implement congressional intent, it would seem that the estate tax exclusion under section 2039(c) remains available for all distributions meeting the (e)(4)(A) criteria, provided there is no (e)(4)(B) election.

B. The Word "Receivable": Problems of Constructive Receipt

Another troubling aspect of the amended section 2039 is the word "receivable" and whether it has assumed a new significance in light of the amendment's insertion before it of the parenthetical "(other than a lump sum distribution)." Prior to the amendment, the word appeared in subsection (c) almost exactly as it does now in subsection (e); subsection (c) provided that "there shall be excluded from the gross estate the value of an annuity or other payment receivable by any beneficiary (other than the executor) under . . ." specified types of qualified plans. The word's function was 1) to introduce the issue of the kind of plan under which the distribution was made, 2) to raise the question of whether the beneficiary or the decedent was the true recipient, and 3) to raise the question of whether the beneficiary was, or should be considered to be, the executor.

¹⁴ Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976*, 592-93 (1976), reprinted in 76-2 C.B. 1, 604-05 [hereinafter *General Explanation*]. The General Explanation was not received by the tax committees and represents only the staff's view of congressional intent. The Chief of Staff at the time was the late Lawrence N. Woodworth, who at the time of his death in December, 1977 was Assistant Secretary of the Treasury for Tax Policy.

¹⁵ This view, of course, assumes that the beneficiary is liable for the estate tax.

¹⁶ H. REP., *supra* note 13, at 624, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 4118, 4262. This language was carried over to the *General Explanation*, *supra* note 14, at 594, reprinted in 76-2 C.B. 1, 606.

¹⁷ *General Explanation*, *supra* note 14, at 593, reprinted in 76-2 C.B. 1, 605.

¹⁸ See text at notes 26-28 *infra*.

The insertion by the Tax Reform Act, immediately prior to the word "receivable," of the parenthetical, "(other than a lump sum distribution)," raises additional questions regarding the word's interpretation in cases where the governing instrument of the plan does not preclude receipt of a lump sum. Is the exclusion automatically lost when a lump sum distribution may be elected by a plan fiduciary? By the participant? By a beneficiary? Is the exclusion under subsection (c) automatically lost when the *income tax treatment* of a lump sum distribution may be elected?

The original three functions of "receivable" have been the subjects of considerable law. Under Regulation §20.2039-2, issued prior to the amendment, examples (1) through (3) deal with identifying the distribution as one from a qualified plan as contemplated by the statute, and example (5) explains the applicability of section 2039(c) to section 403(b) plans. A critical problem concerns when payment is receivable under a "contract purchased by an employees' trust." The Tax Court has held that because an annuity contract contained settlement options that were not in the plan, once the contract was assigned to a retiree, it was no longer a "contract purchased by an employees' trust" within the meaning of that term as used in section 2039(c).¹⁹ One of the concurring judges in this case relied instead on the doctrine of constructive receipt, characterizing the proceeds as "a mere savings arrangement, under which the cash surrender value of his retirement contracts was held for him at interest."²⁰

Example (4) of Regulation § 20.2039-2 illustrates constructive receipt, but again, only in a pre-amendment context, that of whether the amount was receivable by the beneficiary or by the decedent. Under that example, the decedent could have elected a lump sum at retirement but preferred an arrangement under which he was paid interest only and his beneficiary received the principal. The example determines that the proceeds were not receivable by the beneficiary under a qualified plan, because the decedent, through his ability to receive the sum, already had constructively received it.

Similar situations have arisen under section 402, when a death has intervened between a plan termination or other event triggering a distribution, and actual distribution. Although the development of the law of constructive receipt under sections 402 and 403 is beyond the scope of this discussion, it is nevertheless interesting to observe that a new context in which constructive receipt questions are likely to arise is that in which a plan participant dies during the period in which the Pension Benefit Guaranty Corporation is considering a request to approve a distribution because of termination of the plan.

¹⁹ Estate of Max Silverman v. Commissioner, 61 T.C. 605, 617-18 (1974).

²⁰ *Id.* at 624 (Hall, J., concurring). The problem of "constructive receipt" in the estate tax area develops from the requirements of section 2039(c) and section 2039(e) that the annuity receivable by a beneficiary be acquired under a qualified retirement plan. If the individual covered by the plan has constructively received the plan benefits, then the beneficiary receives the benefits not under the plan as required by section 2039(c), but directly from the plan participant. Estate of Brooks v. Commissioner, 50 T.C. 585 (1968). However, because the constructive receipt doctrine was primarily developed in an income tax context, *see, e.g.,* Corliss v. Bowers, 281 U.S. 376 (1930), its applicability for purposes of section 2039(c) and (e) is not yet settled. S. SURREY, W. WARREN, P. McDANIEL & H. GUTMAN, FEDERAL WEALTH TRANSFER TAXATION 465-67 (1977).

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With respect to the pre-amendment issue of when a benefit that is not directly payable to an estate is nonetheless considered receivable by the executor, answers have been emerging on a piece-meal basis.²¹ As a starting point, the rules set forth in Regulation § 20.2042-1(b), made applicable by Regulation § 20.2039-2(b) to distributions under a qualified plan, provide, in pertinent part:

If . . . the proceeds are receivable by another beneficiary but are subject to an obligation, legally binding on the other beneficiary, to pay taxes, debts, or other charges enforceable against the estate, then the amount of such proceeds required for the payment in full (to the extent of the beneficiary's obligation) of such taxes, debts, or other charges is includible in the gross estate.

