AN INTRODUCTION
TO
ESTATE PLANNING

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The need for estate planning is often overlooked by people who assume that only the wealthy need the protection that estate planning can provide. The process of anticipating and arranging, during a person's life, for the management and disposal of that person's estate during the person's life and at and after death, while minimizing gift, estate, generation skipping transfer and income tax, can seem daunting to the individual. Estate planning also includes planning for incapacity as well as a process of reducing or eliminating uncertainties over the administration of a probate and maximizing the value of the estate by reducing taxes and other expenses. When a person passes, there are certain problems which, if not planned for, create a burden on those who are left behind. Proper estate planning can eliminate or reduce these problems. Once a plan is in place, it should be checked at least annually to assure that all beneficiary designations are up-to-date and the durable power of attorney/ies are correct.

Three primary objectives of estate planning would be:

- Avoid Probate
- Minimize Federal Estate Tax
- Have an Organized Plan in Place

Planning your estate requires thoughtful consideration of several key issues:

- Financial Burden

    - Probate Fees – These are generally paid to the executor of the estate and the attorney who assists with the probate.
    - Death Taxes – Estates that exceed certain amounts may be subject to both state and federal death taxes.

- Estate assets are improperly arranged

    - Liquidity – There is not enough liquid (cash type) assets to pay estate settlement costs.
    - Cash Flow – There is not enough income to care for loved ones left behind: e.g., spouse or minor children.

- Transfer of Assets

    - Estate assets may be subject to probate delays and expense.
    - Asset transferred to minors may be in cumbersome guardianship accounts until they attain age 18 (or 21 in some states) and are then distributed outright to the children.
    - ***Additional death taxes may be paid because there was not pre-death planning.***

- Care of Minors

    - Guardians: Parents can nominate a guardian for their minor children in a will.
    - Asset Management: if the wrong persons are chosen to manage the assets left for the minors, the assets may be lost or unnecessarily reduced.

WHO MAKES MEDICAL DECISION WHEN I CANNOT?

Modern medicine can now keep someone "alive" in situations that formerly would have resulted in death.

- "Living Will" – provides guidance as to the type of medical treatment to be provided or withheld and the general circumstances under which the directive applies.
- Durable Power of Attorney
    - Healthcare - Many states have laws allowing a person to appoint someone to make healthcare decisions for them if they become unable to do so for themselves.
    - Financial and Legal Decisions – Many states also have laws allowing a person to choose someone to make legal and financial decisions should that person become hospitalized, disabled or otherwise incapacitated.

*Note: Powers of attorney should be given to **trusted** individuals who are proficient in both financial and legal matters. Remember that medical powers of attorney can be separate and assigned to someone else.*

WILLS

ADVANTAGES OF A WILL

- Avoids Distribution Under the Law of Intestacy
- Permit the Nomination of a Guardian for Minor Children
- Waiver of Probate Bond
- Choosing the Executor
- Making Specific Bequests to Individuals
- Sale of Assets During the Administration of Probate
- Authorizing the Continuation of a Business
- Deferring Distributions to Minors
- Tax Savings
- Peace of Mind

KINDS OF WILLS

Here is a brief glossary of terms used in the law for various kinds of wills:

Simple Will: A will that just provides for the outright distribution of assets for an uncomplicated estate.

Testamentary Trust Will: A will that sets up one or more trusts for some of your estate assets to go to after you die.

Pourover Will: A will that leaves some of your assets in a trust that you had already established before your death.

Holographic Will: A will that is unwitnessed and in the testator's handwriting. About 20 states recognize the validity of such wills.

Oral Will (also called nuncupative will): A will that is spoken - not written down. A few states permit these.

Joint Will: One document that covers both a husband and wife (or any two people). These are often a big mistake and are especially inadvisable for estates larger than $675,000.

Living Will: Not really a will at all--since it has force while you are still alive and doesn't dispose of property--but often executed at the same time you make your will. Tells doctors and hospitals whether you wish life support in the event you are terminally ill or as a result of accident or illness cannot be restored to consciousness.

MAKING A WILL

A will is a revocable transfer to take effect on death. Wills have been with us since the first days of recorded history. Archaeologists have found 4500-year-old hieroglyphics leaving property to others in Egyptian tombs. Bible readers recall that Jacob left Joseph a larger inheritance than his brothers received, and the trouble that caused. Whether in ancient Egypt or modern America, all wills are different. What you put in yours depends on what property you have, whom you want it to go to, the dynamics of your family, and so on.

THE SEVEN ESSENTIALS OF A VALID WILL

To be valid, your will does not have to conform to a specific formula. For example, in states that recognize handwritten wills, some wills scrawled on the back of an envelope have stood up in court. However, there are certain elements that usually must be present.

1. You must be of legal age to make a will. This is 18 in most states, but may be several years older or younger in some places - check with a lawyer, if you need to know.

2. You must be of sound mind, which means that you should know you are executing a will, know the general nature and extent of your property, and know the objects of your bounty, i.e. your spouse, descendants and other relatives that would ordinarily be expected to share in your estate. Although you do not have to be found mentally incompetent by a court for your will to be challenged on the grounds of incompetence, the law presumes that a testator was of sound mind, and the standard for proving otherwise is very high - much more than mere absent-mindedness or forgetfulness. Because disgruntled relatives who want to challenge a will occasionally use this sound-mind requirement to attack the testator's mental capacity, in special cases the execution of a will is sometimes videotaped and kept on file, so if someone raises a question after the testator dies, the videotape can be good evidence of testamentary capacity.

3. The will must have a substantive provision that disposes of property, and it must indicate your intent to make the document your final word on what happens to your property - that is, that you really intended it to be a will.

4. The will must be voluntarily signed by the testator, unless illness or accident or illiteracy prevents it, in which case you can direct that your lawyer or one of the witnesses sign for you. This requires a lawyer's guidance, or at least knowledge of your state's law, since an invalid signature could void a will.

5. Although oral wills are permitted in limited circumstances in some states, wills must usually be written and witnessed. The will scrawled on an envelope will not work in these states. To be safe, do not handwrite a will if you can avoid it.

6. Though some states do allow informal oral and written wills in certain circumstances, all states have standards for formal wills. Writing a formal will and following these standards helps assure that your wishes will be followed after your death. In almost all states, the signing of a formal will must be witnessed by at least two adults who understand what they are witnessing and are competent to testify in court. There have to be three in Vermont and New Hampshire, three plus a notary in Puerto Rico. In most states, the witnesses have to be disinterested (i.e., not getting anything in your will). If they are not, you run the risk of voiding certain provisions in the will, opening it to challenge or invalidating the entire will.

7. A formal will must be properly executed, which means that it contains a statement at the end attesting that it is your will, the date and place of signing, and the fact that you signed it before witnesses, who then also signed it in your presence and watched each other signing it. Most states allow so-called self-proving affidavits, which eliminate the necessity of having the witnesses testify that they witnessed the signing; the affidavit is proof enough. In other states, if the witnesses are dead or unavailable, the court may have to get someone else to verify the legitimacy of their signatures.

If your will does not meet these conditions, it might be disallowed by a court, and your estate would then be distributed according to a previous will or under your state's intestacy laws.

WHO CAN WRITE A WILL?

Legally, you do not have to use a lawyer to write your will. If it meets the legal requirements in your state, it is valid whether or not you wrote it with a lawyer's help. Nonetheless, studies show that more than 85% of Americans who have wills used a lawyer's help in preparing them.

Below are some alternatives and considerations to take into account in deciding which to use.

Doing it yourself

Several alternatives are absolutely free, but not often used. For example, oral wills are permissible in less than half the states, sometimes under very limited circumstances, such as when they are uttered in your final illness. Also, oral wills often apply only to personal property.

Handwritten, unwitnessed wills are valid in about half the states and effective to dispose of more kinds of property. Nonetheless, they are not recommended. Since they rarely follow legal formalities, it is sometimes hard to prove that they are intended to be wills, or intended to be your last will, and they are vulnerable to fraud and they often do not cover all the testator's assets.

Soldiers' and seamen's wills are permitted by about half the states. They allow people actually serving in the armed forces to dispose of their wages and personal property orally or in an informal written document. Often, they are only valid during wartime, when the will-maker is in a hostile zone, and they usually cease to be valid after a certain time that varies by state.

Statutory wills are another free alternative available in a few states. A statutory will is a form that has been created by a state statute. Since the statutory will includes all the formalities, all you have to do is get a copy at a stationery store, fill it out, have it witnessed, and you have a valid will. Unfortunately, these wills are very limited. They assume you want to leave everything to your spouse and children and provide for few other gifts. You must follow the form - they cannot legally be changed.

In recent years, several books and computerized will kits have come on the market which claim to enable you to make your own will. The cost of a book may run $20 or more, the cost of a kit $70 or more. For simple estates - involving little money and other assets, and in which everything is to go to a few people - they might be a viable alternative. However, make sure that a given book or kit is up-to-date and thorough, especially since probate laws vary from state to state. The kits are easier than the books to fit into your estate plan - they typically take you through a will with computer prompts that enable you to alter the document to fill typical needs.

Doing it this way may not be easy. Do-It-Yourself books and kits, some lawyers say, have caused more work for lawyers (and bills for clients) than they have avoided. There is a famous case about one man who thought he would get two wills for the price of one will kit. He made a form will for himself, then took that and substituted his wife's name for his own in the signature clause and the introductory clause. But he failed to change the name of the beneficiaries - meaning that when his wife died, she left all her property to herself! This one, of course, ended up in court, at a substantial cost to the surviving husband.

Once you begin totaling up all your assets, you may be surprised to find that your estate is larger than you thought. At the same time, family relationships are becoming more complicated. Today, a do-it-yourself will might not do the job.

Using a lawyer

The cost of having a will drawn up professionally depends on the size and complexity of your estate, the going rates for lawyers in your area, your lawyer's experience, and so on.

About 74 million Americans belong to group legal service plans. These plans enable members to get legal services either free or at reduced cost. In many programs, simple wills are either free or cost far less than the going rate. More comprehensive estate planning and preparation of other documents are available from lawyers at a reduced hourly rate. About 90% of plans are available to members of certain organizations (like AARP, the military or a union), or to workers in certain industries as a result of collective bargaining agreements. Some of these plans have no fee at all to the participant; others may have a modest fee. About 10% of plans are available to individuals, including one through the Signature Group of Montgomery Ward's.

Legal clinics are another low-cost alternative. They can prepare your will for modest amounts because legal assistants do much of the work under a lawyer's guidance. That work often consists of adapting standard computerized forms to fit the needs of the client. If you have a small, simple estate, the cost may be modest, and you may have the benefit of professional advice and reassurance that your will meets the standards for validity in your state.

If you want to use a private lawyer, many will give you the first consultation free. Ask one to give you a price or range of prices for preparing a will or estate plan; it might be cheaper than you think. Often, lawyers have a written fee schedule for various kinds of wills. If yours does not, before you give the final go-ahead to draw up your will, ask the estimated cost (or at least a range of likely costs).

You should most certainly use a lawyer if you own a business, if your estate exceeds $1 million (making tax planning a factor under current law), or if you anticipate a challenge to the will from a disgruntled relative or anyone else.

As noted previously, a skillfully drawn will generally saves you money in the long run. By giving the executor (the person you choose to administer your estate after you die) authority to act efficiently, by saying that a surety bond will not be required and by directing that the involvement of the probate court be kept to a minimum, you can save your family money.

PROBATE

The probate system in the United Stated is patterned after the British common law system. Probate is the system by which property is distributed at death. Briefly stated, the probate process is where:

- The decedent's purported will, if any, is entered in court
- Once hearing evidence from the representative of the estate, the court will decide if the will is indeed valid
- A personal representative is appointed by the court as a fiduciary to gather and take control of the estate's assets
- Known and unknown creditors are notified either through direct contact or publication in the media to file any claim/s against the estate
- Claims will be paid out in the order or priority governed by state law
- Any remaining funds will be distributed to beneficiaries named in the will, or heirs, if there is no will
- The probate judge will close out the estate

Probate avoidance

Due to the time and expenses associated with the traditional probate process, modern estate planners frequently counsel clients to enact probate avoidance strategies. Some common probate-avoidance strategies include:

- revocable living trusts,
- joint ownership of assets and naming death beneficiaries,
- making lifetime gifts,
- purchasing life insurance.

If a revocable living trust is used as a part of an estate plan, the key to probate avoidance is ensuring that the living trust is "funded" during the lifetime of the person establishing the trust. After executing a trust agreement, the settlor should ensure that all assets are properly re-registered in the name of the living trust. If assets (especially higher value assets and real estate) remain outside of a trust, then a probate proceeding may be necessary to transfer the asset to the trust upon the death of the testator.

WRITING A WILL

Freedom of disposition

After your lawyer has a good idea of what you want and what your assets are, he or she will probably suggest various options to help you achieve those objectives. In general, you can pick whom you want your property to go to and leave it in whatever proportions you want.

There are exceptions, however. For example, a surviving husband or wife may be entitled to a statutory share of the estate regardless of the will. This is a percentage set by state law. (You or your spouse can voluntarily give up this legal protection in a prenuptial agreement.) Otherwise, you can disinherit anyone, but if you are disinheriting a family member, you should do so specifically, not by omission. In some states surviving spouses are entitled by law to the family home as a homestead right. Though your spouse can try to give it to someone else in the will, you would have to approve it or the property is yours.

