

# Qualified and Nonqualified Retirement Plan Benefits and Trusts

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Qualified and Nonqualified Retirement Plans (“Plans”) are today one of the most valuable assets that an individual owns at his/her time of retirement and death. Participation in Plans is subject to guidelines and rules that must be adhered to strictly.

Most Plans are categorized as “trusts fund plans” with the trust agreement between the employer and a trustee. The employer is typically the administrator of the Plan and the employee participating in the Plan is the beneficiary. It is important to understand that the employee is not the owner of the Plan despite the inclusion of the Plan benefits in his/her gross estate at death and, potentially, federal and/or state estate tax impact to them.

## Qualified Retirement Plans

“Qualified Retirement Plans” are classified as two types of plans: defined benefit plans and defined contribution plans. Qualified Retirement Plans include 401(k) and 403(b) plans, money-purchase pension plans, profit-sharing plans, IRAs, government or 457 plans, tax-sheltered annuity, self-employment plans, and other types of retirement plans. Qualified Retirement Plans receive favorable tax treatment and allow employers and self-employed individuals to deduct their Plan contributions, provided they meet certain requirements. Employees are not immediately taxed on Plan contributions made by them or on their behalf, and the Plan earnings will accrue for their benefit on a tax-deferred basis.

## Nonqualified Retirement Plans

“Nonqualified Retirement Plans” are classified as two types of plans: individual contracts and employer plans. They are not required to meet the same rigid requirements, under the Internal Revenue Code or ERISA, as Qualified Retirement Plans. They consist of excess benefit plans, deferred bonus, rabbi trusts, stock options, phantom stock, and split-dollar life insurance plans. Most nonqualified plans have transferable death benefits, may be discriminatory in their application, and do not have the contribution limits and other restrictive requirements found in Qualified Retirement Plans. Employers do not receive any tax deduction for contributions made on behalf of an employee until the employee receives the plan proceeds.

## Trusts as Plan Beneficiary

If you name a Trust as the beneficiary of a Plan it must meet the following requirements: (1) valid under state law; (2) either irrevocable or will become irrevocable upon the owner's death; (3) the Trust beneficiaries must be identifiable from the instrument; and (4) copy of the Trust instrument or special affidavit must be filed with the plan administrator. It is important to understand that only an individual may be a designated as the beneficiary of

a Plan. If an ineligible individual or entity is designated as the Plan beneficiary, the Plan will be treated as having no designated beneficiary. However, the trustee of a Trust may be named as the beneficiary of a Plan. This allows the beneficiaries of the Trust (not the Trust itself) to be treated as the designated beneficiary for purposes of determining the required minimum distributions (“look-through treatment”). It is important to recognize that, because the Trust entity will be ignored, all of the beneficiaries must be eligible recipients.

## Minimum Required Distributions (MRD)

All beneficiaries of a Trust, with respect to its interest in a Plan, will be treated as designated beneficiaries of the individual under the Plan for purposes of determining the required minimum distributions under §401(a)(9). If Plan benefits, pursuant to the terms of a Trust, are payable to multiple designated beneficiaries, then the designated beneficiary with the shortest life expectancy will be the designated beneficiary for purposes of determining the applicable distribution period. In order to avoid this unwanted consequence, it is important to have the beneficiary designation refer to separate trusts if the main trust is to be divided at the owner's death (for example, “To the Trustees of the separate trusts set forth in the Agreement of the John Doe Trust, in the proportions stated therein”). Alternatively, in order to obtain the same result, separate trusts may be created and the account separated by the Trustee prior to 30 September of the year following the year of the owner's death.

If the beneficiary of the Trust is another trust (QTIP trust; general power of appointment marital deduction trust; credit shelter trust; or irrevocable life insurance trust), the beneficiaries of the other trust will be treated as being the designated beneficiaries of the first trust. This will result in them being designated under the Plan for purposes of determining the distribution period. The availability of this option is contingent upon strict accordance with the Treasury Regulation requirements.

## Advantages

The advantages of naming a Trust as the beneficiary of a Plan include the following: (1) control the timing and amount of distributions to trust beneficiaries (important if one or more of the beneficiaries is young, irresponsible, or subject to legal or debt problems); (2) address “what-if” scenarios (divorce or addiction); (3) address disability or illness-related issues; and (4) control the management and asset investment on behalf of the beneficiary.

## Disadvantages

The disadvantages of naming a Trust as the beneficiary of a Plan, without proper planning, include the following: (1) the potential for non-individual or contingent beneficiaries of the

Trust causing an accelerated payout; (2) a remote successor beneficiary being counted as the oldest beneficiary for payout purposes; and (3) higher income tax rates on undistributed income.

### Trust Distributions

Distributions that flow from a Plan to a Trust will be taxed at ordinary income tax rates and will be governed by the terms of the Trust agreement. Distributions may then flow from the Trust to the named beneficiary. However, depending upon the language contained in the Trust instrument, some or all of the distribution may remain in the Trust and not be paid to the beneficiaries.

The Code provides that the amount actually distributed to any distributee by a Plan “shall be taxable” to the distributee in the year in which the amount is distributed. With respect to a Trust, if the individual trustor is the primary beneficiary and is to receive, under the terms of the trust agreement, all trust estate income and distributions of principal, and the trustee is required by the terms of the trust agreement to distribute income to or for the benefit of the trustor, then, the trustor should be considered the distributee who is taxable on the receipt of Plan proceeds.

When an Irrevocable Trust is named as the Plan beneficiary, it is important to recognize that a higher income tax rate will be applicable to trust income. If the trustee pays all of the required minimum distributable income to the beneficiary, the protective trust terms

and benefits may be lost. Alternatively, income that is retained in the trust will be taxed at higher income tax rates.

### Dealing with Disability or Incapacity

Since a Trust may not be the owner of a Plan, if you become disabled or incapacitated, the only way to exercise control over the Plan would be under a durable power of attorney or through guardianship proceedings. However, by having a properly drafted Trust, as the recipient of the Plan distributions, one can avoid unwanted consequences and potential loss of medical benefits.

### Increased Military Death Benefit for Survivors

On Wednesday, 11 May 2005, President Bush signed into law the Fiscal Year 2005 Supplemental Appropriations Act (H.R. 1268). A major provision of the law is the increase in the military’s tax-free “death gratuity” from \$12,000 to \$100,000 for the next of kin of any military personnel killed in combat zones or in combat-related training since 7 Oct. 2001. In addition, the law includes a provision increasing military life insurance payments from \$250,000 to \$400,000.

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