A 1973 Revenue Ruling decided that the exclusion was not lost if the testamentary trustee was prohibited by the decedent's will from using plan distributions for the estate's benefit.²² The ruling endorsed a position established earlier that year in *Korslin v. United States*.²³ There, constructive receipt was alleged because the decedent's trustee, who was the recipient of plan proceeds, was empowered under the trust to satisfy a premarital agreement. However, state law prohibited plan proceeds from being spent for such obligations,²⁴ and they were not so used.²⁵

In a 1975 case, the Tax Court considered facts involving a plan distribution to an inter vivos trust.²⁶ The decedent's will provided that certain stock should not be sold by the estate unless other estate property proved insufficient to satisfy its obligations. In that instance, the trustees under the will were authorized to sell the stock to the inter vivos trustees, who were permitted, although not required, to lend funds to or buy property from the estate.²⁷ Both transactions, in fact, were completed.²⁸ However, the court concluded, citing Regulation § 20.2042, that the section 2039(c) exclusion was not lost, in view of the absence of a binding obligation on the trustee-beneficiary to pay obligations of the decedent's estate.²⁹

A revenue ruling issued last year stripped the word "receivable" of much of its power in testamentary situations.³⁰ The ruling held that the exclusion was applicable even though the trustee-recipient of plan proceeds had been given discretion under the decedent's will to use trust funds to satisfy the estate's obligations, so long as state law relieved such trustee of any binding obligation to do so.³¹

²¹ For intensive discussions of this issue before and after recent legislation, see Metzger, *Trust Recipient of Death Benefits Under a Qualified Retirement Plan—Section 2039(c)*, TAX MGMT (BNA) 74-15, 3, 3-7 (July 22, 1974); Mirarchi, *Maintaining the Estate Tax Exclusion for Qualified Plan Distributions*, 116 Tr. & Est. 147, 147-49, 202-04 (1977).

²² Rev. Rul. 73-404, 1972-2 C.B. 319.

²³ 31 AFTR 2d (P-H) 73-1437 (E.D. Wis. 1973).

²⁴ WIS. STAT. §§ 231.49 and 272.18(31) (West 1957).

²⁵ Estate of Joseph E. Salisbury, 34 T.C.M. 1441 (CCH 1975).

²⁶ 31 AFTR 2d (P-H) 73-1437 (E.D. Wis. 1973).

²⁷ *Id.* at 1454.

²⁸ *Id.*

²⁹ *Id.* at 1455.

³⁰ Rev. Rul. 77-157, 1977-19 I.R.B. 23 (1977).

³¹ *Id.* at 24.

In other situations, the extent to which constructive receipt will be found is not known. There is still no answer to whether, and in what situations, amounts will be deemed receivable by an executor when state law does allow the attachment of plan proceeds by creditors. Nor has there been any decision as to what happens when a beneficiary designation fails because it does not meet the requirements for executing testamentary documents in a state that applies such requirements to such designations. If a state were not to recognize a beneficiary chosen by a method sanctioned only by the plan, it might be argued that the amount could not be received by that beneficiary and was therefore "receivable" by the executor.³² Similarly, there remains the rarely mentioned problem of whether instructions that insurance proceeds are to be paid to the trustee of a qualified plan constitute "designation of a beneficiary" as such.³³

Against this background, the amended statute raises an additional constructive receipt question: whether the existence of a choice as to payment or tax treatment will foreclose the exclusion. Generally, post-mortem elections are antithetical to the usual concept that estates are administered as of the date of death. However, the General Explanation to the Tax Reform Act of 1976, in amplification of the Congressional Committee Reports, states:

Qualification for the estate tax exclusion is not affected by the mere existence of a right in a party, such as the plan's benefits committee, to select whether the benefits are paid in a lump sum or as an annuity so long as the right to select is irrevocably exercised no later than the earlier of the date the estate tax return is filed, or the date on which the return is required to be filed (including extension of time to file).³⁴

The explanation is silent as to the effect of a right in a potential beneficiary to make the election; that is, whether the existence of constructive receipt for income tax purposes generates constructive receipt by the estate.³⁵ As matters now stand, if the plan provides that any choice made by a beneficiary is conditioned upon approval by a plan fiduciary, constructive receipt will probably be avoided on all counts, but care should be taken to let the record show that administrative consideration is bona fide and approval neither discriminatory nor automatic. In any event, however, it is hoped that regulations will formally indicate who may permissibly participate in making a plan election.

³² This problem should not arise in Massachusetts. MASS. GEN. LAW ANN. ch. 167, § 68 (West Supp. 1976), effective January 18, 1977, exempts valid designations under qualified plans from the usual requirements for making testamentary dispositions.

³³ Cf. Mirarchi, *Maintaining the Estate Tax Exclusion for Qualified Plan Distributions*, 116 TR. & EST. 147, 202 (1977).

³⁴ General Explanation, *supra* note 14, at 594, reprinted in 76-2 C.B. 1, 605.

³⁵ Since the text of the explanation in this paragraph is quite general, omissions are not necessarily of significance. For example, a lump sum and an annuity are mentioned, and installment payments are not. Also, in discussing the selection between a lump sum and an annuity, the explanation does not deal with whether for this purpose, the election of a distribution option and the election under (e)(4)(B) should be distinguished. It is possible that all of these points will be clarified by regulations.