Some states limit how much you can leave to a charity if you have a surviving spouse or children, or if you died soon after making the provision (under the assumption someone exerted undue influence on you).

Most states impose some restrictions on conditions listed in wills that are bizarre, illegal or against public policy of the state. For example, if you wanted to set up an institute to promote terrorism and violent overthrow of the government, the probate court would probably throw out the bequest.

Some people try to make their influence felt beyond the grave by attaching conditions to a gift made in the will (as opposed to the purely advisory language in a letter of intent). Most lawyers advise against this; courts do not like such conditions, and you are inviting a will contest if you try to tie them to a gift. You cannot require your daughter to divorce her no-account husband to claim her inheritance from you; nor can your husband make your inheritance contingent on a promise you will never remarry; nor can you force that secular humanist son-in-law to go to church every Sunday. For the most part, though, it is your call.

CLAUSE-BY-CLAUSE

There is no set formula for what goes into a will. There are some things you might want to think about if you fall into certain categories – younger couples, older couples, single people, divorced people, and so on.

Below are the more common clauses of a basic will, following the order of clauses of the sample will in this section, to illustrate some typical will contents. Funeral expenses and payment of debts. Your debts do not die with you; your estate is still liable for them, and your executor needs no authority to pay them off.

If your debts exceed your assets, your state law will prescribe the order in which the debts must be paid by category. Funeral expenses and expenses of administration usually receive first priority. Family allowances, taxes, and last illness expenses will also appear near the top of the list. If you want certain creditors to be paid off first, ask your lawyer how to ensure this will happen considering your state's particular law.

As for funeral directions, while you can put them in your will, be aware that the will might not be found until after you are buried. It is best to put these in a separate document.

You can also forgive any debts someone owes you by stating it in your will.

Gifts of personal property

It is important to carefully identify all recipients of your largesse, including their address and relationship to you. There are too many cases of people leaving property to "my cousin John," not realizing that more than one person might fit that description. Or you leave something to "my sister's husband," and she later divorces him and remarries - who gets the gift? A court might have to decide.

If you have several children or other relatives in the same category (cousins, siblings, etc.), and you want them to divide your estate or some portion of it equally, you should state that you are giving the gift to the class ("my cousins") not to them as individuals ("Mutt and Jeff"). That way, if one of them dies, the others would take the whole gift. Otherwise, the dead cousin's heirs would take his share of the gift. On the other hand, if you definitely do want a beneficiary's children to take a gift if he predeceases you, you would use language that indicates this, typically "to my cousins, A, B, and C and their issue, per stirpes." This is technical territory, but the main thing to remember about gifts to a class is this: if you have several beneficiaries, use language that will account for the possibility of one of the class members dying before you do.

For similar reasons, you should usually be specific about the gifts you are making. Do not just leave "household property" to someone, because that category is vague enough to spark a dispute in court, or at least in the family. Spell out the items ("stereo equipment, clothing, books, cash"), or just omit any mention at all and let them pass through the residuary clause.

On the other hand, in cases where the specific item of property might change between the time you write the will and the time you die, you might want to be more general in your phrasing - leaving your son not "my 1986 Yugo" but "the car I own when I die." The same applies to stocks or bank accounts; the bank may be taken over by another bank; the stock may be sold. Better to include a general description or leave a dollar amount or fractional share.

Make sure the language you use in giving the gift is unambiguous: "I give..." "I direct that... "and so on. Wishy-washy terms like "It is my wish that..." might be taken to be merely an expression of hope, not an order. At the very least, such precatory language could invite a court challenge.

In general, it is simpler for your executor if you leave your property to people in broad but specific categories ("all my furniture") rather than passing it on it piece-by-piece ("my kitchen table") to many different people. If you want specific gifts of sentimental value to go to certain people, consider giving them to those people before you die, so you can witness their pleasure (and, if your estate is large, lower estate taxes). Or, some attorneys advise leaving most items to one or two people, and then writing a letter of intent that advises those people about how you want them to spend that money or distribute those items. Some states have laws providing for these letters but some do not. That means LETTERS OF INTENT MAY NOT BE LEGALLY BINDING. Use them only with people you can trust. (One way to handle specific bequests of personal property is through a tangible personal property memorandum or TPPM).

Remember also that personal property can include intangible assets like insurance policies (for instance, if you own a policy on your spouse's life, that policy and cash value of the premiums paid into it can be passed on through your will), bank accounts, certain employee benefits, and stock options.

Finally, if you have multiple beneficiaries you want to share in a gift, be careful to specify what percentage of ownership each will have. If you fail to do this, the court will probably presume that you intended the beneficiaries to share equally. Most lawyers counsel against shared gifts, because it means several people have to agree on use of the property, and one co-owner may be able to force a sale. But there are some indivisible assets - a house, typically - where you may have little choice but to let more than one person share in the gift. If so, talk to the beneficiaries first and make sure they agree on how they will jointly use and manage the gift. And be sure to designate alternative beneficiaries (usually the others who will share in the gift) in case one of them dies before you do.

You can save on taxes by using gifts wisely. This section of your will can be used to give gifts to institutions and charities as well as to people.

Gifts of Real Estate

Most people prefer that their spouses receive the family home. If the home is not held in joint tenancy (survivorship), you should have instructions about what will happen to it in your will.

It is possible to give what lawyers call a life estate. This is giving something to a person, to use for as long as he or she lives but that reverts to your estate or passes to someone else after he or she dies. It is a way of assuring, for example, that your husband will have the use of your house while he lives, but that it will pass to the children of your first marriage after he dies. The rules governing such transfers, or any transfers different from a fee simple outright transfer of ownership, are so complicated that you must use a lawyer to make such a gift properly.

If you die before you have paid off the mortgage on your house, your estate will normally have to pay it off. If you are afraid this will drain the estate too much, or if you want the recipient of the house to keep paying on the mortgage, you must specify that in your will. If you have not paid off the family house, and you are afraid your survivors can not afford to, you may be able to buy mortgage-canceling insurance to pay it off.

Executors

It helps to spell out certain powers the executor (or, as he or she is called under the laws of some states, the personal representative) can have in dealing with your estate: to buy, lease, sell and mortgage real estate; to borrow and lend money; to exercise various tax options. Giving the executor this kind of flexibility can save months of delay and many dollars by allowing him or her to cope with unanticipated situations. If you run a business, be sure to give your executor specific power to continue the business - or enter into new business arrangements. If you do not, the law may require that the business be liquidated or sold.

Residuary clause

This is one of the most crucial parts of a will, covering all assets not specifically disposed of by the will. You will probably accumulate assets after you write your will, and if you have not specifically given an asset to someone, it will not pass through the will - unless you have a residuary clause that, as Lyndon Johnson used to say of grandmother's nightdress, covers everything. (If your will omits a residuary clause, the assets not left specifically to anyone would pass on through the intestate succession laws, after long delays and extensive court involvement.) No matter how small your residuary estate seems at the time you write your will, you should almost always leave it to the person you most care about.

The residuary clause distributes assets that you might not have anticipated owning. For example, normally anything you own in joint tenancy would pass automatically to the other tenant at your death, and so you would not include it in your will. But what if the joint tenant has died before you? Your estate now probably owns the entire asset, and your residuary clause would ensure that it goes to someone you care about.

Testamentary Trusts

As we will see in the next section, you can set up a testamentary trust in your will or have your will direct funds from your estate into a trust you had previously established (your will would then be a pour-over will). You would normally do so in a separate clause in your will.

AFTER THE WILL IS WRITTEN

Executing the will

After you have drawn up your will, there remains one step: the formal legal procedure called executing the will. This requires witnesses to your signing the will. In all states, the testimony of at least two witnesses is needed as proof of the will's validity. In some states, the witnesses must actually show up in court to attest to this, but in a growing number of states, a will which is formally executed with the signatures notarized (and a self-proving affidavit attached) is considered to be self-proved and may be used without testimony of witnesses or other proof.

Who should you pick to be your witnesses? The witnesses should have no potential conflict of interest - which means they should absolutely not be people who receive any gifts under the will, or who might benefit from your death. You need not bring them with you to your lawyer's office; typically, some employees of your lawyer will witness the signing. You should sign every page of the original. The witnesses will watch you sign the will and then sign a statement attesting to this.

Where to keep your will

It is not a bad idea to make a few unsigned copies of your will and have them available for ready reference, but to avoid confusion; you should sign only one original. This – and only this – is your legally valid will. Keep it in a safe place, a fire proof box, your lawyer's office, etc. Some jurisdictions will permit you to lodge the will with the probate court for a nominal fee, but in some places, that makes the will a public record. If privacy is paramount for you, you should ask your lawyer or the probate office how best to accomplish this.

You should also keep a record of other estate planning documents with your will, such as a trust agreement, IRAs, insurance policies, income savings plans such as 401(k) plans, government savings bonds (if payable to another person), and retirement plans.

What if you lose your will? Have your lawyer draw up a new will as soon as possible and execute it with all the necessary formalities. If your family situation, state of residence, or income hasn't changed, your lawyer should be able to use copies of your lost will as a guide.

While many people keep their wills in their safe deposit boxes at a bank, in some jurisdictions the law requires those boxes to be sealed immediately after death, until the estate is sorted out.

Needless to say, if your will is inside that box - or your cemetery deeds and burial instructions—sorting things out might get pretty complicated. If you do keep it in a safety deposit box, make sure to provide that someone else (and certainly the executor you name) can get at the will when you die. Tell your executor and your beneficiaries where the will is located, and make sure your executor, or someone you trust, has authority (and a key!) to open the box after your death. Many estates have gone through long probate delays because the bank did not have permission to let anyone open the safety deposit box except the person who had just died. If you name a bank as executor or co-executor, deliver the original will to the bank for safekeeping.

It is OK to store copies of the will in your home. Personal papers such as your birth certificate, citizenship records, marriage certificate, coin collections, jewelry, heirlooms, medals and so on may be kept in your safe deposit box. Financial records, like securities, mortgage documents, contracts, leases and deeds are also safe to store.

What about a trust agreement? Unlike a will, a trust may have more than one original, in which case, there will be language saying something like, "This trust is executed in four counterparts, each of which has the force of an original." Your trustee, successor trustee, and lawyer should each have a copy. And every time you amend the trust, be sure to have the amendment in a separate copy so indicated and signed by you. Unless the amendment is a complete restatement of the trust (i.e., a complete reworking of the trust), attach an executed copy to each signed copy of the trust, if possible.

TRUSTS

TRUST

TRUSTOR TRANSFERS → CORPUS (ASSETS) → BENEFICIARIES

TRUSTEE MANAGES FOR BENEFITS OF BENEFICIARIES

Like a will, a trust is a very useful instrument in the estate-planning arsenal. Estates can be as diverse as people, and the flexibility of a trust makes it useful for many different needs. A trust can do a number of things a will cannot do as well, including:

- manage assets efficiently if you should die and your beneficiaries are minor children or others not up to the responsibility of handling the estate;
- protect your privacy (unlike a will, a trust is confidential);
- depending on how it is written, and on state law, a trust can protect your assets by reducing taxes;
- if it is a living trust, the trustee can manage property for you while you are alive, providing a way to care for you if you should become disabled. A living trust also avoids probate, lowers estate administration costs, and speeds transfer of your assets to beneficiaries after your death.

Should you have a trust? It depends on the size of your estate and the purpose of the trust. For example, if you mainly want a living trust to protect assets from taxes and probate, but your estate is under the current federal tax floor and small enough to qualify for quick and inexpensive probate in your state, some lawyers would tell you it is not worth the cost. If, however, you want to avoid a court hearing if you become incompetent or unable to provide for yourself or you want to provide for grandchildren, minor children, or relatives with a disability that makes it difficult for them to manage money, a trust has many advantages.

Basic Principles

Property of any sort may be held in a trust. The uses of trusts are many and varied, for both personal and commercial reasons, and trusts may provide benefits in estate planning, asset protection and taxes. Living trusts may be created during a person's life (through the drafting of a trust instrument) or after death in a will.

In a relevant sense, a trust can be viewed as a generic form of a corporation where the settlors (investors) are also the beneficiaries. This is particularly evident in the Delaware business trust, which could theoretically, with the language in the "governing instrument", be organized as a cooperative corporation or a limited liability corporation, although traditionally the Massachusetts business trust has been commonly used in the US. One of the most significant aspects of trusts is the ability to partition and shield assets from the trustee, multiple beneficiaries, and their respective creditors (particularly the trustee's creditors), making it "bankruptcy remote", and leading to its use in pensions, mutual funds, and asset securitization as well protection of individual spendthrifts through the spendthrift trust.

TERMONOLOGY USED IN CREATING A TRUST

- **Appointer**: This is the person who can appoint a new trustee or remove an existing one. This person is usually mentioned in the trust deed.
- **Appointment:** In trust law, "appointment" often has its everyday meaning. It is common to talk of "the appointment of a trustee", for example. However, "appointment" also has a technical trust law meaning, either:
  - the act of *appointing* (i.e. giving) an asset from the trust to a beneficiary (usually where there is some choice in the matter—such as in a discretionary trust); or
  - the name of the document which gives effect to the appointment.

  The trustee's right to do this, where it exists, is called a power of appointment. Sometimes, a power of appointment is given to someone other than the trustee, such as the settlor, the protector, or a beneficiary.

