How Best to Use the Grandfather Election for Retirement Plans

Clients who made a grandfather election to exempt certain retirement benefits from the 15% excise tax and the additional estate tax must evaluate whether to withdraw the grandfather amount during life or retain it until death.

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A 15% excise tax is imposed on qualified plan and IRA benefits received in any year in excess of a specified threshold.[1] There is also a 15% additional estate tax on retirement benefits at death in excess of a specific threshold.[2]

Individuals whose retirement benefits exceeded $562,500 on 8/1/86 were able to make a grandfather election on their 1986, 1987, or 1988 income tax returns to exempt their accrued benefits as of 8/1/86 from these taxes.[3] Due to the interplay of the grandfather election with the thresholds, however, many individuals will lose the benefit of their grandfather election if they do not use it during lifetime.

For purposes of the excise tax on annual distributions, the threshold is $150,000 in 1995 ($155,000 for 1996). This figure is adjusted for inflation annually.[4] Thus, if Amy receives IRA distributions of $200,000 in 1995, she will pay excise tax of $7,500 (15% of $50,000), in addition to paying income tax on her $200,000 distribution.

Recovery of grandfather amount

One of two methods can be used to determine how the grandfather amount is recovered against distributions received: the discretionary method or the attained age method.[5] An individual wishing to use the discretionary method had to so elect when making the grandfather election.[6] This article assumes that the discretionary method was elected.

Under the discretionary method, all distributions received between 8/1/86 and 12/31/86 are treated as a recovery of the grandfather amount. Thereafter, 10% of all distributions are treated as a recovery of the grandfather amount. Accordingly, in the above example, if Amy receives $200,000 of IRA distributions in 1995, this reduces her grandfather amount by $20,000 under the discretionary method.

An individual can elect to accelerate the rate of recovery of the grandfather amount to 100% at any time. If this election is made, all distributions are treated as a recovery of the grandfather amount until the grandfather amount is exhausted. The acceleration election is made on Form 5329, which is filed with the individual income tax return.

The threshold at death. With respect to the 15% additional estate tax, the threshold equals the present value of a hypothetical annuity. For purposes of this hypothetical annuity, the annual payment is equal to the annual threshold amount ($150,000 in 1995); the life expectancy equals the decedent's life expectancy as of his death (as if he had not died); and the interest rate is equal to 120% of the midterm applicable federal rate (which is the same interest rate used to value annuities, life estates, and remainders generally).[7] If, however, the remaining grandfather amount exceeds the hypo-

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thetical annuity, the threshold equals the remaining grandfather amount.[8]

This can be illustrated as follows, based on the interest rate of 7.6% in effect in July 1995:

Decedent's Age at Death	Value of Hypothetical Annuity
60	$1,385,670
65	1,255,470
70	1,110,420
75	955,230
80	790,230

Example. If Bob dies in July 1995 at age 75 with an IRA of $3 million, of which $1 million is grandfathered, the additional estate tax is $300,000 (15% of $2 million). If Bob had not made the grandfather election, the additional estate tax would have been $306,716 (15% of $2,044,770), based on a hypothetical annuity valued at $955,230. Consequently, Bob saved only $6,716 by virtue of his grandfather election. If the value of Bob's hypothetical annuity had exceeded his remaining grandfather amount, the benefit of his grandfather election would have been completely wasted.

The effects of the decedent's age at death and of the interest rates should also be noted. As the above table demonstrates, the value of the hypothetical annuity decreases as the individual's age increases. Moreover, the value of the hypothetical annuity is greater at lower interest rates, and is lower at high interest rates. In this regard, the applicable interest rates have ranged from as low as 6% to as high as 9.6% in the last two years.

Using the grandfather amount during lifetime

If, instead of waiting until death, Bob had withdrawn his $1 million grandfather amount immediately before death, he would not have paid any excise tax on it on account of his grandfather election. Because Bob withdrew $1 million during lifetime, his IRA would be $2 million at his death. He would still be exempt from additional estate tax on the $955,230 value of the hypothetical annuity, so that his additional estate tax would be $156,716 (15% of $1,044,770). To achieve this result, Bob must elect to accelerate the recovery of his grandfather amount, so that his $1 million lifetime withdrawal is treated as a recovery of his grandfather amount.

Another advantage of withdrawing the grandfather amount during life is that the income tax paid on it is removed from the estate for estate tax purposes.

While Section 691(c) provides an income tax deduction for the federal estate tax paid on qualified plan and IRA benefits, it does not provide a deduction for the state death taxes paid on these benefits. As a result, the Section 691(c) deduction does not fully eliminate double taxation. By contrast, paying federal and state income tax on plan benefits during life completely removes these payments from the estate. This is illustrated in Exhibit 1 on this page, which assumes a 55% estate tax rate (consisting of 39% federal estate tax and 16% state estate tax[9]), a 40.788% federal income tax rate,[10] and a 6% state income tax rate.