I.R.S. Letter Rul. 7817012 (January 24, 1978) applied § 2039(c) despite the beneficiary's option to select a lump sum, because the actual distribution was not completed within one of her taxable years.

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III. RELATIVE MERITS OF VARIOUS DISTRIBUTION OPTIONS

Under present law, a lump sum distribution is taxed, roughly speaking, as follows: For a section 402(e)(4)(A) lump sum from a corporate non-contributory qualified plan, a part of the distribution—in proportion to the participant's period of plan membership completed before 1974—is taxable as a capital gain,³⁶ and the remainder is taxed in the normal manner for ordinary income, unless an election under section 402(e)(4)(B) is made to have the ordinary income portion specially taxed under section 402(e)(1). That section, entitled Imposition of Separate Tax on Lump Sum Distributions, provides a special averaging technique, designed to approximate the tax payable on such an amount if it had been distributed over a ten-year period. A Keogh plan participant's entire distribution is ordinary income, taxed at the usual rate, unless the (e)(4)(B) election is made. If so made, then the capital gains and the special averaging provisions apply.³⁷ Section 402(e)(4)(L) provides a further election to treat the entire distribution as ordinary income, subject to special averaging treatment.

Assuming the (e)(4)(B) election is included in section 2039(c)'s reference to a lump sum distribution, the decision to make or to forgo the election must be tailored to the individual case. The size of the estate, the availability of a marital deduction or a section 691(c) deduction, as well as the effect of state law, will be important considerations. Also to be taken into account are pre- and post-1974 participation in the plan, the age of the employee,³⁸ the amount of plan proceeds, the existence of a minimum distribution allowance,³⁹ and the availability of other forms of distributions. Other circumstances that could affect the decision are almost limitless: for example, the existence of life insurance,⁴⁰ farm property,⁴¹ or closely-held business property;⁴² the amount and nature of other income taxable to the plan beneficiary; the liquidity needs of the estate and of individual beneficiaries; and the value of any gifts made by the decedent. Finally, the existence of a trust as beneficiary would warrant special consideration.

Only with all of this in mind can the following examination of alternatives be read with perspective. A second caveat is, of course, that some of the effects discussed are relevant to a choice made during the participant's lifetime in contemplation of his or her retirement, while others will have post-mortem impact only.

³⁶ I.R.C. § 402(a)(2).

³⁷ *Id.*, last sentence.

³⁸ A participant who has reached age 59½ may make only one election under section 402(e)(4)(B). For a recent application of this rule, see Private Letter Ruling No. 7748053, Internal Revenue Service, September 2, 1977.

³⁹ I.R.C. § 402(e)(1)(C) establishes that a minimum distribution allowance is deductible from the total taxable amount of a plan distribution subject to the initial separate tax. This minimum distribution allowance is described in I.R.C. § 402(e)(1)(D). It is phased out as the taxable amount increases, and is equal to zero when the amount reaches \$70,000.

⁴⁰ Proceeds of life insurance contracts payable by reason of the insured's death generally are excludible from gross income of the beneficiary under I.R.C. § 101(a).

⁴¹ I.R.C. § 2032A provides special valuation of farm and real property for estate tax purposes.

⁴² I.R.C. § 303 affords capital gain rather than dividend treatment to specified distributions in redemption of corporate stock where the corporation equals at least 50% of the value of the gross estate of a decedent.

A. *Advantages of Selecting a Payment Option That Is Not a Lump Sum Distribution*

Evaluating the advantages of a distribution that is not a lump sum entails two questions: the first is why the estate tax exclusion is desirable, and the second is why, apart from the loss of the exclusion, a lump sum distribution may lack attractiveness.

1. Reasons to Choose the Estate Tax Exclusion

a. *Helpful to Large Estates.* Periodic payments will produce an actual income tax spread the absence of which special lump sum income tax benefits were designed to approximate. The situation in which compensatory income tax treatment would not be worth as much as the estate tax exclusion is most likely to occur, of course, when the estate is in a high estate tax bracket and the plan beneficiary is in a low income tax bracket. This analysis assumes that if the plan beneficiary and the estate beneficiary are different, their relationship is such that an overall tax saving will be to the advantage of both.

b. *Greater Percentage Inclusion of Other Property.* Certain income and estate tax relief provisions afforded under the Code are conditioned upon inclusion in the estate of a specified percentage of a particular type of property.⁴³ The exclusion of plan proceeds raises the inclusion percentage of these other kinds of property.

2. Disadvantages of Lump Sum Distribution Other Than the Loss of the Estate Tax Exclusion

a. *Loss of Sheltered Investment.* The most commonly mentioned reason for avoiding a distribution of an entire interest in a plan is that the after-tax remainder of the distribution will no longer be tax-sheltered in a qualified trust.⁴⁴ Clearly, the merits of this argument will depend upon the tax consequences of the alternative investment options open to the recipient, as well as upon nontax factors involved in the desire for immediate control of the entire amount, such as the purchase of a retirement home or the availability of a higher-yield investment.

b. *Effect on Second Estate.* If the beneficiary dies without disposing of the sum, the amount will be included in a second estate.

c. *Six-Year Aggregation.* The advantages of lump sum tax treatment may be eroded by the requirement that all lump sum distributions—including annuity contracts—made within a six-year period be aggregated and included in computing the total amount taxed as ordinary income.⁴⁵ The effect of this provision is to raise the rate of tax, although any tax previously paid is subtracted from the new amount due.