- **As Trustee For (ATF)**: This is the legal term used to imply that an entity is acting as a trustee.
- **Beneficiary**: A beneficiary is anyone who receives benefits from any assets the trust owns.
- **In Its Own Capacity (IIOC)**: This term refers to the fact that the trustee is acting on its own behalf.
- **Protector:** A protector may be appointed in an express, *inter vivos* trust, as a person who has some control over the trustee - usually including a power to dismiss the trustee and appoint another. The legal status of a protector is the subject of some debate. No one doubts that a *trustee* has fiduciary responsibilities. If a *protector* also has fiduciary responsibilities, then the courts - if asked by beneficiaries - could order him or her to act in the way the court decrees. However, a protector is unnecessary to the nature of a trust - many trusts can and do operate without one. Also, protectors are comparatively new, while the nature of trusts has been established over hundreds of years. It is therefore thought by some that protectors have fiduciary duties, and by others that they do not. The case law has not yet established this point.
- **Settlor(s)**: This is the person (or persons) who creates the trust. **Grantor**(s) is a common synonym.
- **Terms of the Trust** means the settlor's wishes expressed in the Trust Instrument.
- **Trust deed**: A trust deed is a legal document that defines the trust such as the trustee, beneficiaries, settlor and appointer, and the terms and conditions of the agreement.
- **Trust distributions**: A trust distribution is any income or asset that is given out to the beneficiaries of the trust.
- **Trustee:** A person (either an individual, a corporation or more than one of either) who administers a trust. A trustee is considered a fiduciary and owes the highest duty under the law to protect trust assets from unreasonable loss for the trust's beneficiaries.

WHAT IS A TRUST?

A trust is a legal relationship in which one person (or qualified trust company) (trustee) holds property for the benefit of another (beneficiary). The property can be any kind of real or personal property - money, real estate, stocks, bonds, collections, business interests, personal possessions and automobiles. It is often established by one person for the benefit himself or of another. In those cases, it generally involves at least three people: the grantor (the person who creates the trust, also known as the settler or donor), the trustee (who holds and manages the property for the benefit of the grantor and others), and one or more beneficiaries (who are entitled to the benefits).

It may be helpful to think of a trust as a contract between the grantor and the trustee. The grantor makes certain property available to the trustee, for certain purposes. The trustee (who often receives a fee) agrees to manage the property in the way specified.

Putting property in trust transfers it from your personal ownership to the trustee who holds the property for you. The trustee has legal title to the trust property. For most purposes, the law looks at these assets as if they were now owned by the trustee. For example, many trusts have separate taxpayer identification numbers. But trustees are not the full owners of the property. Trustees have a legal duty to use the property as provided in the trust agreement and permitted by law. The beneficiaries retain what is known as equitable title, the right to benefit from the property as specified in the trust.

The donor may retain control of the property. If you set up a revocable living trust with yourself as trustee, you retain the rights of ownership you would have if the assets were still in your name. You can buy anything and add it to the trust, sell anything out of the trust, and give trust property to whomever you wish.

If you set up the trust by your will to take effect at your death – a testamentary trust – you retain the title to the property during your lifetime, and on your death, it passes to the trustee to be distributed to your beneficiaries as you designate.

We speak of putting assets "in" a trust, but they don't actually change location. Think of a trust instead as an imaginary container. It's not a geographical place that protects your car, but a form of ownership that holds it for your benefit. On your car title, the owner blank would simply read "the Richard Petty trust." It's common to put whole bank and brokerage accounts, as well as homes and other real estate, into a trust.

After your trust comes into being, your assets will probably still be in the same place they were before you set it up--the car in the garage, the money in the bank, the land where it always was--but it will have a different owner: the Richard Petty trust, not Richard Petty.

HOW DO TRUSTS OPERATE?

There is no such thing as a standard trust, just as there is no standard will. You can include any provision you want, as long as it does not conflict with state law. The provisions of a written trust instrument govern how the trustee holds and manages the property. That varies greatly depending on why the trust was set up in the first place.

In a living trust, the grantor may be the trustee and the beneficiary. In trusts set up in your will, the trustee is often one or more persons or, for larger estates where investment expertise is required, a corporate trust company or bank.

Trusts can be revocable (that is, you can legally change the terms and end the trust) or irrevocable. **Here it is enough to say that a revocable trust gives the donor great flexibility but no tax advantages**. If the trust is revocable and you are the trustee, you will have to report the income from the trust on your personal income tax return, instead of on a separate income tax statement for the trust. The theory is that by retaining the right to terminate the trust, you have kept enough control of the property in it to treat it for tax purposes as if you owned it in your name.

Irrevocable trusts are the other side of the coin – far less flexibility but with possible tax benefits. The trustee must file a separate tax return.

Trusts can be very simple, intended for limited purposes, or they can be quite complex, spanning two or more generations, providing tax benefits and protection from creditors of the beneficiary, and displacing a will as the primary estate planning vehicle.

ADVANTAGES AND DISADVANTAGES OF A LIVING TRUST

ADVANTAGES

- Assets in the trust are not subject to probate administration
- Professional management is available
- Successor trustee
- Annual court accounting not required
- Can collect life insurance proceeds immediately
- Management is uninterrupted by incapacity
- Time management
- Segregation of assets
- Trial run for the trustee
- Privacy
- Less expenses with fewer delays
- Less vulnerable to attach than a will
- Uninterrupted management at death
- Avoidance of probate in other states

DISADVANTAGES

- Creditors may not be cut off as quickly as they are in probated estates
- Effort required to transfer assets
- Fees to establish plus ongoing administrative charges
- Lack of automatic revocation in the event of divorce
- Memorandum disposition of personal property
- Loss of probate estates, tax entity and other tax issues
- Do not make gifts directly from a living trust
- Financing property
- Claims of creditors

WHO NEEDS A TRUST?

Parents with Young Children

If you have young children, want to assure a good education for them, and will have enough assets to do so after death (including life insurance proceeds), you should consider setting up a trust. The trustee manages the property in the trust for the benefit of your children during their lifetime or until they reach the ages that you designate. Then any remaining property in the trust may be divided among the children. This type of arrangement has an obvious advantage over an inflexible division of property among children of different ages without regard to their respective ages or needs.

Trusts are more flexible than giving outright gifts to minors in your will (which requires a guardian) or a gift under the Uniform Transfer to Minors Act, which requires appointment of a custodian and transfers of property to the child at age 18. Issues to consider when setting up a trust for the benefit of your children:

One Trust or Many?

Most people will set up one trust that all the children can draw on, until they've completed their educations (or reached an age by which they should have done so).

Then the remaining principal is divided among them equally. This permits the trustee greater flexibility to distribute ("sprinkle") the money unequally according to need; for example, one child may choose to pursue an advanced degree at an expensive private university, while another may drop out of community college after a semester. Obviously, they will have different educational expenses. Where

very young children are involved, it's especially important to build in some flexibility; who knows if a two-year-old may turn out to need special counseling or education by the time he turns five or six?

There are two philosophies about what to do if there's a disparity in ages among the children. One theory is that the older children have already received the benefit of the parents' spending before they died, so the trustee should have authority to make unequal distributions in favor of the younger children to compensate. The other camp, by contrast, thinks it better to establish separate trusts, so that the older children don't have to wait until they're well into adulthood before the trust assets are distributed (which usually happens when the youngest child reaches majority age). You'll have to decide which course is best for your family's circumstances.

Generally speaking, the less money you have to distribute, the more likely you would put it all in one trust. Since there is a limited amount of money, you want to pool it to be sure that it goes for the greatest need. On the other hand, if equality is your primary consideration and there's plenty of money available to take care of each child's likely needs, then you may want to set up separate trusts for each child, to assure that each gets an equal share.

What should the assets be used for?

You can specify that the trust pay for education, health care, food, rent and other basic support. Given life's unpredictability, however, it is often better to write a vague standard (e.g., "for the support of my children") into the document and allow the trustee the discretion to decide if an expenditure is legitimate. Such a provision also gives the trustee flexibility.

For example, if one of your children has an unanticipated expenditure, like a serious illness, the trustee could give him more money that year than the other children.

When should the assets be distributed?

Some parents pick the age of majority (18) or the age when a child will be out of college (22 or so). If all the assets are in one trust that serves several children, you would usually have the assets distributed when the youngest child reaches the target age. If you have separate trusts and a pretty good idea about each child's level of maturity, you can pick the age that seems appropriate for each one to receive his or her windfall.

If you don't know when each child will be capable of handling money, you can leave the age of distribution up to the trustee (and risk friction between the trustee and the children), have the trustee distribute the assets at different times (say, half when the first child turns 25 and the rest when the youngest does so), or just pick an age for each child, such as 30.

Like any trust, a children's trust costs money to set up: lawyers' fees for creating the trust, fees for preparing and filing the separate tax returns required, and so on. For families of limited assets, it might be best to give the money via a custodial account under the Uniform Gift to Minors Act or the Uniform Transfers to Minors Act.

People with beneficiaries who need help Trusts are especially popular among people with beneficiaries who aren't able to manage property well. This includes elderly beneficiaries with special needs or a relative who may be untrustworthy with money. For example, if you have a granddaughter who has been in a juvenile detention center, it may be a good idea to require her to obtain the money at intervals from a trustee instead of giving her a gift outright in your will. A discretionary trust gives the trustee leeway to give the beneficiary as much or as little he or she thinks appropriate.

Another type of trust is for improvident beneficiaries - a spendthrift trust. It is simply a trust in which your instructions to the trustee carefully control how much money is released from the trust and at what intervals, so you can keep an irresponsible beneficiary from the temptation of getting thousands of dollars in one stroke. You can stipulate that the trustee will pay only certain expenses for the beneficiary--those you (or the trustee) consider legitimate, such as rent and utility bills. In a spendthrift trust the beneficiary cannot assign his or her interest in the trust, and creditors of the beneficiary cannot get at the principal in a trust, but can make a claim (if it is otherwise legal) on whatever income the beneficiary receives. Spendthrift provisions raise a number of tricky questions and should be used cautiously. Your lawyer can tell you whether such a trust is appropriate for your situation.

People who own property that is hard to divide

Trusts help you transfer property that is not easily divided evenly among several beneficiaries.

Suppose you have a little vacation cottage on the Cape, and four children who each want to use it. You can pass it to them in a trust that sets out each child's right to use the property, establishes procedures to prevent conflicts, requires that when the property is sold the trustee divide the proceeds evenly (or unevenly, if some children are not as well off as others), and sets up a procedure by which any child may buy out another's interest in the cottage. People who want to control their property because of family dynamics.

Through a trust, you can maintain more control over a gift than you can through a will. Some people use trusts to pass money to a relative when they have doubts about that person's spouse. For example, you love your son, but don't trust his wife, Livia. You're afraid she'll spend the money you give him on astrologers and shoes. Leave the money in trust for your son instead of making a direct gift to him, and you can direct that he get only the income, so neither he nor his wife can squander the principal. In many states, if you leave money in trust to your son, Livia cannot get at the assets if they divorce. Moreover, he can choose how much, if any, of the trust income or principal to leave Livia; if she hasn't been a good and faithful companion, he can leave the whole thing to whomever he desires.

People concerned about estate taxes

Trusts are very useful to people with substantial assets, because they can help avoid or reduce estate taxes. For example, by establishing a trust for their benefit, you can make tax-free gifts (up to the limit allowed by law) each year to your children or grandchildren during your lifetime, even if they are minors. This will reduce your taxable estate and save taxes upon your death. A properly drawn trust may also reduce estate taxes by utilizing the marital deduction or avoiding the generation skipping tax.

There are Federal Estate Tax Tables to determine the taxable amount of the estate. In simple terms, the "taxable" estate is a decedent's gross estate (everything he or she owned on the date of death) less transfers to a spouse, gifts of charity and taxes and other allowable estate expenses.

SETTING UP A TRUST

If you establish one in your will, the trust provisions are contained in that document. If you create a trust during your lifetime, its provisions are contained in the trust agreement or trust declaration. The provisions of that trust document (not your will or state law) will determine what happens to the property in the trust upon your death. With any type of trust, one of the most important issues is choosing the trustee.

Funding the trust

A testamentary trust is funded after your death, with assets that you've specified in your will and through beneficiary designations of your life insurance, IRA, and so on. Such trusts generally receive most of the estate assets, such as the proceeds from the sale of a house. Or you could set up an "unfunded" standby trust. This is a trust that could be called "minimally" funded to avoid confusion. It may have a nominal sum of money in it--$100 or so--to get it started while you're alive (and thus make it a living trust), but it only receives substantial assets when you die. Your pour-over will would direct that many or all of your assets be transferred from your estate to the trust at your death.

Life insurance payable to the trust, as well as designating the trust as the beneficiary of IRAs, profit-sharing plans, and so on, will pass these assets directly to the trust outside of probate. However, other assets not already owned by the trust when you die will have to go through probate. This is why many lawyers shy away from unfunded trusts, unless probate avoidance isn't the primary goal.

If your estate--with life insurance benefits included--will add up to more than $1 million, you can save taxes by removing the life insurance proceeds from your estate and establishing an irrevocable life insurance trust that owns the policy; all incidents of ownership in the policy belong to the trust. When you die, the proceeds are paid into the trust, escaping estate taxation and creditors in so far as the insurance policy is concerned.

Trusts and taxes

There are a few basic principles worth mentioning here. While gifts under the $1 million level (in a trust or in a will) escape federal estate taxation, the recipients of the trust income will still have to pay income tax when they receive income from the trust. They would not have to pay tax on the principal in the trust when they collected it (unless their state has an inheritance tax).