EXHIBIT 1
Effect of Income Tax Payment

$100 Withdrawal During Lifetime	
Income	$100.00
State income tax (6%)	(6.00)
Federal taxable income	94.00
Federal income tax (40.788%)	(38.34)
Net after income tax	55.66
Estate tax (55%)	(30.61)
Net after all taxes	25.05
Total taxes	$ 74.95

$100 Retained Until Death	
Income	$100.00
Section 691(c) deduction	(39.00)
Sub-total	61.00
State income tax (6%)	(3.66)
Federal taxable income	57.34
Federal income tax (40.788%)	(23.39)
Estate tax (55%)	55.00
Total taxes	82.05
Net after all taxes	$ 17.95

As shown in Exhibit 1, the total income and estate taxes on $100 withdrawn during lifetime are $74.95, leaving a net of $25.05 after all taxes are paid. By comparison, the total taxes on $100 retained until death are $82.05, leaving a net of $17.95 after all taxes are paid. Hence, in this example, the net after-tax proceeds of amounts withdrawn during lifetime are 40% greater than the net after-tax proceeds of amounts retained until death. The difference can be even greater, depending on the applicable state income and estate taxes.

Another advantage of withdrawing the grandfather amount during lifetime is that it provides funds that can be used to make gifts. While it may appear at first glance that the gift and estate tax burdens are the same, this is not the case (assuming that the donor lives for at least three years after making the gift). The difference is due to the fact that the estate tax is computed on a gross basis (tax inclusive), while the gift tax is

[1] Section 4980A(a).
[2] Section 4980A(d).
[3] Section 4980A(f).
[4] Section 4980A(c)(1).
[5] Temp. Reg. 54.4981A-1T, Q&A b-11.
[6] Temp. Reg. 54.4981A-1T, Q&A b-12.
[7] Sections 4980A(d)(3)(B) and 4980A(f)(2)(B); Temp. Reg. 54.4981A-IT, Q&A d-7.
[8] Section 4980A(f)(2)(B).
[9] This rate equals the top rate of the federal estate tax credit for state death taxes under Section 2011.
[10] Income tax rate of 39.6% multiplied by 1.03 to take into account the reduction of itemized deductions under Section 68.

computed on a net basis (tax exclusive). In other words, assuming a 50% tax rate, $100 at death is subject to estate tax of $50. But the same $100 could be used to make a gift of $66.67 and pay the resulting gift tax of $33.33 (50% of $66.67). This yields a tax savings of $16.67 if the donor lives for at least three years after making the gift. If the donor dies within three years, the gift tax is includable in her estate[11] (although, except for retained interest gifts and gifts of life insurance, the gift itself is generally not so included).[12]

In addition to the difference in the way the estate and the gift taxes are computed, lifetime gifts offer other pluses. A donor can take advantage of the gift tax annual exclusion for gifts of up to $10,000 per donee per year.[13] She can also use her unified credit (which is equivalent to a $600,000 estate and gift tax exemption) during lifetime, and remove from her estate any subsequent income and growth on the gift.[14] The donee can use all or part of the gift to purchase insurance on the donor's life. If the donee or a trust for the donee's benefit is the owner of the policy, the insurance proceeds can be sheltered from estate tax in the donor's estate. In this way, the donee can be sure how much he will have at the donor's death, regardless of investment performance or how long the donor lives.

The transfer tax benefits are not limited to estate and gift taxes but also encompass the generation-skipping transfer (GST) tax.[15] Under the GST tax provisions generally, if a donor gives or bequeaths property outright to a grandchild, or in trust for a child and then to a grandchild, the donor is taxed if he or she first transferred the property to the

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child, and the child then gave or bequeathed the property to the grandchild in a second taxable transfer. Each person has a $1 million GST exemption.[16] Just as lifetime gifts enable the subsequent increase in the value of the property to avoid estate tax, such gifts also enable the subsequent appreciation to escape GST tax.

Countervailing factors

A major countervailing factor is the loss of income tax deferral precipitated by withdrawing the grandfather amount. While the rules governing distributions from qualified plans and IRAs are extremely complicated,[17] they can be summarized as follows.

Qualified plan and IRA benefits are subject to income tax when they are received. Accordingly, if income tax deferral were the only factor, it would be advantageous to defer the receipt of benefits as long as possible.

The required beginning date (RBD) is April 1 following the date the participant reaches age 70½.[18] If the participant dies before the RBD, a designated beneficiary can receive the benefits over his or her own life expectancy.[19] For this purpose, one can look through certain trusts to the beneficiary of the trust. Estates and other types of trusts do not qualify as designated beneficiaries and must receive the benefits within five years after the employee's death.[20] A spouse can roll the benefits over into his or her own IRA,[21] or can defer distributions until the participant would have reached age 70½.[22]

For example, suppose Carol dies before her RBD. She names her son, David, as the beneficiary of her IRA. David is age 40 at Carol's death, and has a life expectancy of 42.5 years.[23] David must receive at least 1/42.5 of Carol's IRA the first year, 1/41.5 the next year, and so on.