⁴³ See, note 42 *supra*, for example. In addition, sections 6166 and 6166A provide extensions of time to pay tax when the estate consists largely of an interest in a closely held business.

⁴⁴ Siegel, *TRA: Impact on Pensions and ESOPs—Part II*, 176 N.Y.L.J. 166 (1976).

⁴⁵ I.R.C. § 402(e)(2). An annuity contract is includible under this Code section at the "current actuarial value of the contract determined at the date of distribution," unreduced by any employee investment in the contract partially allocated to "basis" according to T.I.R. 1315, 1974 STAND. FED. TAX. REP. (CCH) ¶ 6985A; see Cook & Adkins, *supra* note 11.

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The language of the Code is ambiguous as to treatment of a trust beneficiary for purposes of this aggregation. Under section 402(e)(2), a beneficiary of a trust to which any such lump sum distribution has been made is treated as the recipient if, under the rules of Subchapter J, he is considered to be the grantor of the trust. The beneficiary is also treated as the recipient if he is an employee "with respect to the plan under which the distribution is made." It seems obvious that this was not intended to refer to every employee in the plan, but only to the employee *in respect of whom the distribution under the plan was made*; however, Proposed Regulation §1.402(e)-2(e)(6)⁴⁶ merely adds that "the term, 'an employee with respect to the plan under which the distribution is made', means an individual who, immediately before the distribution is made, is a participant in the plan under which the distribution is made." Perhaps the final regulations will redefine the term and indicate its significance.

d. *Limited Income-Splitting Opportunities.* Although liability for payment of the tax is apportioned, the tax on the ordinary income portion of a distribution to multiple recipients is computed as though the distribution were made to a single recipient.⁴⁷

e. *Uncertain Consequences of Lump Sums for Trust Beneficiaries.* Although a trust to which the distribution is made is a "recipient" and can elect lump sum treatment, it has not yet been made entirely clear that beneficiaries to whom the trust distributes can escape income tax exposure. It is probable that such exposure does not exist, because a trust beneficiary is taxed under section 652 on distributable net income (DNI), and DNI is based upon the trust's taxable income. Under section 402(e)(3), the ordinary income portion subject to the separate tax is deductible from such taxable income and therefore will not be involved in derivation of DNI. This proposition appears to be acknowledged by the congressional statement that:

If the lump sum distribution is made to a recipient *other than a trust* during the employee's life time, it is intended that the usual assignment-of-income and constructive receipt rules will apply to determine whether the employee is to be liable for the tax upon the distribution.⁴⁸

This language could be taken to mean that such rules do not apply if the distribution were made to a trust. Further evidence of nontaxability at the beneficiary level can be inferred from the omission of mention of ten-year averaging in the proposed amendments to Regulation § 1.652(b)-1 (and, by reference, to Regulation § 1.662(b)-1) if the omission is the result of the belief that there is no need to deal with a tax that the beneficiaries will never bear. On the other hand, it does not seem philosophically consistent to continue to tax the beneficiaries on the capital gains portion, if any, and to tax the trust on the ordinary income portion, unless it was intended that the phase-out of capital gains treatment would eventually adjust this.

⁴⁶ 40 F.R. 22548 (1975).

⁴⁷ I.R.C. § 402(e)(2). See also Proposed Treas. Reg. § 1.402(e)-2(e)(6); T.I.R. 1429, Rev. Proc. 76-4, 76-1 C.B. 543 (1976).

⁴⁸ H. R. REP. NO. 1280, 93d Cong., 1st Sess., reprinted in [1974] U.S. CODE CONG. & AD. NEWS 5038, 5130 n.1 (emphasis added).

Another unresolved issue regarding the consequences of lump sum distributions to trust beneficiaries involves the effect of the second sentence of section 402(e)(2), which sentence, for six-year aggregation purposes, identifies the "recipient" as the employee-beneficiary in certain cases. If this sentence, when read in conjunction with section 402(e)(1)(E), which taxes the "recipient" on the ordinary income portion, imposes the tax not on the trust but on the employee-beneficiary, the result conflicts with the generally accepted trust accounting rule that when a beneficiary receives a lump sum distribution the amount is not income but corpus. Moreover, if the individual is taxable under section 402(e)(1)(E), and he or she is a life beneficiary only, state trust law may require the trustee to reimburse him or her for having benefitted persons having an interest in the remainder.⁴⁹ In that case, the tax burden would be transferred back to corpus, despite what section 402(e) appears to require.

f. *Unavailability of "Maxi-Tax."* A lump sum distribution is not subject to the fifty-percent maximum tax, because section 1348 (b)(1)(B) excludes such sums from the definition of "personal service income."⁵⁰

g. *Unwanted Effect on Adjusted Gross Income.* The deduction from gross income of the ordinary income portion under section 402(e)(3) may be disadvantageous in certain circumstances. Ordinarily, if large losses or deductions exist, they may be used to offset ordinary income. Because of the 402(e)(3) deduction, the ordinary income portion of a lump sum cannot be so sheltered, and therefore is fully taxable, albeit under the special provisions of section 402(e)(1)(A).