The trustee pays, out of the principal, the taxes on income from the trust that's reinvested or put back into the principal. Capital gains from the sale of stock, real estate and the like are generally added to the principal unless you specify otherwise.

The choice of trustee can affect the tax the trust owes. If the beneficiary is made the only trustee, some of the tax advantages of the trust can be lost. Similarly, the more powers the grantor retains, the more likely the assets in the trust will be taxable, either during the grantor's life as income tax or after death as estate tax. Consult your attorney or a tax advisor before setting up any trust for tax purposes.

Terminating a trust

Only charitable trusts can last indefinitely. Since trusts of this sort are established to accomplish a substantial benefit to the public, it is entirely appropriate that Rhodes scholarships, Pulitzer and Nobel prizes, and thousands of other awards and grants be funded by trusts that are expected to endure.

Private trusts, set up to benefit private beneficiaries, cannot last forever. The rule against perpetuities, which is embodied in state law and may vary somewhat from state to state, is designed to limit the time a trust may be operative. Usually it specifies that a trust can last no longer that the life of a person alive at the time the trust is created, plus 21 years. So, if you set up a trust to benefit your infant granddaughter and any children she may eventually have, and she has a long life, your trust may extend 100 years, but not much more.

Your trust agreement should contain a clause that provides how it can be terminated. A good trust drawn up by a lawyer will certainly have such a clause.

A trust often terminates when the principal is distributed to the beneficiaries, at the time stated in the trust agreement. For example, you might provide that a trust for the benefit of your children would end when the youngest child reaches a certain age. At that time, the trustee would distribute the assets to the beneficiaries according to your instructions. The law generally allows a "windup phase" to complete administration of trust duties (e.g., filing tax returns) after the trust has officially terminated.

You can also give your trustees the discretion to distribute the trust assets and terminate the trust when they think it's a good idea, or place some restrictions on their ability to do so. For example, you could allow the trustees to terminate the trust in their discretion, provided that your daughter has completed her education.

Your trust should have a termination provision even if it is an irrevocable trust. "Irrevocability" means that you, the donor, cannot change your mind about how you want the trust to terminate. It doesn't mean that you cannot set up termination procedures in the first place. If you have an irrevocable trust and don't have a termination provision, it can usually terminate only if all beneficiaries consent and no material purpose of the trust is defeated.

However, an irrevocable trust can also be terminated if there was fraud, duress, undue influence or other problems when the trust was set up; if the trustee and the beneficiary become the same person; if the operation of the trust becomes impracticable or illegal; or if the period of time specified in state law expires. We're obviously into technical territory here, so the basic rule is, don't set up an irrevocable trust unless you're prepared to live--and die--by its terms.

CONSUMER TIP

Note: When you approach a lawyer to help you set up a trust, make sure he or she is willing to work with you to tailor the trust to your particular needs; otherwise, the primary benefit of trusts – their flexibility – is wasted.

It is another reason to avoid those prefabricated, all-purpose trusts you see in self-help books and at seminars. A good lawyer will provide you with a financial analysis to show how much you might save over time by structuring your trust in certain ways.

Make sure you choose a lawyer who is familiar with estate planning, trusts and, if your trust is used for saving taxes, tax law. IRS regulations governing trusts change often, and the agency has always given trusts special scrutiny.

WHAT LAW APPLIES IF I SET UP A TRUST AND THEN MOVE TO ANOTHER STATE?

State law governs trusts. If the trust involves real estate, the law of the state where the property is located applies. If it is personal property, like a car or money, or most other things, the law of the state where the grantor created the trust will probably control. If you have residences in more than one state, you can provide in your trust which of those states' laws will control the disposition of your real property.

KINDS OF TRUSTS

Charitable trusts are created to support some charitable purpose. Often these trusts will make an annual gift to a worthy cause of your choosing, simultaneously helping good causes and reducing the taxes on your estate.

Discretionary Trusts permit the trustee to distribute income and principal among various beneficiaries or to control the disbursements to a single beneficiary, as he or she sees fit.

Insurance Trusts are tax-saving trusts in which trust assets are used to buy a life insurance policy whose proceeds benefit the settlor's beneficiaries.

Living Trusts enable you to put your assets in a trust while still alive. You can wear all the hats, donor, trustee and beneficiary, or have someone else be trustee and have other beneficiaries.

Medicaid qualifying trusts are trusts that may help you qualify for federal Medicaid benefits by placing certain property in a trust, sometimes limiting your assets for Medicaid purposes. This device is mostly used when family members are concerned with paying the costs of nursing home care.

Revocable trusts are simply ones that can be changed, or even terminated, at any time by the donor. (Though most living trusts are revocable, a living trust and a revocable trust are not synonymous).

Irrevocable trusts cannot be changed or terminated before the time specified in the trust, but the loss of flexibility may be offset by savings in taxes.

Spendthrift trusts can be set up for people whom the grantor believes wouldn't be able to manage their own affairs--like an extravagant relative, or someone who's mentally incompetent. They may also be useful for beneficiaries who need protection from creditors.

Support trusts direct the trustee to spend only as much income and principal as may be needed for the education and support of the beneficiary.

Testamentary trusts are set up in wills.

Totten trusts are not really trusts at all. They're simply bank accounts that pass to a beneficiary immediately upon your death.

Wealth trusts are tax-saving trusts that benefit several generations of your descendants.

FIVE OTHER REASONS TO HAVE A TRUST

1. **Trusts are generally more difficult to contest than wills.**
2. Trusts can be flexible; you can authorize that payments fluctuate with the cost of living, allow extra withdrawals in case of emergency, or even set a standard figure for payment each year; if the income doesn't meet that amount, the difference can be made up out of the principal.
3. Or you can use them to impose discipline on the beneficiary. You could require the beneficiary to live within a set figure, getting a certain amount of income each year, regardless of inflation, need, or the stock market's effect on the principal.
4. **Trusts are sometimes set up in divorce, for example to provide for the education of the couple's children.**
5. **Trusts can also be helpful if you want to make a major charitable gift but wish to retain some use of the property.**

Mediation

Mediation serves as an alternative to a full-scale litigation to settle disputes. At a mediation, family members and beneficiaries discuss plans on transfer of assets. Because of the potential conflicts associated with blended families, step siblings, and multiple marriages, creating an estate plan through mediation allows people to confront the issues head-on and design a plan that will minimize the chance of future family conflict and meet their financial goals.

TAXES

Pre-Retirement Taxes

Conventional wisdom holds that it is almost always better to invest in a tax-deferred vehicle like a 401(k) plan or IRA than in an after-tax investment. This holds that even if the initial investment itself is made with money that has already been taxed, the earnings accumulate untaxed, and this adds immeasurably to the positive power of compounding. Because your earnings (and often the contribution) are untaxed until you begin withdrawing money in retirement, the government is in effect providing you leverage in the investment. This allows you to amass far more money for retirement than you could in a taxable alternative. Additionally, you control when it gets taxed, and at what rate, by deciding on the amount of the withdrawal and when to take it. By contrast, in conventional investments, you are taxed on all money going in and on all dividends and gains in the year they are received.

Income, gift, and estate tax planning plays a significant role in choosing the structure and vehicles used to create an estate plan. In the United States, assets left to a spouse or any qualified charity are not subject to U.S. Federal estate tax. Assets left to anyone else—even the decedent's children— are taxed if that part of the estate has a value of more than $5,430,000 for a person dying in 2015.

One way to avoid U.S. Federal estate and gift taxes is to distribute the property in incremental gifts during the person's lifetime. Individuals may give away as much as $14,000 per year (in 2015) without incurring gift tax. Other tax-free alternatives include paying a grandchild's college tuition or medical insurance premiums free of gift tax—but only if the payments are made directly to the educational institution or medical provider.

Other tax advantaged alternatives to leaving property, outside of a will, include qualified or non-qualified retirement plans (e.g. 401(k) plans and IRAs) certain "trustee" bank accounts, transfer on death (or TOD) financial accounts, and life insurance proceeds.

Because life insurance proceeds generally are not taxed for U.S. Federal income tax purposes, a life insurance trust could be used to pay estate taxes. However, if the decedent holds any incidents of ownership like the ability to remove or change a beneficiary, the proceeds will be treated as part of his estate and will generally be subject to the U.S. Federal estate tax. For this reason, the trust vehicle is used to own the life insurance policy. The trust must be irrevocable to avoid taxation of the life insurance proceeds.

History of Income Taxes

The federal, state, and local tax systems in the United States have been marked by significant changes over the years in response to changing circumstances and changes in the role of government. The types of taxes collected, their relative proportions, and the magnitudes of the revenues collected are all far different than they were 50 or 100 years ago. Some of these changes are traceable to specific historical events, such as a war or the passage of the 16th Amendment to the Constitution that granted the Congress the power to levy a tax on personal income. Other changes were more gradual, responding to changes in society, in our economy, and in the roles and responsibilities that government has taken unto itself.

Colonial Times

For most of our nation's history, individual taxpayers rarely had any significant contact with Federal tax authorities as most of the Federal government's tax revenues were derived from excise taxes, tariffs, and customs duties. Before the Revolutionary War, the colonial government had only a limited need for revenue, while each of the colonies had greater responsibilities and thus greater revenue needs, which they met with different types of taxes. For example, the southern colonies primarily taxed imports and exports, the middle colonies at times imposed a property tax and a "head" or poll tax levied on each adult male, and the New England colonies raised revenue primarily through general real estate taxes, excises taxes, and taxes based on occupation.

England's need for revenues to pay for its wars against France led it to impose a series of taxes on the American colonies. In 1765, the English Parliament passed the Stamp Act, which was the first tax imposed directly on the American colonies, and then Parliament imposed a tax on tea. Even though colonists were forced to pay these taxes, they lacked representation in the English Parliament. This led to the rallying cry of the American Revolution that "taxation without representation is tyranny" and established a persistent wariness regarding taxation as part of the American culture.

The Post-Revolutionary Era

The Articles of Confederation, adopted in 1781, reflected the American fear of a strong central government and so retained much of the political power in the States. The national government had few responsibilities and no nationwide tax system, relying on donations from the States for its revenue. Under the Articles, each State was a sovereign entity and could levy tax as it pleased.

When the Constitution was adopted in 1789, the Founding Fathers recognized that no government could function if it relied entirely on other governments for its resources, thus the Federal Government was granted the authority to raise taxes. The Constitution endowed the Congress with the power to "…lay and collect taxes, duties, imposts, and excises, pay the Debts and provide for the common Defense and general Welfare of the United States." Ever on guard against the power of the central government to eclipse that of the states, the collection of the taxes was left as the responsibility of the State governments.

To pay the debts of the Revolutionary War, Congress levied excise taxes on distilled spirits, tobacco and snuff, refined sugar, carriages, property sold at auctions, and various legal documents. Even in the early days of the Republic, however, social purposes influenced what was taxed. For example, Pennsylvania imposed an excise tax on liquor sales partly "to restrain persons in low circumstances from an immoderate use thereof." Additional support for such a targeted tax came from property owners, who hoped thereby to keep their property tax rates low, providing an early example of the political tensions often underlying tax policy decisions.

Though social policies sometimes governed the course of tax policy even in the early days of the Republic, the nature of these policies did not extend either to the collection of taxes so as to equalize incomes and wealth, or for the purpose of redistributing income or wealth. As Thomas Jefferson once wrote regarding the "General Welfare" clause:

“To take from one, because it is thought his own industry and that of his father has acquired too much, in order to spare to others who (or whose fathers) have not exercised equal industry and skill, is to violate arbitrarily the first principle of association, "to guarantee to everyone a free exercise of his industry and the fruits acquired by it."

With the establishment of the new nation, the citizens of the various colonies now had proper democratic representation, yet many Americans still opposed and resisted taxes they deemed them unfair or improper. In 1794, a group of farmers in southwestern Pennsylvania physically opposed the tax on whiskey, forcing President Washington to send Federal troops to suppress the Whiskey Rebellion, establishing the important precedent that the Federal government was determined to enforce its revenue laws. The Whiskey Rebellion also confirmed, however, that the resistance to unfair or high taxes that led to the Declaration of Independence did not evaporate with the forming of a new, representative government.

During the confrontation with France in the late 1790's, the Federal Government imposed the first direct taxes on the owners of houses, land, slaves, and estates. These taxes are called direct taxes because they are a recurring tax paid directly by the taxpayer to the government based on the value of the item that is the basis for the tax. The issue of direct taxes as opposed to indirect taxes played a crucial role in the evolution of Federal tax policy in the following years. When Thomas Jefferson was elected President in 1802, direct taxes were abolished and for the next 10 years there were no internal revenue taxes other than excises.

To raise money for the War of 1812, Congress imposed additional excise taxes, raised certain customs duties, and raised money by issuing Treasury notes. In 1817 Congress repealed these taxes, and for the next 44 years the Federal Government collected no internal revenue. Instead, the Government received most of its revenue from high customs duties and through the sale of public land.

The Civil War

When the Civil War erupted, the Congress passed the Revenue Act of 1861, which restored earlier excises taxes and imposed a tax on personal incomes. **The income tax was levied at 3% on all incomes higher than $800 a year.** This tax on personal income was a new direction for a Federal tax system based mainly on excise taxes and customs duties. Certain inadequacies of the income tax were quickly acknowledged by Congress and thus none was collected until the following year.