If the participant is living at the RBD, he can receive distributions over the joint and survivor life expectancies of himself and a designated beneficiary.[24] A beneficiary other than a spouse who is more than ten years younger than the participant is treated as if she were only ten years younger than the participant.[25] In computing life expectancies, the life expectancies of the participant and his spouse (if the spouse is the beneficiary) can be recalculated annually.[26]

Upon the participant's death, the beneficiary must receive distributions as rapidly as the participant had been receiving distributions.[27] For this purpose, the beneficiary can use her actual age, even if the beneficiary is not the spouse and is more than ten years younger than the participant. If, however, the participant had been recalculating his age annually and

11 Section 2035(c).
12 Section 2035(d).
13 Section 2503(b).
14 Section 2505.
15 Sections 2601 *et seq.*
16 Section 2631.
17 See Sections 401(a)(9) and 408(a)(6); Prop. Regs. 1.401(a)(9)-1 and 1.408-8.
18 Section 401(a)(9)(C); Prop. Reg. 1.401(a)(9)-1, Q&A B-2.
19 Section 401(a)(9)(B)(iii); Prop. Reg. 1.401(a)(9)-1, Q&A C-1.
20 Prop. Reg. 1.401(a)(9)-1, Q&A D-2A and D-5.
21 Section 408(d)(3)(C)(ii).
22 Section 401(a)(9)(B)(iv).
23 Reg. 1.72-9, Table V.
24 Section 401(a)(9)(A)(ii); Prop. Reg. 1.401(a)(9)-1, Q&A B-1.
25 Section 401(a)(9)(G); Prop. Reg. 1.401(a)(9)-2.
26 Section 401(a)(9)(D); Prop. Reg. 1.401(a)(9)-1, Q&A E-6.
27 Section 401(a)(9)(B).

did not leave a designated beneficiary, all the benefits become payable at the participant's death. For example, if the participant designates a grandchild as beneficiary and dies before or shortly after reaching RBD, the post-death income tax deferral will be substantial and may outweigh both the additional estate tax and the failure of the Section 691(c) deduction to fully eliminate the double tax.

Similarly, if the participant lives to an advanced age and receives his benefits over an extended period of time, he will achieve substantial income tax deferral by leaving his benefits in the IRA as long as possible, while at the same time taking advantage of the annual threshold amounts and also removing the income tax payments from his estate. The same result is achieved if the participant designates his spouse as beneficiary and she lives to an advanced age and receives the benefits over an extended time.

On the other hand, a participant who has no designated beneficiary, was recalculating his life expectancy, and is in poor health is more likely to achieve an overall tax savings by withdrawing his grandfather amount. For instance, assume that when Eric reached his RBD, he designated his wife, Fran, as his beneficiary and elected to recalculate both his and Fran's life expectancies. Eric is now 80 years old, and Fran is deceased. Eric must withdraw 1/9.5 of his benefits this year, 1/8.9 of his benefits next year, and so on in accordance with the applicable life expectancy tables.[28] Since Eric's remaining life expectancy is relatively short, and since all his benefits will be distributed (and subject to income tax) upon his death, he may want to consider withdrawing his grandfather amount now.

An advantage of withdrawing the grandfather amount during life is that the income tax paid on it is removed from the estate for estate tax purposes.

It is not possible to make a lifetime gift of qualified plan or IRA benefits. To make a gift during life, a participant must withdraw the benefits, pay income tax (giving up any potential income tax deferral), and then make a gift of the proceeds.

Estate planning

A participant who plans to permit his beneficiaries to take advantage of post-death income tax deferral should keep in mind that the estate tax is due nine months after death.[29] He should make sure that sufficient life insurance proceeds or other liquid assets are available to pay the estate tax. Otherwise, it may be necessary to withdraw qualified plan or IRA benefits to pay the estate tax, which would accelerate the income tax and destroy the desired income tax deferral.

The IRS may grant discretionary extensions of up to ten years to pay estate tax.[30] Interest is payable on the deferred tax[31] but may be deductible as an administration expense for estate tax purposes.[32]

A participant should consider the estate planning aspects of qualified plan and IRA distributions. The beneficiary can be the spouse, a QTIP trust, a credit shelter trust, children, grandchildren, a charity, or a charitable remainder trust. There are income tax, estate tax, excise tax, and GST tax advantages and disadvantages with each choice. Moreover, the beneficiary designation should be coordinated with the participant's overall estate planning.

The rules governing qualified plan and IRA distributions are complex, and each case should be analyzed individually in light of the participant's situation and objectives. ■

28 Reg. 1.72-9, Table V.
29 Sections 6075(a) and 6151(a).
30 Section 6161(a).
31 Sections 6601(a) and 6601(b)(1).
32 Section 2053(a)(2).