The deduction also reduces for the year in which it is taken the amount of deductible contributions to charity allowed under the provisions of section 170, because deductibility increases with the size of the "contribution base," defined as adjusted gross income.⁵¹

h. *Imposition of Minimum Tax and 1976 Cure.* Even prior to 1976, the capital gains portion of a lump sum distribution constituted a tax preference item under section 57,⁵² to which the minimum tax of section 56 applied.⁵³ The Tax Reform Act increased the minimum tax rate and thus increased the cost of lump sum treatment. This seemed to contravene the principle that lump sum distributions be favorably taxed. In recognition of this, the Tax Reform Act attempted to restore a measure of flexibility in the choice of distribution forms. This was done through the enactment of section 402(e)(4)(L) which allows the taxpayer to elect to have his or her pre-1974 participation in a plan treated as post-1973 participation. The entire sum thus becomes ordinary income and because the capital gain element disappears, no tax preference item is created, and no minimum tax is imposed. In general, this is in the taxpayer's favor; however, care should be taken to ensure that, in particular circumstances, such treatment does in fact produce the best overall results.

⁴⁹ MEMBERS OF THE COMMITTEE ON EMPLOYEE BENEFITS OF THE SECTION OF TAXATION OF THE AMERICAN BAR ASSOCIATION. COMMENTS RE: 75:11365 (April 30, 1975). These comments were a composite of the individual views of the members and are in no way to be construed as representing the position of the American Bar Association or its Section of Taxation or any Committee thereof.

⁵⁰ I.R.C. § 1348(b)(1) excepts any amount to which these sections apply: 72(m)(5), 402(a)(2), 402(e), 403(a)(2), 408(e)(2), 408(e)(3), 408(e)(4), 408(e)(5), 408(l), or 409(c).

⁵¹ I.R.C. § 170(b).

⁵² I.R.C. § 47(a)(9)(A).

⁵³ I.R.C. § 56(a).

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i. *Effect of State Law.* The implication of applicable state law must not be overlooked. A state's income tax law may not yet have reference to the Internal Revenue Code as amended by the 1976 Act. If, for example, a state's income tax law followed the Internal Revenue Code as it existed on January 1, 1971, a lump sum distribution might be treated entirely as capital gain for state income tax purposes. Accordingly, a taxpayer choosing a lump sum for federal purposes would be taxed, on his or her state return, at the capital gains rate on the entire amount, which rate conceivably could be *higher* than the ordinary income rate.⁵⁴

B. Reasons to Choose Lump Sum

As a rule of thumb, income tax relief is usually preferable to estate tax relief, in view of the relative tax rates, and because the unified credit⁵⁵ and the marital deduction⁵⁶ shelter many estates entirely from estate tax. Other benefits associated with lump sum treatment are these:

1. Death Benefit Exclusion

When measuring the advantages of a lump sum against those of the estate tax exclusion, one must consider not just the income tax saved under section 402, but also the value of being able to exclude a death benefit of up to \$5000. Any amount that was nonforfeitable by an individual at his or her death is excludible under section 101(b) only if it is paid as a lump sum distribution from a qualified or section 403(b) plan.⁵⁷

2. Deduction for Estate Tax on Income in Respect of a Decedent

Similarly, the financial effect of a lump sum must be considered in conjunction with the availability of a deduction under section 691(c) in respect of any estate tax paid on plan distributions characterized as income in respect of a decedent.⁵⁸

⁵⁴ Massachusetts has recently updated its income tax law to correlate with the Internal Revenue Code as amended on May 23, 1977. MASS. GEN. LAW ANN. ch. 62, § 1(c) (West Supp. 1977). Prior to this amendment, however, section 1(c) was referenced to the 1971 Internal Revenue Code and all lump sum distributions were treated as capital gain.

It remains problematic whether a lump sum, to the extent it is favorably taxed at the federal level, must be unfavorably treated at the state level. In a recent case, it was held that the capital gains portion may not be taxed at the higher rate, because it is part of a distribution that constitutes a single unit arising in an employment setting. *Frank E. and Estate of Anne I. Daley v. State Tax Commission*, No. 80901 (Massachusetts Appellate Tax Board, February 3, 1978) (unpublished opinion). But see T.I.R. 78-1 (Jan. 1978). *The *Daley* ruling is presently being appealed by the Massachusetts Department of Corporations and Taxation.

⁵⁵ I.R.C. § 2505.

⁵⁶ I.R.C. § 2056.

⁵⁷ I.R.C. § 101(b)(2)(B). Note that I.R.C. § 101(b)(3) makes this exclusion unavailable to the self-employed and that I.R.C. § 101(b)(2)(B) omits mention of IRAs.

⁵⁸ Payments made are often "in respect of a decedent" to the extent that the decedent would have been required to include it in income had he or she survived to receive it. See M. FERGUSON, J. FREELAND, & R. STEPHENS, *FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES* 170-78 (1970), Supp. 62-64 (1977).

3. Employer Securities Not Taxed

Under section 402(e)(4)(J) and Regulation § 1.402(a)-1(b)(1)(A), tax deferral is afforded to that part of a section 402(e)(4)(A) lump sum distribution consisting of net unrealized appreciation of employer securities. Such amounts will not be taxed until the eventual disposition of the securities. When such securities are not part of a qualified lump sum, tax is deferred only on that part of the appreciation attributable to an employee's own contributions.