By the spring of 1862 it was clear the war would not end quickly and with the Union's debt growing at the rate of $2 million daily it was equally clear the Federal government would need additional revenues. On July 1, 1862, the Congress passed new excise taxes on such items as playing cards, gunpowder, feathers, telegrams, iron, leather, pianos, yachts, billiard tables, drugs, patent medicines, and whiskey. Many legal documents were also taxed and license fees were collected for almost all professions and trades.

The 1862 law also made important reforms to the Federal income tax that presaged important features of the current tax. For example, a two-tiered rate structure was enacted, with taxable incomes up to $10,000 taxed at a 3% rate and higher incomes taxed at 5%. A standard deduction of $600 was enacted and a variety of deductions were permitted for such things as rental housing, repairs, losses, and other taxes paid. In addition, to assure timely collection, taxes were "withheld at the source" by employers.

The need for Federal revenue declined sharply after the war and most taxes were repealed. By 1868, the main source of Government revenue derived from liquor and tobacco taxes. The income tax was abolished in 1872. From 1868 to 1913, almost 90% of all revenue was collected from the remaining excises.

The 16th Amendment

Under the Constitution, Congress could impose direct taxes only if they were levied in proportion to each State's population. Thus, when a flat rate Federal income tax was enacted in 1894, it was quickly challenged and in 1895 the U.S. Supreme Court ruled it unconstitutional because it was a direct tax not apportioned according to the population of each state.

Lacking the revenue from an income tax and with all other forms of internal taxes facing stiff resistance, from 1896 until 1910 the Federal government relied heavily on high tariffs for its revenues. The War Revenue Act of 1899 sought to raise funds for the Spanish-American War through the sale of bonds, taxes on recreational facilities used by workers, and doubled taxes on beer and tobacco. A tax was even imposed on chewing gum. The Act expired in 1902, so that Federal receipts fell from 1.7% of Gross Domestic Product to 1.3%.

While the War Revenue Act returned to traditional revenue sources following the Supreme Court's 1895 ruling on the income tax, debate on alternative revenue sources remained lively. The nation was becoming increasingly aware that high tariffs and excise taxes were not sound economic policy and often fell disproportionately on the less affluent. Proposals to reinstate the income tax were introduced by Congressmen from agricultural areas whose constituents feared a Federal tax on property, especially on land, as a replacement for the excises.

Eventually, the income tax debate pitted southern and western Members of Congress representing more agricultural and rural areas against the industrial northeast. The debate resulted in an agreement calling for a tax, called an excise tax, to be imposed on business income, and a Constitutional amendment to allow the Federal government to impose tax on individuals' lawful incomes without regard to the population of each State.

By 1913, 36 States had ratified the 16th Amendment to the Constitution. In October, Congress passed a new income tax law with rates beginning at 1% and rising to 7% for taxpayers with income in excess of $500,000. Less than 1% of the population paid income tax at the time. Form 1040 was introduced as the standard tax reporting form and, though changed in many ways over the years, remains in use today.

One of the problems with the new income tax law was how to define "lawful" income. Congress addressed this problem by amending the law in 1916 by deleting the word "lawful" from the definition of income. As a result, all income became subject to tax, even if it was earned by illegal means. Several years later, the Supreme Court declared the Fifth Amendment could not be used by bootleggers and others who earned income through illegal activities to avoid paying taxes. Consequently, many who broke various laws associated with illegal activities and were able to escape justice for these crimes were incarcerated on tax evasion charges.

Prior to the enactment of the income tax, most citizens were able to pursue their private economic affairs without the direct knowledge of the government. Individuals earned their wages, businesses earned their profits, and wealth was accumulated and dispensed with little or no interaction with government entities. The income tax fundamentally changed this relationship, giving the government the right and the need to know about all manner of an individual or business' economic life. Congress recognized the inherent invasiveness of the income tax into the taxpayer's personal affairs and so in 1916 it provided citizens with some degree of protection by requiring that information from tax returns be kept confidential.

World War I and the 1920s

The entry of the United States into World War I greatly increased the need for revenue and Congress responded by passing the 1916 Revenue Act. The 1916 Act raised the lowest tax rate from 1% to 2% and raised the top rate to 15% on taxpayers with incomes in excess of $1.5 million. The 1916 Act also imposed taxes on estates and excess business profits.

Driven by the war and largely funded by the new income tax, by 1917 the Federal budget was almost equal to the total budget for all the years between 1791 and 1916. Needing still more tax revenue, the War Revenue Act of 1917 lowered exemptions and greatly increased tax rates. In 1916, a taxpayer needed $1.5 million in taxable income to face a 15% rate. By 1917 a taxpayer with only $40,000 faced a 16% rate and the individual with $1.5 million faced a tax rate of 67%.

Another revenue act was passed in 1918, which hiked tax rates once again, this time raising the bottom rate to 6% and the top rate to 77%. These changes increased revenue from $761 million in 1916 to $3.6 billion in 1918, which represented about 25% of Gross Domestic Product (GDP). Even in 1918, however, only 5% of the population paid income taxes and yet the income tax funded one-third of the cost of the war.

The economy boomed during the 1920s and increasing revenues from the income tax followed. This allowed Congress to cut taxes five times, ultimately returning the bottom tax rate to 1% and the top rate down to 25% and reducing the Federal tax burden as a share of GDP to 13%. As tax rates and tax collections declined, the economy was strengthened further.

In October of 1929 the stock market crash marked the beginning of the Great Depression. As the economy shrank, government receipts also fell. In 1932, the Federal government collected only $1.9 billion, compared to $6.6 billion in 1920. In the face of rising budget deficits which reached $2.7 billion in 1931, Congress followed the prevailing economic wisdom at the time and passed the Tax Act of 1932 which dramatically increased tax rates once again. This was followed by another tax increase in 1936 that further improved the government's finances while further weakening the economy. By 1936 the lowest tax rate had reached 4% and the top rate was up to 79%. In 1939, Congress systematically codified the tax laws so that all subsequent tax legislation until 1954 amended this basic code. The combination of a shrunken economy and the repeated tax increases raised the Federal government's tax burden to 6.8% of GDP by 1940.

The Social Security Tax

The state of the economy during the Great Depression led to passage of the Social Security Act in 1935. This law provided payments known as "unemployment compensation" to workers who lost their jobs. Other sections of the Act gave public aid to the aged, the needy, the handicapped, and to certain minors. These programs were financed by a 2% tax, one half of which was subtracted directly from an employee's paycheck and one half collected from employers on the employee's behalf. The tax was levied on the first $3,000 of the employee's salary or wage.

World War II

Even before the United States entered the Second World War, increasing defense spending and the need for monies to support the opponents of Axis aggression led to the passage in 1940 of two tax laws that increased individual and corporate taxes, which were followed by another tax hike in 1941. By the end of the war the nature of the income tax had been fundamentally altered. Reductions in exemption levels meant that taxpayers with taxable incomes of only $500 faced a bottom tax rate of 23%, while taxpayers with incomes over $1 million faced a top rate of 94%. These tax changes increased federal receipts from $8.7 billion in 1941 to $45.2 billion in 1945. Even with an economy stimulated by war-time production, federal taxes as a share of GDP grew from 7.6% in 1941 to 20.4% in 1945. Beyond the rates and revenues, however, another aspect about the income tax that changed was the increase in the number of income taxpayers from 4 million in 1939 to 43 million in 1945.

Another important feature of the income tax that changed was the return to income tax withholding as had been done during the Civil War. This greatly eased the collection of the tax for both the taxpayer and the Bureau of Internal Revenue. However, it also greatly reduced the taxpayer's awareness of the amount of tax being collected, i.e. it reduced the transparency of the tax, which made it easier to raise taxes in the future.

Developments after World War II

Tax cuts following the war reduced the Federal tax burden as a share of GDP from its wartime high of 20.9% in 1944 to 14.4% in 1950. However, the Korean War created a need for additional revenues which, combined with the extension of Social Security coverage to self-employed persons, meant that by 1952 the tax burden had returned to 19% of GDP.

In 1953, the Bureau of Internal Revenue was renamed the Internal Revenue Service (IRS), following a reorganization of its function. The new name was chosen to stress the service aspect of its work. By 1959, the IRS had become the world's largest accounting, collection, and forms-processing organization. Computers were introduced to automate and streamline its work and to improve service to taxpayers. In 1961, Congress passed a law requiring individual taxpayers to use their Social Security number as a means of tax form identification. By 1967, all business and personal tax returns were handled by computer systems, and by the late 1960s, the IRS had developed a computerized method for selecting tax returns to be examined. This made the selection of returns for audit fairer to the taxpayer and allowed the IRS to focus its audit resources on those returns most likely to require an audit.

Throughout the 1950s, tax policy was increasingly seen as a tool for raising revenue and for changing the incentives in the economy, but also as a tool for stabilizing macroeconomic activity. The economy remained subject to frequent boom and bust cycles and many policymakers readily accepted the new economic policy of raising or lowering taxes and spending to adjust aggregate demand and thereby smooth the business cycle. Even so, however, the maximum tax rate in 1954 remained at 87% of taxable income. While the income tax underwent some manner of revision or amendment almost every year since the major reorganization of 1954, certain years marked especially significant changes. For example, the Tax Reform Act of 1969 reduced income tax rates for individuals and private foundations.

Beginning in the late 1960s and continuing through the 1970s the United states experienced persistent and rising inflation rates, ultimately reaching 13.3% in 1979. Inflation has a deleterious effect on many aspects of an economy, but it also can play havoc with an income tax system unless appropriate precautions are taken. Specifically, unless the tax system's Parameters, i.e. its brackets and its fixed exemptions, deductions, and credits, are indexed for inflation, a rising price level will steadily shift taxpayers into ever higher tax brackets by reducing the value of those exemptions and deductions.

During this time, the income tax was not indexed for inflation and so, driven by a rising inflation, and despite repeated legislated tax cuts, the tax burden rose from 19.4% of GDP to 20.8% of GDP. Combined with high marginal tax rates, rising inflation, and a heavy regulatory burden, this high tax burden caused the economy to under-perform badly, all of which laid the groundwork for the Regan Tax Cut, also known as the Economy Recovery Tax Act of 1981.

The Regan Tax Cut

The Economic Recovery Tax Act of 1981, which enjoyed strong bi-partisan support in the Congress, represented a fundamental shift in the course of federal income tax policy. Champion in principle for many years by then-Congressman Jack Kemp (R-NY) and then Senator Bill Roth (R-DE), it featured a 25% reduction in individual tax brackets phased in over 3 years, and indexed for inflation thereafter. This brought the top tax bracket down to 50%.

The 1981 Act also featured a dramatic departure in the treatment of business outlays for plant and equipment, i.e. capital cost recovery, or tax depreciation. Heretofore, capital cost recovery had attempted roughly to follow a concept known as economic depreciation, which refers to the decline in the market value of a producing asset over a specified period of time. The 1981 Act explicitly displaced the notion of economic depreciation, instituting instead the Accelerated Cost Recovery System which greatly reduced the disincentive facing business investment and ultimately prepared the way for the subsequent boom in capital formation. In addition to accelerated cost recovery, the 1981 Act also instituted a 10% Investment Tax Credit to spur additional capital formation.

Prior to, and in any circles even after the 1981 tax cut, the prevailing view was that tax policy is most effective in modulating aggregate demand whenever demand and supply become mismatched, i.e. whenever the economy went in to recession or became "over-heated". The 1981 tax cut represented a new way of looking at tax policy, though it was in fact a return to a more traditional or neoclassical economic perspective. The essential idea was that taxes have their first and primary effect on the economic incentives facing individuals and businesses. Thus, the tax rate on the last dollar earned, i.e. the marginal dollar, is much more important to economic activity than the tax rate facing the first dollar earned or than the average tax rate. By reducing marginal tax rates, it was believed the natural forces of economic growth would be less restrained. The most productive individuals would then shift more of their energies to productive activities rather than leisure and businesses would take advantage of many more now profitable opportunities. It was also thought that reducing marginal tax rates would significantly expand the tax base as individuals shifted more of their income and activities into taxable forms and out of tax-exempt forms.

The 1981 tax cut actually represented two departures from previous tax policy philosophies, one explicit and intended and the second by implication. The first change was the new focus on marginal tax rates and incentives as the key factors in how the tax system affects economic activity. The second policy departure was the de facto shift away from income taxation and toward taxing consumption. Accelerated cost recovery was one manifestation of this shift on the business side, but the individual side also saw a significant shift in the enactment of various provisions to reduce the multiple taxation of individual saving. The Individual Retirement Account, for example, was enacted in 1981.

Simultaneously with the enactment of the tax cuts in 1981, the Federal Reserve Board, with the full support of the Reagan Administration, altered monetary policy so as to being inflation under control. The Federal Reserve's actions brought inflation down faster and further than was anticipated at the time and one consequence was that the economy fell into a deep recession in 1982. Another consequence of the collapse in inflation was that federal spending levels, which had been predicated on a high level of expected inflation, were suddenly much higher in inflation-adjusted terms. The combination of the tax cuts, the recession, and the one-time increase in inflation-adjusted federal spending produced historically high budget deficits which, in turn, led to a tax increase in 1984 that pared back some of the tax cuts enacted in 1981, especially on the business side.

As inflation came down and as more and more of the tax cuts from the 1981 Act went into effect, the economic began a strong and sustained pattern of growth. Though the pain ful medicine of disinflation slowed and initially hid the process, the beneficial effects of marginal rate cuts and reduction in the disincentives to invest took hold as promised.

The Evolution of Social Security and Medicare

The Social Security system remained essentially unchanged from its enactment until 1956. However, beginning in 1956 Social Security began an almost steady evolution as more and more benefits were added, beginning with the addition of Disability Insurance benefits. In 1958, benefits were extended to dependents of disabled workers. In 1967, disability benefits were extended to widows and widowers. The 1972 amendments provided for automatic cost-of-living benefits.

In 1965, Congress enacted the Medicare program, providing for the medical needs of persons aged 65 or older, regardless of income. The 1965 Social Security Amendments also created the Medicaid programs that provides medical assistance for persons with low incomes and resources.

Of course, the expansions of Social Security and the creation of Medicare and Medicaid required additional tax revenues, and thus the basic payroll tax was repeatedly increased over the years. Between 1949 and 1962 the payroll tax rate climbed steadily from its initial rate of 2% to 6%. The expansions in 1965 led to further rate increases, with the combined payroll tax rate climbing to 12.3% in 1980. Thus, in 31 years the maximum Social Security tax burden rose from a mere $60 in 1949 to $3,175 in 1980.

Despite the increased payroll tax burden, the benefit expansions Congress enacted in previous years led the Social Security program to an acute funding crisis in the early 1980s. Eventually, Congress legislated some minor programmatic changes in Social Security benefits, along with an increase in the payroll tax rate to 15.3% by 1990. Between 1980 and 1990, the maximum Social Security payroll tax burden more than doubled to $7,849.

The Tax Reform Act of 1986

Following the enactment of the 1981, 1982, and 1984 tax changes there was a growing sense that the income tax was in need of a more fundamental overhaul. The economic boom following the 1982 recession convinced many political leaders of both parties that lower marginal tax rates were essential to a strong economy, while the constant changing of the law instilled in policy makers an appreciation for the complexity of the tax system. Further, the debates during this period led to a general understanding of the distortions imposed on the economy, and the lost jobs and wages, arising from the many peculiarities in the definition of the tax base. A new and broadly held philosophy of tax policy developed that the income tax would be greatly improved by repealing these various special provisions and lowering tax rates further. Thus, in his 1984 State of the Union speech President Reagan called for a sweeping reform of the income tax so it would have a broader base and lower rates and would be fairer, simpler, and more consistent with economic efficiency.

The culmination of this effort was the Tax Reform Act of 1986, which brought the top statutory tax rate down from 50% to 28% while the corporate tax rate was reduced from 50% to 35%. The number of tax brackets was reduced and the personal exemption and standard deduction amounts were increased and indexed for inflation, thereby relieving millions of taxpayers of any Federal income tax burden. However, the Act also created new personal and corporate Alternative Minimum Taxes, which proved to be overly complicated, unnecessary, and economically harmful.

The 1986 Tax Reform Act was roughly revenue neutral, that is, it was not intended to raise or lower taxes, but it shifted some of the tax burden from individuals to businesses. Much of the increase in the tax on business was the result of an increase in the tax on business capital formation. It achieved some simplifications for individuals through the elimination of such things as income averaging, the deduction for consumer interest, and the deduction for state and local sales taxes. But in many respects the Act greatly added to the complexity of business taxation, especially in the area of international taxation. Some of the over-reaching provisions of the Act also led to a downturn in the real estate markets which played a significant role in the subsequent collapse of the Savings and Loan industry.

Seen in a broader picture, the 1986 tax act represented the penultimate installment of an extraordinary process of tax rate reductions. Over the 22-year period from 1964 to 1986 the top individual tax rate was reduced from 91 to 28%. However, because upper-income taxpayers increasingly chose to receive their income in taxable form, and because of the broadening of the tax base, the progressivity of the tax system actually rose during this period.

The 1986 tax act also represented a temporary reversal in the evolution of the tax system. Though called an income tax, the Federal tax system had for many years actually been a hybrid income and consumption tax, with the balance shifting toward or away from a consumption tax with many of the major tax acts. The 1986 tax act shifted the balance once again toward the income tax. Of greatest importance in this regard was the return to references to economic depreciation in the formulation of the capital cost recovery system and the significant new restrictions on the use of Individual Retirement Accounts.

Between 1986 and 1990 the Federal tax burden rose as a share of GDP from 17.5% to 18%. Despite this increase in the overall tax burden, persistent budget deficits due to even higher levels of government spending created near constant pressure to increase taxes. Thus, in 1990 the Congress enacted a significant tax increase featuring an increase in the top tax rate to 31%. Shortly after his election, President Clinton insisted on and the Congress enacted a second major tax increase in 1993 in which the top tax rate was raised to 36% and a 10% surcharge was added, leaving the effective top tax rate at 39.6%. Clearly, the trend toward lower marginal tax rates had been reversed, but, as it turns out, only temporarily.

The Taxpayer Relief Act of 1997 made additional changes to the tax code providing a modest tax cut. The centerpiece of the 1997 Act was a significant new tax benefit to certain families with children through the Per Child Tax credit. The truly significant feature of this tax relief, however, was that the credit was refundable for many lower-income families. That is, in many cases the family paid a "negative" income tax, or received a credit in excess of their pre-credit tax liability. Though the tax system had provided for individual tax credits before, such as the Earned Income Tax credit, the Per Child Tax credit began a new trend in federal tax policy. Previously tax relief was generally given in the form of lower tax rates or increased deductions or exemptions. The 1997 Act really launched the modern proliferation of individual tax credits and especially refundable credits that are in essence spending programs operating through the tax system.

The years immediately following the 1993 tax increase also saw another trend continue, which was to once again shift the balance of the hybrid income tax-consumption tax toward the consumption tax. The movement in this case was entirely on the individual side in the form of a proliferation of tax vehicles to promote purpose-specific saving. For example, Medical Savings Accounts were enacted to facilitate saving for medical expenses. An Education IRA and the Section 529 Qualified Tuition Program was enacted to help taxpayers pay for future education expenses. In addition, a new form of saving vehicle was enacted, called the Roth IRA, which differed from other retirement savings vehicles like the traditional IRA and employer-based 401(k) plans in that contributions were made in after-tax dollars and distributions were tax free.

Despite the higher tax rates, other economic fundamentals such as low inflation and low interest rates, an improved international picture with the collapse of the Soviet Union, and the advent of a qualitatively and quantitatively new information technologies led to a strong economic performance throughout the 1990s. This, in turn, led to an extraordinary increase in the aggregate tax burden, with Federal taxes as a share of GDP reaching a postwar high of 20.8% in 2000.

The Bush Tax Cut

By 2001, the total tax take had produced a projected unified budget surplus of $281 billion, with a cumulative 10 year projected surplus of $5.6 trillion. Much of this surplus reflected a rising tax burden as a share of GDP due to the interaction of rising real incomes and a progressive tax rate structure. Consequently, under President George W. Bush's leadership the Congress halted the projected future increases in the tax burden by passing the Economic Growth and Tax Relief and Reconciliation Act of 2001. The centerpiece of the 2001 tax cut was to regain some of the ground lost in the 1990s in terms of lower marginal tax rates. Though the rate reductions are to be phased in over many years, ultimately the top tax rate will fall from 39.6% to 33%.

The 2001 tax cut represented a resumption of a number of other trends in tax policy. For example, it expanded the Per-Child Tax Credit from $500 to $1000 per child. It also increased the Dependent

Child Tax Credit. The 2001 tax cut also continued the move toward a consumption tax by expanding a variety of savings incentives. Another feature of the 2001 tax cut that is particularly noteworthy is that it put the estate, gift, and generation-skipping taxes on course for eventual repeal, which is also another step toward a consumption tax. One novel feature of the 2001 tax cut compared to most large tax bills is that it was almost devoid of business tax provisions.

The 2001 tax cut will provide additional strength to the economy in the coming years as more and more of its provisions are phased in, and indeed one argument for its enactment had always been as a form of insurance against an economic downturn. However, unbeknownst to the Bush Administration and the Congress, the economy was already in a downturn as the Act was being debated. Thankfully, the downturn was brief and shallow, but it is already clear that the tax cuts that were enacted and went into effect in 2001 played a significant role in supporting the economy, shortening the duration of the downturn, and preparing the economy for a robust recovery.

One lesson from the economic slowdown was the danger of ever taking a strong economy for granted. The strong growth of the 1990s led to talk of a *"new"* economy that many assumed was virtually recession proof. The popularity of this assumption was easy to understand when one considers that there had only been one very mild recession in the previous 18 years.

Taking this lesson to heart, and despite the increasing benefits of the 2001 tax cut and the early signs of a recovery, President Bush called for and the Congress eventually enacted an economic stimulus bill. The bill included an extension of unemployment benefits to assist those workers and families under financial stress due to the downturn. The bill also included a provision to providing a temporary but significant acceleration of depreciation allowances for business investment, thereby assuring that the recovery and expansion will be strong and balanced. Interestingly, the depreciation provision also means that the Federal tax on business has resumed its evolution toward a consumption tax, once again paralleling the trend in individual taxation.

Federal Income Tax

Federal income taxes are not based on age. Your tax burden does not go down simply because you turn a particular age (of course you may be eligible for an additional deduction). Instead, federal income taxes are bracketed based on your adjusted gross income**.** Effective with the 2003 Tax Act, the brackets have been reduced from a high of 38.56% to 35% (with each respective lower bracket reduced accordingly). This translates to a lower tax bill for you. Also, dividends (until 2010) are now taxed at a lower rate than ordinary income.

In determining a retiree's federal income tax, the end result (in many cases) is a lower tax bill. Again, this is not because of age or even lower income. Instead, it is a result of a change in classification of income. Social Security still represents a significant portion of many retirees income. As such, it is not subject to federal income tax (until the retiree's adjusted gross income exceeds certain levels).

Another item of note is that most retirees (unless they are without medical insurance) will no longer file Schedule A (itemize) with their return. Rather, they will be electing the standard deduction. This results from the shift of income from payroll (subject to state and local income tax) to retirement income (from pensions, IRAs, and Social Security).

Once you determine your expected annual income, you should determine your expected income tax bill. Do not wait until April 15th to pay your tax bill; otherwise you may be subjected to additional taxes and penalties for late payment. Instead, either pay the expected tax bill quarterly, or better yet, have it deducted from your pension or IRA payments. You can also have income tax withheld from your Social Security check.

SOCIAL SECURITY TAX

There are 3 taxes you should be aware of regarding Social Security: payroll, income and penalty.

Payroll Tax

The maximum amount of earnings subject to the Social Security payroll tax will climb 7.3 percent in 2017 to $127,200—up by $8,700 from the $118,500 maximum for 2016 and 2015, the Social Security Administration (SSA) announced on Oct. 18. Of the estimated 173 million workers who will pay Social Security taxes in 2017, about 12 million will pay more because of the increase in the taxable-maximum amount.

This adjustment, which takes effect Jan. 1, is based on the government's estimate of real wage growth in the recent past. The 2017 jump in the taxable-earnings cap is the largest one-year increase since 1983, in part because federal law kept the taxable maximum unchanged for 2016 due to a lack of cost-of-living increase in Social Security benefits.

Social Security is financed by a 12.4% tax on wages up to the taxable-earnings cap, with half (6.2%) paid by workers and the other half paid by employers. This taxable wage base usually goes up each year—it rose from $117,000 in 2014 to $118,500 in 2015 but stayed put at that level for 2016.

Income Tax

The income tax is assessed at two levels: 50% and 85%. Generally, up to 50% of your benefits will be taxable. However, up to 85% of your benefits can be taxable if either of the following situations apply to you:

(1) The total of one-half of your benefits and all of your other income is more than $34,000 ($44,000) if you are married filing jointly), or
(2) You are married filing separately and lived with your spouse at any time during 2002.

Note: *The tax rate is not 50% or 85%. These percentages only apply to the amount of Social Security you would have to include in your taxable income. Therefore, it is important to keep in mind your taxable income when taking distributions from retirement accounts. While you may be aware of the federal income tax on the distributions, you may unknowingly subject your Social Security to taxes as well. This is especially true with required minimum distributions (age 70½).*

Penalty (Working While Receiving Social Security Benefits)

You can get Social Security retirement or survivors' benefits and work at the same time. However, under the law, your benefits could be reduced if you earn more than certain amounts.

How much can you earn and still get benefits?

If you work and are full retirement age (age 65 and 6 months in 2017) or older, you may keep all of your benefits, no matter how much you earn. If you are younger than age 65 and 6 months all year, there is a limit to how much you can earn and still receive full Social Security benefits. If you are younger than age 65 and 6 months in all of 2017, we must deduct $1 from your benefits for each $2 you earned above $16,920.

What income counts?

If you work for someone else, only your wages count toward Social Security's earnings limits. If you are self-employed, we count only your net earnings from self-employment. Social Security does not count income such as other government benefits, investment earnings, interest, pensions, annuities and capital gains.

If you work for wages, income counts when it is earned, not when it is paid. If you have income that you earned in one year, but the payment was made in the following year, it should not be counted as earnings for the year you receive it. Some examples are accumulated sick or vacation pay and bonuses.

If you are self-employed, income counts when you receive it--not when you earn it--unless it is paid in a year after you become entitled to Social Security and earned before you became entitled.