4. Effect on Adjusted Gross Income

The deduction of the ordinary income portion afforded by section 402(e)(3) reduces adjusted gross income, and makes the "medical deduction" easier to attain, because in order to be deductible, section 213(a) demands that medical care and medically-related expenses exceed specified percentages of adjusted gross income.

5. Effect of State Estate Tax

Since many states base their own estate tax system on the Internal Revenue Code as it existed at a particular date,⁵⁹ it will be necessary for these states to amend the operative date clause of such provisions if lump sums are to be denied preferential estate tax treatment. In the absence of such amendment, lump sum distributions will probably still qualify for estate tax exclusion at the state level.

IV AN APPROACH TO ESTATE PLANNING AND QUALIFIED PLAN DESIGN

The estate planner must be careful to extract from his or her client complete information about membership under qualified plans and should review any outstanding beneficiary designations on file with the client's employer and former employers.

It is a truism that the choice of a beneficiary of plan proceeds should not be entirely, or even primarily, dictated by tax results.⁶⁰ One aspect of the new tax law that may legitimately influence the naming of a beneficiary is that regardless of whether the participant, the beneficiary, or a plan fiduciary is responsible under the plan for choosing the *form of distribution*, it is the "taxpayer" who is charged with making the section 402(e)(4)(B) election. It may be wise to put this election in the hands of a sophisticated trustee.

⁵⁹ See, e.g., MASS. GEN. LAW ANN. ch. 62, § 1(c) (West Supp. 1977).

⁶⁰ Various aspects of the amended section 2039 are beginning to produce some ingenious arrangements. One such scheme that has been advanced intends to produce a tax advantage by means of splitting the distribution where the trust has been funded by an annuity that at no time could be amended, transferred or surrendered to the insurer. The theory offered in its favor is that the cash surrender value is paid in installments and qualifies under I.R.C. § 2039(c) for estate tax exclusion, while the balance, paid in a single sum to a second beneficiary, also qualifies because it was not paid "from a trust which forms part of a plan" and thereby is not a lump sum distribution within the meaning of I.R.C. § 402(e)(4). Proponents of this arrangement claim that the at-risk portion also could qualify for the life insurance exclusion of I.R.C. § 101.

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A trustee beneficiary might also be the better choice if it develops that it is the lump sum distribution, and not the optional special taxation, that affects the estate tax exclusion. If so, when it has been decided that the estate tax exclusion is desirable, one obvious way to achieve or approximate a "total distribution" that is nevertheless not a section 402(e)(4)(A) lump sum distribution is to divide the payment between two taxable years of the recipient. If the recipient is a testamentary trust, or a trust that becomes irrevocable at the grantor's death, its status is that of a new taxpayer and it is entitled to elect any fiscal year, pursuant to the provisions of section 441(b). In contrast, a beneficiary of a new trust would have to accomplish this result by a change of taxable years, a change which must be approved by the Commissioner, and it is doubtful that a substantial business purpose for the change—a requirement of the regulations⁶¹—could be established.

The planner is reasonably safe in advising the client, where it is otherwise appropriate to do so, to have plan proceeds payable to a trustee under a trust created under the will or otherwise. He or she would be well served, however, by the addition to the governing instruments of a spendthrift clause, prohibiting the use of any qualified plan assets for payment of estate obligations so as to prevent constructive receipt by the estate.

If it is decided that a trustee will be placed in the position of making a decision to elect a form of payment or a form of taxation, an exculpatory clause should be considered, against the possibility that the beneficiary of the plan proceeds or the estate beneficiary claims that the choice made was a breach of fiduciary duty owed to him or her.

Like the estate planner, the pension planner also must minimize fiduciary risk, although in the pension area, elimination of statutory liability through exculpation has largely been prohibited.⁶² The plan instrument nevertheless can be structured to reduce the possibility of circumstances in which a former participant or beneficiary can complain that plan design, fiduciary choice, or fiduciary advice resulted in a loss or in detrimental tax treatment. Further, those charged with drafting and running the plan must be aware that if the plan as written or in operation favors the "prohibited group,"—employees who are officers, shareholders, or highly compensated⁶³—qualification might be successfully challenged by the Internal Revenue Service.

Unless the plan provides no opportunity to select among distribution options, the Plan Administrator will have to describe alternatives, and inherent in that duty is some risk of misstatement. When a plan offers an election against a "qualified joint and survivor annuity," or an election of an in-service death benefit for the spouse of a participant who chooses to

⁶¹ Treas. Reg. § 1.442-1(b), T.D. 7323, 39 F.R. 34409 (1974).

⁶² Exculpatory clauses in respect of Part 4 of Title 1 of ERISA are outlawed under ERISA, 29 U.S.C. § 1110(a) (Supp. IV 1974). Insurance policies and indemnification are not prohibited, provided the plan does not bear their cost. *Id.* § 1110(b); see I.B. 75-4 (Office of Employee Benefits Security, U.S. Dep't of Labor). In addition, the effect of state law, and the provisions of existing corporate articles and by-laws should be evaluated before indemnification is undertaken.