Special rules for the first year you retire

Sometimes people who retire in mid-year already have earned more than the yearly earnings limit. That is why there are special rules that apply to earnings for one year, usually the first year of retirement. Under these rules, you can get a full Social Security check for any whole month you are retired, regardless of your yearly earnings.

Also, if you are self-employed, we consider how much work you do in your business to determine whether you are retired. One way is by looking at the amount of time that you spend working. In general, if you work more than 45 hours a month in self-employment, you are not retired; if you work less than 15 hours a month, you are retired. If you work between 15 and 45 hours a month, you will not be considered retired if it is in a job that requires a lot of skill or you are managing a sizable business.

Reporting changes in your earnings

Social Security adjusts the amount of your Social Security benefits in 2005 based on what you reported you would earn that year.

If other family members get benefits based on your work, your earnings after you start getting retirement benefits could reduce their benefits, too. However, if your spouse and children get benefits as family members, their earnings affect only their own benefits.

Will my extra earnings increase my benefits?

Your original Social Security benefit was based on your highest years of earnings. But each year, Social Security reviews the records for all Social Security recipients who work. If your latest year of earnings turns out to be one of your highest years, they refigure your benefits and pay you any increase due. This is an automatic process and is usually completed by October of the following year. For example, by October 20017, you should get an increase for your 20016 earnings if those earnings raised your benefit. The increase would be retroactive to January 2016.

Note: Full retirement age is 66 for people born between 1943 and 1954. Beginning with 1955, two months are added for every birth year until the full retirement age reaches 67 for people born in 1960 or later.

CAPITAL GAINS & DIVIDENDS

Short-term capital gains tax rates

Any time you sell an investment you have held for one year or less, you are subject to short-term capital gains taxes. Short-term capital gains are taxed as ordinary income, which means they are taxed the same way your regular paycheck is taxed.

Long-term capital gains tax rates

Long-term capital gains apply to any investment held for a year and a day (or longer), and your tax rate for long-term gains is based on your income level and tax bracket. Currently, the majority of tax filers are subject to a 15% long-term capital gains tax rate. The country's highest earners are subject to a 20% rate, while lower earners don't pay any taxes on long-term capital gains.

The following table shows what your long-term capital gains tax rate will be, based on your current tax bracket:

Tax Bracket	Long-Term Capital Gains Tax Rate
10%	0%
15%	0%
25%	15%
28%	15%
33%	15%
35%	15%
39.6%	20%

Note: Tax Brackets and Tax Rates may change with the election of President Donald Trump.

Dividends

Dividends are distributions of money, stock, or other property paid to you by a corporation. You also may receive dividends through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some amounts you receive that are called dividends are actually interest income.

The most common kinds of distributions are:

- Ordinary dividends,
- Capital gain distributions, and
- Non-dividend distributions.

Most distributions are paid in cash (check). However, distributions can consist of more stock, stock rights, other property, or services.

Form 1099-DIV. Most corporations use Form 1099-DIV, Dividends and Distributions, to show you the distributions you received from them during the year. Keep this form with your records. You do not have to attach it to your tax return. Even if you do not receive Form 1099-DIV, you must still report all of your taxable dividend income. For example, you may receive distributive shares of dividends from partnerships or subchapter S corporations. These dividends are reported to you on Schedule K-1 (Form 1065) and Schedule K-1 (Form 1120S).

Dividends on stock sold. If stock is sold, exchanged, or otherwise disposed of after a dividend is declared, but before it is paid, the owner of record (usually the payee shown on the dividend check) must include the dividend in income.

Dividends received in January. If a regulated investment company (mutual fund) or real estate investment trust (REIT) declares a dividend (including any exempt-interest dividend or capital gain distribution) in October, November, or December payable to shareholders of record on a date in one of those months but actually pays the dividend during January of the next calendar year, you are considered to have received the dividend on December 31. You report the dividend in the year it was declared.

Ordinary Dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to you. This means they are not capital gains. You can assume that any dividend you receive on common or preferred stock is an ordinary dividend unless the paying corporation tells you otherwise. Ordinary dividends will be shown in box 1a of the Form 1099-DIV you receive.

Qualified Dividends

Qualified dividends are the ordinary dividends that are subject to the same 5% or 15% maximum tax rate that applies to net capital gain. They should be shown in box 1b of the Form 1099-DIV you receive.

Qualified dividends are subject to the 15% rate if the regular tax rate that would apply is 25% or higher. If the regular tax rate that would apply is lower than 25%, qualified dividends are subject to the 5% rate.

To qualify for the 5% or 15% maximum rate, all of the following requirements must be met.

(1) The dividends must have been paid by a U.S. corporation or a qualified foreign corporation.
(2) The dividends are not of the type listed later under *Dividends that are not qualified dividends*.
(3) You meet the holding period.

Holding period. You must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. The ex-dividend date is the first date following the declaration of a dividend on which the buyer of a stock will not receive the next dividend payment.

When counting the number of days, you held the stock, include the day you disposed of the stock, but not the day you acquired it.

Exception for preferred stock. In the case of preferred stock, you must have held the stock more than 90 days during the 181-day period that begins 90 days before the ex-dividend date if the dividends are due to periods totaling more than 366 days. If the preferred dividends are due to periods totaling less than 367 days, the holding period in the preceding paragraph applies.

Holding period reduced where risk of loss is diminished. When determining whether you met the minimum holding period discussed, you cannot count any day during which you meet any of the following conditions.

1. You had an option to sell, were under a contractual obligation to sell, or had made (and not closed) a short sale of substantially identical stock or securities.
2. You were grantor (writer) of an option to buy substantially identical stock or securities.
3. Your risk of loss is diminished by holding one or more other positions in substantially similar or related property.

Qualified Foreign Corporation. A foreign corporation is a qualified foreign corporation if it meets any of the following conditions.

1. The corporation is incorporated in a U.S. possession.

2. The corporation is eligible for the benefits of a comprehensive income tax treaty with the United States that the Treasury Department determines is satisfactory for this purpose and that includes an exchange of information program. For a list of those treaties.

3. The corporation does not meet (1) or (2) above, but the stock for which the dividend is paid is readily tradable on an established securities market in the United States.

A corporation is not a qualified foreign corporation if it is a foreign personal holding company, foreign investment company, or a passive foreign investment company during its tax year in which the dividends are paid or during its previous tax year.

Readily tradable stock: Any stock (such as common, ordinary, or preferred stock), or an American depositary receipt in respect of that stock, is considered to satisfy requirement (3) if it is listed on one of the following securities markets: the New York Stock Exchange, the NASDAQ Stock Market, the American Stock Exchange, the Boston Stock Exchange, the Cincinnati Stock Exchange, the Chicago Stock Exchange, the Philadelphia Stock Exchange, or the Pacific Exchange, Inc.

Dividends that are not qualified dividends. The following dividends are not qualified dividends. They are not qualified dividends even if they are shown in box 1b of Form 1099-DIV.

- Capital gain distributions.
- Dividends paid on deposits with mutual savings banks, cooperative banks, credit unions, U.S. building and loan associations, U.S. savings and loan associations, federal savings and loan associations, and similar financial institutions. (Report these amounts as interest income.)
- Dividends from a corporation that is a tax-exempt organization or farmer's cooperative during the corporation's tax year in which the dividends were paid or during the corporation's previous tax year.
- Dividends paid by a corporation on employer securities which are held on the date of record by an employee stock ownership plan (ESOP) maintained by that corporation.
- Dividends on any share of stock to the extent that you are obligated (whether under a short sale or otherwise) to make related payments for positions in substantially similar or related property.
- Payments in lieu of dividends, but only if you know or have reason to know that the payments are not qualified dividends.
- Payments shown in Form 1099-DIV, box 1b, from a foreign corporation to the extent you know or have reason to know the payments are not qualified dividends.

Dividends Used to Buy More Stock

The corporation in which you own stock may have a dividend reinvestment plan. This plan lets you choose to use your dividends to buy (through an agent) more shares of stock in the corporation instead of receiving the dividends in cash. If you are a member of this type of plan and you use your dividends to buy more stock at a price equal to its fair market value, you still must report the dividends as income.

If you are a member of a dividend reinvestment plan that lets you buy more stock at a price less than its fair market value, you must report as dividend income the fair market value of the additional stock on the dividend payment date.

You also must report as dividend income any service charge subtracted from your cash dividends before the dividends are used to buy the additional stock. But you may be able to deduct the service charge.

In some dividend reinvestment plans, you can invest more cash to buy shares of stock at a price less than fair market value. If you choose to do this, you must report as dividend income the difference between the cash you invest and the fair market value of the stock you buy. When figuring this amount, use the fair market value of the stock on the dividend payment date.

Money Market Funds

Report amounts you receive from money market funds as dividend income. Money market funds are a type of mutual fund and should not be confused with bank money market accounts that pay interest.

Taxable Stock Dividends and Stock Rights. Distributions of stock dividends and stock rights are taxable to you if any of the following apply.

1. You or any other shareholder has the choice to receive cash or other property instead of stock or stock rights.
2. The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders.
3. The distribution is in convertible preferred stock and has the same result as in (2).
4. The distribution gives preferred stock to some common stock shareholders and common stock to other common stock shareholders.
5. The distribution is on preferred stock. (The distribution, however, is not taxable if it is an increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right.)

The term “stock” includes rights to acquire stock, and the term “shareholder” includes a holder of rights or convertible securities. If you receive taxable stock dividends or stock rights, include their fair market value at the time of the distribution in your income.

Dividends on insurance policies. Insurance policy dividends that the insurer keeps and uses to pay your premiums are not taxable. However, you must report as taxable interest income the interest that is paid or credited on dividends left with the insurance company.

If dividends on an insurance contract (other than a modified endowment contract) are distributed to you, they are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract.

TAX PENALTIES IN RETIREMENT PLANS

Pre 59½ - Early Distributions

You must include early distributions of taxable amounts from your traditional IRA in your gross income. Early distributions are also subject to an additional 10% tax. Early distributions generally are amounts distributed from your traditional IRA account or annuity before you are age 59½, or amounts you receive when you cash in retirement bonds before you are age 59½.

Age 59½ Rule

Generally, if you are under age 59½, you must pay a 10% additional tax on the distribution of any assets (money or other property) from your traditional IRA. Distributions before you are age 59½ are called early distributions. The 10% additional tax applies to the part of the distribution that you have to include in gross income. It is in addition to any regular income tax on that amount.

NOTE: You may have to pay a 25%, rather than 10%, additional tax if you receive distributions from a SIMPLE IRA before you are age 59½.

Exceptions

There are several exceptions to the age 59½ rule. Even if you receive a distribution before you are age 59½, you may not have to pay the 10% additional tax if you are in one of the following situations:

- You have unreimbursed medical expenses that are more than 7.5% of your adjusted gross income.
- **The distributions are not more than the cost of your medical insurance**.
- You are disabled.
- **You are the beneficiary of a deceased IRA owner.**
- You are receiving distributions in the form of an annuity.
- The distributions are not more than your qualified higher education expenses.
- You use the distributions to buy, build, or rebuild a first home.
- The distribution is due to an IRS levy of the qualified plan.

Distributions that are timely and properly rolled over, as discussed earlier, are not subject to either regular income tax or the 10% additional tax. Certain withdrawals of excess contributions after the due date of your return are also tax free and therefore not subject to the 10% additional tax.

Unreimbursed medical expenses. Even if you are under age 59½, you do not have to pay the 10% additional tax on distributions that are not more than:

- The amount you paid for unreimbursed medical expenses during the year of the distribution, minus
- 7.5% of your adjusted gross income (defined later) for the year of the distribution.

You can only take into account unreimbursed medical expenses that you would be able to include in figuring a deduction for medical expenses on Schedule A, Form 1040. You do not have to itemize your deductions to take advantage of this exception to the 10% additional tax.

Medical Insurance. Even if you are under age 59½, you may not have to pay the 10% additional tax on distributions during the year that are not more than the amount you paid during the year for medical insurance for yourself, your spouse, and your dependents. You will not have to pay the tax on these amounts if all of the following conditions apply.

- You lost your job.
- You received unemployment compensation paid under any federal or state law for 12 consecutive weeks because you lost your job.
- You receive the distributions during either the year you received the unemployment compensation or the following year.
- You receive the distributions no later than 60 days after you have been reemployed.

Disabled. If you become disabled before you reach age 59½, any distributions from your traditional IRA because of your disability are not subject to the 10% additional tax. You are considered disabled if you can furnish proof that you cannot do any substantial gainful activity because of your physical or

mental condition. A physician must determine that your condition can be expected to result in death or to be of long, continued, and indefinite duration.

Beneficiary. If you die before reaching age 59½, the assets in your traditional IRA can be distributed to your beneficiary or to your estate without either having to pay the 10% additional tax.

However, if you inherit a traditional IRA from your deceased spouse and elect to treat it as your own, any distribution you later receive before you reach age 59½ may be subject to the 10% additional tax.

Annuity. You can receive distributions from your traditional IRA that are part of a series of substantially equal payments over your life (or your life expectancy), or over the lives (or the joint life expectancies) of you and your beneficiary, without having to pay the 10% additional tax, even if you receive such distributions before you are age 59½. You must use an IRS-approved distribution method and you must take at least one distribution annually for this exception to apply. The “required minimum distribution method, ” when used for this purpose, results in the exact amount required to be distributed, not the minimum amount.