⁶³ I.R.C. § 401(a)(4) provides that a trust will only qualify if the contributions or benefits under the related plan do not discriminate in favor of employees who are officers, shareholders, or highly compensated.

remain employed after qualifying for early retirement, a specific duty of disclosure is prescribed.⁶⁴ In such cases, a general description of the availability and effect of the election is required, and the participant must be told that he or she may request specific information as to the effect of a qualified joint and survivor annuity on his or her pension payments.⁶⁵ There is no requirement that a plan provide a potential beneficiary with this information, and no guidelines have been issued as to the extent and nature of the disclosure requirement, when the joint and survivor form is not in issue. For all plans, however, section 102(a)(1) of ERISA provides that participants and beneficiaries be furnished with a summary plan description "written in a manner calculated to be understood by the average plan participant, and . . . sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of their rights and obligations under the plan."⁶⁶

There is, therefore, no way to insulate the fiduciary entirely against all responsibility related to accurate disclosure of distribution forms offered by a plan. It seems equally clear that the fiduciary's responsibility will usually stop short of tax planning for the participant or beneficiary, but where the duty lies is uncertain. There often will be an obligation to advise the employee that tax advice should be sought when a beneficiary and manner of distribution are selected. What is necessary in order not to mislead the participant even to the over-conservative extent of urging unneeded and expensive tax counselling, will depend on the particular relationship between the fiduciary and participant, the knowledge of the participant's affairs that can be imputed to the fiduciary, the depth of retirement counseling offered and whether or not the counselor implies to the participant that all the issues relating to his or her retirement choices have been covered.

It is difficult to imagine a fiduciary being held liable for failing to consider or determine correctly the overall maximum tax savings among all the parties involved, and almost inconceivable except in special circumstances, that he or she might be expected to have the means to discover, much less evaluate, all the information. Nevertheless, whether or not the sophistication of the fiduciary, as well as that of the participant, may be legitimately considered, is still an open question. The relationship of professionalism to the "prudent man standard" has been the subject of discussion in connection with a fiduciary's investment responsibility,⁶⁷ but no attention has been paid to whether such relationship affects the fiduciary's general duty to act "solely in the interest of the participants and beneficiaries."

Fiduciary liability can be kept to a minimum if the plan is drafted to provide only automatic forms of distribution, or, the problems of disclosure aside, if the plan leaves all choices to the participant or beneficiary. However, even when a plan provides for a predetermined form of payment,

⁶⁴ 1.R.C. § 401(a)(11).

⁶⁵ See *id.*

⁶⁶ 29 U.S.C. § 1022(a)(1) (Supp. 1974).

⁶⁷ ERISA section 404(a)(1), 29 U.S.C. § 1104 (Supp. IV 1974) sets forth the so-called "prudent man" rule. See generally Klevan, *Fiduciary Responsibility Under ERISA's Prudent Man Rule: What Are the Guideposts*, 45 J. OF TAX. 152 (1976).

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charges might be made that plan design favors the group most likely to benefit from the probable tax consequences of that form of payment. If a plan were to provide only annuities or installment payments, the accusation could be made that this discriminated against low-paid people with small estates, who do not need the estate tax exclusion and otherwise might benefit from being able to receive a lump sum distribution. This charge seems insubstantial in view of the encouragement under ERISA of the joint and survivor annuity form as the preferred form in respect of married participants, and the acceptance, under the regulations, of a situation in which an annuity is the only form of distribution available.⁶⁸

If a plan offered a lump sum only, the discrimination issue should vanish, since there are no rules against discrimination *against* the prohibited group. Instead, any liability could flow only from the disclosure duty in respect of the (e)(4)(B) election, because this is a taxpayer function that a plan itself can probably not assume, or, as one authority has suggested, from the plan's violation of the exclusive purpose rule if it could be demonstrated that in opting for administrative convenience, the plan failed to give primary consideration to the participants' and beneficiaries' best interests.⁶⁹ Another response to such a discrimination charge is that the chance that a "lump sum only" plan would hurt the recipient is especially remote if the employee survives to receive the lump sum, since in that case a surprising amount of flexibility will still be available. In many instances, the employee will be able to convert a forced lump sum distribution into a deferred lump sum or a deferred annuity by rolling the amount into an IRA or, if he has self-employment income, into a Keogh Plan. Either would postpone taxation and would shelter any additional income earned on the deferred amount. Ultimately, the form and time period of the payment would depend on which arrangement, Keogh or IRA, had been selected.⁷⁰

The most commonly proposed method of minimizing fiduciary discretion is, of course, maximizing participant discretion. The major disadvantage of this approach is that there is little flexibility left for post-mortem planning if a participant chooses both the beneficiary and the form of payment. Moreover, it would seem that if a participant or beneficiary were aware of the result, under the plan, of his or her failure to make a valid designation, the plan and fiduciary would be largely protected, provided

⁶⁸ See note 61 *supra*. Care should be taken to avoid the pitfalls of the *Silverman* case, note 19 *supra*.

⁶⁹ See Sollee, *Shaping Qualified Plan Payout Provisions and Use of Rollovers Under New 2039(c)*, 47 J. OF TAX. 4 (1977) [hereinafter Sollee].

⁷⁰ For a discussion of rollover options, see Beers, *Estate Taxation of Employee Benefits Under the Tax Reform Act of 1976*, 1977 EXEC. COMP. J. 3, 4-8.

On the hypothesis that mere omission to make an I.R.C. § 402(e)(4)(B) election will not operate to preserve a desired tax exclusion, an alternative way to achieve the exclusion for a single payment is to persuade the employer to eliminate the death benefit under the qualified plan. A lump sum could be paid *de hors* the plan to or for the benefit of a surviving spouse or other nonestate beneficiary. The payment would not need benefit of I.R.C. § 2039(c) because it would be excludible on other grounds if it were not payable pursuant to a binding agreement and did not constitute an interest owned in whole or in part by the decedent at his or her date of death. For an examination of various techniques for excluding death benefits that are not paid from qualified plans, see Margolis, *Death-Benefit-Only Plans Create Estate Planning Opportunities for High Tax-Bracket Executives*, 4 EST. PLAN. 282, 283-85 (1977); Treanor, *Employer-provided Widow's Benefit, No Estate Tax but Possible Gift Tax*, 47 J. OF TAX. 34, 35-36 (1977).

that the disclosure made to the individual were sufficient, and provided further that the disposition of proceeds were made in a reasonable manner.

At the other extreme, when the manner of distribution is left entirely to the fiduciary, vulnerability is maximized, and where the tax objectives of the plan distributee and the estate beneficiary differ, there may be additional problems, beginning with whether, and when, the fiduciary may be considered to be on notice of these facts. At present, there is no experience under which to evaluate how such a fiduciary is to "discharge his duties with respect to a plan solely in the interest of the participants and their beneficiaries" Nevertheless, there are bound to be situations in which a strong fiduciary system works best, such as plans which have traditionally operated under such rule, where fiduciary authority is a significant feature of the plan as a whole, and where the fiduciary is compensated or indemnified to his or her satisfaction. Fiduciary dominance is apt to be appropriate in small professional corporations, or in other closely held corporations where the principal shareholders or their family members constitute the plan fiduciary and where the plan architect probably will be the architect of the principal employees' estate plans.

Most situations would appear to call for a plan design that maximizes participant discretion and, in default of the participant's choice, relies on the beneficiary to select a manner of payment, subject to the plan fiduciary's consent.⁷¹ Appropriate variations may be incorporated, but all

⁷¹ The following is a suggested draft governing the distribution options under a qualified plan. In view of the absence of experience and regulations, the reader should be mindful of its experimental and tentative nature. It should also be noted that this language contemplates that the term, "Beneficiary," be defined in the plan as anyone other than the Participant entitled to receive a benefit.

Distributions in respect of the death of a Participant or Beneficiary as designated under this Plan shall be governed by the following procedure ("Participant" shall include former Participant):

(a) Each Participant shall designate one or more Beneficiaries, including contingent Beneficiaries, to receive all or part of such Participant's distributable account in existence under this Plan at the Participant's death. This designation shall be in writing in such manner as the Plan Administrator shall provide. A Participant shall also specify therein the time and manner of distribution and may change or revoke such designation and/or specification at any reasonable time before payments begin.

(b) The Plan Administrator shall direct the Trustee to apply the amount standing to the credit of such Participant's account as of the Valuation Date that coincides with (or if it does not coincide, that immediately precedes) his or her death, pursuant to the foregoing designation and specification. However:

(i) If the specification is absent or ineffective in whole or in part, the Plan Administrator shall direct payment in such manner as the Beneficiary or Beneficiaries shall elect, such election to be subject to the Plan Administrator's approval. In default of any such election, the Plan Administrator shall choose the form of payment.

(ii) If an authorized Beneficiary does not exist at the time of a Participant's death, the Plan Administrator shall direct the Trustee to make payment in a lump sum or in installments to the Participant's spouse, and if none, to the Participant's issue by right of representation, and if none, in a lump sum to the duly appointed executor or administrator of the Participant's estate.

(iii) If distribution is begun to a Beneficiary and no valid designation exists in respect of amounts which remain undistributed at such Beneficiary's death, any such amounts shall be paid to such Beneficiary's estate

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should be within an arrangement under which the participant retains control over his or her interest in the plan and can coordinate them with an estate plan. If the choice falls to the beneficiary with fiduciary approval, the fiduciary is saved from having to shoulder the entire burden while the beneficiary has some protection from constructive receipt.

CONCLUSION

Although it has been urged that the estate tax preference be eliminated,⁷² Congress, in the 1976 Tax Reform Act, chose a more moderate course. It extended the tax preference to IRA and Keogh plan proceeds, while restricting the exclusion to non-lump sum distributions. The full meaning of the amendment, however, will not be understood until the Service provides guidelines for a number of questions engendered by the Code changes.

Moreover, the trade-off between income and estate tax benefits now forces trustees and beneficiaries of qualified plans to make sophisticated decisions as respects plan distribution options. This new complexity necessarily will interject an added set of concerns into the formulations not only of estate planners, but also of those who construct pension programs.

in a lump sum. If a valid designation exists, but a manner of payment has not otherwise been provided, the amount shall be paid in a lump sum.

⁷² See, e.g., U.S. TREASURY DEPT. TAX REFORM STUDIES AND PROPOSALS 363-64 (1969); AMERICAN LAW INSTITUTE, FEDERAL ESTATE & GIFT TAXATION 15-16 (1969); Gaubatz, *The Unfinished Task of Estate & Gift Taxation*, 63 IOWA L. REV. 85, 112 (1977).