There are two other IRS -approved distribution methods that you can use. They are generally referred to as the “fixed amortization method” and the “fixed annuitization method.” These two methods are not discussed in this publication because they are more complex and generally require professional assistance.

The payments under this exception must generally continue until at least 5 years after the date of the first payment, or until you reach age 591/, whichever is later. If a change from an approved distribution method is made before the end of the appropriate period, any payments you receive before you reach age 59½ will be subject to the 10% additional tax. This is true even if the change is made after you reach age 59½. The payments will not be subject to the 10% additional tax if another exception applies or if the change is made because of your death or disability.

One-time switch. If you are receiving a series of substantially equal periodic payments, you can make a one-time switch to the required minimum distribution method at any time without incurring the additional tax. Once a change is made, you must follow the required minimum distribution method in all subsequent years.

Higher Education Expenses. Even if you are under age 59½, if you paid expenses for higher education during the year, part (or all) of any distribution may not be subject to the 10% additional tax. The part not subject to the tax is generally the amount that is not more than the qualified higher education expenses for the year for education furnished at an eligible educational institution. The education must be for you, your spouse, or the children or grandchildren of you or your spouse.

When determining the amount of the distribution that is not subject to the 10% additional tax, include qualified higher education expenses paid with any of the following funds.

- Payment for services, such as wages.
- A loan.
- A gift.
- An inheritance given to either the student or the individual making the withdrawal.
- A withdrawal from personal savings (including savings from a qualified tuition program).

Do not include expenses paid with any of the following funds.

- Tax-free distributions from a Coverdell education savings account.
- Tax-free part of scholarships and fellowships.
- Pell grants.
- Employer-provided educational assistance.
- Veterans' educational assistance.
- Any other tax-free payment (other than a gift or inheritance) received as educational assistance.

Qualified higher education expenses. Qualified higher education expenses are tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a student at an eligible educational institution. They also include expenses for special needs services incurred by or for special needs students in connection with their enrollment or attendance. In addition, if the individual is at least a half-time student, room and board are qualified higher education expenses.

Eligible educational institution*.* This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

First home. Even if you are under age 59½, you do not have to pay the 10% additional tax on distributions you receive to buy, build, or rebuild a first home. To qualify for treatment as a first-time homebuyer distribution, the distribution must meet all the following requirements.

1. It must be used to pay qualified acquisition costs (defined later) before the close of the 120th day after the day you received it.
2. It must be used to pay qualified acquisition costs for the main home of a first-time homebuyer (defined later) who is any of the following.
    a. Yourself.
    b. Your spouse.
    c. Your or your spouse's child.
    d. Your or your spouse's grandchild.
    e. Your or your spouse's parent or other ancestor.

3. When added to all your prior qualified first-time homebuyer distributions, if any, the total distributions cannot be more than $10,000.

If both you and your spouse are first-time homebuyers (defined later), each of you can receive distributions up to $10,000 for a first home without having to pay the 10% additional tax.

Qualified acquisition costs. Qualified acquisition costs include the following items.

- Costs of buying, building, or rebuilding a home.
- Any usual or reasonable settlement, financing, or other closing costs.

First-time homebuyer. Generally, you are a first-time homebuyer if you had no present interest in a main home during the 2-year period ending on the date of acquisition of the home which the distribution is being used to buy, build, or rebuild. If you are married, your spouse must also meet this no-ownership requirement.

Date of acquisition. The date of acquisition is the date that:

- You enter into a binding contract to buy the main home for which the distribution is being used, or
- The building or rebuilding of the main home for which the distribution is being used begins.

Additional 10% tax

The additional tax on early distributions is 10% of the amount of the early distribution that you must include in your gross income. This tax is in addition to any regular income tax resulting from including the distribution in income.

Example: Tom Jones, who is 35 years old, receives a $3,000 distribution from his traditional IRA account. Tom does not meet any of the exceptions to the 10% additional tax, so the $3,000 is an early distribution. Tom never made any nondeductible contributions to his IRA. He must include the $3,000 in his gross income for the year of the distribution and pay income tax on it. Tom must also pay an additional tax of $300 (10% × $3,000).

Age 70½ Required Minimum Distributions (RMD)

You cannot keep funds in a traditional IRA indefinitely. Eventually they must be distributed. If there are no distributions, or if the distributions are not large enough, you may have to pay a 50% excise tax on the amount not distributed as required. The requirements for distributing IRA funds differ, depending on whether you are the IRA owner or the beneficiary of a decedent's IRA.

Required minimum distribution. The amount that must be distributed each year is referred to as the required minimum distribution.

Distributions not eligible for rollover. Amounts that must be distributed (required minimum distributions) during a particular year are not eligible for rollover treatment.

IRA Owners

If you are the owner of a traditional IRA, you must start receiving distributions from your IRA by April 1 of the year following the year in which you reach age 70½. April 1 of the year following the year in which you reach age 70½ is referred to as the required beginning date.

You must receive at least a minimum amount for each year starting with the year you reach age 70½ (your 70½ year). If you do not (or did not) receive that minimum amount in your 70½ year, then you must receive distributions for your 70½ year by April 1 of the next year. If an IRA owner dies after reaching age 70½, but before April 1 of the next year, no minimum distribution is required because death occurred before the required beginning date.

Even if you begin receiving distributions before you reach age 70½, you must begin calculating and receiving required minimum distributions by your required beginning date.

More than minimum received. If, in any year, you receive more than the required minimum distribution for that year, you will not receive credit for the additional amount when determining the minimum required distributions for future years. This does not mean that you do not reduce your IRA account balance. It means that if you receive more than your required minimum distribution in one year, you cannot treat the excess (the amount that is more than the required minimum distribution) as part of your required minimum distribution for any later year. However, any amount distributed in your 70½ year will be credited toward the amount that must be distributed by April 1 of the following year.

The required minimum distribution for any year after the year you turn 70½ must be made by December 31 of that later year.

Example: You reach age 70½ on August 20, 2016. For 2016, you must receive the required minimum distribution from your IRA by April 1, 2017. You must receive the required minimum distribution for 2017 by December 31, 2017.

If you do not receive your required minimum distribution for 2016 until 2017, both your 2016 and your 2017 distributions will be includible on your 2017 return.

Distributions from individual retirement account. If you are the owner of a traditional IRA that is an individual retirement account, you or your trustee must figure the required minimum distribution for each year.

Distributions from individual retirement annuities. If your traditional IRA is an individual retirement annuity, special rules apply to figuring the required minimum distribution. For more information on rules for annuities, see Regulations section 1.401(a)(9)-6.

Change in marital status. For purposes of figuring your required minimum distribution, your marital status is determined as of January 1 of each year. If you are married on January 1, but get divorced or your spouse dies during the year, your spouse as of January 1 remains your sole beneficiary for that year. For purposes of determining your distribution period, a change in beneficiary is effective in the year following the year of death or divorce.

Designation of an IRA beneficiary

In the United States, without a beneficiary statement, the default provision in the custodian-agreement will apply, which may be the estate of the owner resulting in higher taxes and extra fees.

- Identity - A specific, identifiable individual must be designated as beneficiary.
- Contingent beneficiary - If the primary beneficiary predeceases the IRA owner, the contingent beneficiary becomes the designated beneficiary. If a contingent beneficiary is not named, the default provision in the custodian-agreement applies.
- Death - At the IRA owner's death, the primary beneficiary may select his or her own beneficiaries. There is no obligation to retain the contingent beneficiary designated by the IRA owner.
- Multiple accounts - An IRA owner can split an IRA into several IRA's each with different beneficiaries, assets and value.

Change of beneficiary. If your spouse is the sole beneficiary of your IRA, and he or she dies before you, your spouse will not fail to be your sole beneficiary for the year that he or she died solely because someone other than your spouse is named a beneficiary for the rest of that year. However, if you get divorced during the year and change the beneficiary designation on the IRA during that same year, your former spouse will not be treated as the sole beneficiary for that year.

Figuring the Owner's Required Minimum Distribution

Figure your required minimum distribution for each year by dividing the IRA account balance (defined next) as of the close of business on December 31 of the preceding year by the applicable distribution period or life expectancy.

IRA account balance. The IRA account balance is the amount in the IRA at the end of the year preceding the year for which the required minimum distribution is being figured.

Contributions. Contributions increase the account balance in the year they are made. If a contribution for last year is not made until after December 31 of last year, it increases the account balance for this year, but not for last year. Disregard contributions made after December 31 of last year in determining your required minimum distribution for this year.

Outstanding rollovers and re-characterizations. The IRA account balance is adjusted by outstanding rollovers and re-characterizations of Roth IRA conversions that are not in any account at the end of the preceding year.

For a rollover from a qualified plan or another IRA that was not in any account at the end of the preceding year, increase the account balance of the receiving IRA by the rollover amount valued as of the date of receipt.

If a conversion contribution or failed conversion contribution is contributed to a Roth IRA and that amount (plus net income allocable to it) is transferred to another IRA in a subsequent year as a re-characterized contribution, increase the account balance of the receiving IRA by the re-characterized contribution (plus allocable net income) for the year in which the conversion or failed conversion occurred.

Distributions. Distributions reduce the account balance in the year they are made. If a distribution for last year is not made until after December 31 of last year, it reduces the account balance for this year, but not for last year. Disregard distributions made after December 31 of last year in determining your required minimum distribution for this year.

Example 1: Laura was born on October 1, 1934. She is an unmarried participant in a qualified defined contribution plan. She reaches age 70½ in 2005. Her required beginning date is April 1, 2006. As of December 31, 2004, her account balance was $26,500. No rollover or re-characterization amounts were outstanding. Using Table III in Appendix C, the applicable distribution period for someone her age (71) is 26.5 years. Her required minimum distribution for 2005 is $1,000 ($26,500 ÷ 26.5). That amount is distributed to her on April 1, 2006.

Example 2: Joe, born October 1, 1933, reached 70½ in 2004. His wife (his beneficiary) turned 56 in September 2004. He must begin receiving distributions by April 1, 2005. Joe's IRA account balance as of December 31, 2003, is $30,100. Because Joe's wife is more than 10 years younger than Joe and is the sole beneficiary of his IRA, Joe uses Table II in Appendix C. Based on their ages at year end (December 31, 2004), the joint life expectancy for Joe (age 71) and his wife (age 56) is 30.1 years. The required minimum distribution for 2004, Joe's first distribution year (his 701/ year), is $1,000 ($30,100 ÷ 30.1). This amount is distributed to Joe on April 1, 2005.

Distribution period. This is the maximum number of years over which you are allowed to take distributions from the IRA. The period to use for 2004 is listed next to your age as of your birthday in 2004 in Table III or IRA Pub. 590.

Life expectancy. If you must use Table I, your life expectancy for 2005 is listed in the table next to your age as of your birthday in 2005. If you use Table II, your life expectancy is listed where the row or column containing your age as of your birthday in 2005 intersects with the row or column containing your spouse's age as of his or her birthday in 2005. Both Table I and Table II are in IRS Pub. 590.

Distributions during your lifetime. Required minimum distributions during your lifetime are based on a distribution period that generally is determined using Table III (Uniform Lifetime) in IRS Pub. 590. To figure the required minimum distribution for 2017, divide your account balance at the end of 2016 by the distribution period from the table. This is the distribution period listed next to your age (as of your birthday in 2017) in Table III in IRS Pub. 590, unless the sole beneficiary of your IRA is your spouse who is more than 10 years younger than you.

To help you complete your tax return, use the following appendices that include worksheets and tables.

1. Appendix A — Worksheet for Determining Required Minimum Distributions.
2. Appendix B — Life Expectancy Tables. These tables are included to assist you in computing your required minimum distribution amount if you have not taken all your assets from all your traditional IRAs before age 70½.
    a. Table I (Single Life Expectancy).
    b. Table II (Joint Life and Last Survivor Expectancy).
    c. Table III (Uniform Lifetime).

Further explanation of the above-mentioned items will be addressed later in the material.

Sole beneficiary spouse who is more than 10 years younger. If the sole beneficiary of your IRA is your spouse and your spouse is more than 10 years younger than you, use the life expectancy from Table II (Joint Life and Last Survivor Expectancy). The life expectancy to use is the joint life and last survivor expectancy listed where the row or column containing your age as of your birthday in 2005 intersects with the row or column containing your spouse's age as of his or her birthday in 2005. You figure your required minimum distribution for 2005 by dividing your account balance at the end of 2004 by the life expectancy from Table II (Joint Life and Last Survivor Expectancy) in IRS Pub. 590.

Distributions in the year of the owner's death. The required minimum distribution for the year of the owner's death depends on whether the owner died before the required beginning date. If the owner died before his or her required beginning date, base required minimum distributions for years after the year of the owner's death generally on your single life expectancy.

If the owner died on or after the required beginning date, the required minimum distribution for the year of death generally is based on Table III (Uniform Lifetime) in IRS Pub. 590. However, if the sole beneficiary of the IRA is the owner's spouse who is more than 10 years younger than the owner, use the life expectancy from Table II (Joint Life and Last Survivor Expectancy). You figure the required minimum distribution for the year in which an IRA owner dies as if the owner lived for the entire year.

IRA Beneficiaries

The rules for determining required minimum distributions for beneficiaries depend on whether the beneficiary is an individual. The rules for individuals are explained below.

Surviving Spouse

If you are a surviving spouse who is the sole beneficiary of your deceased spouse's IRA, you may elect to be treated as the owner and not as the beneficiary. If you elect to be treated as the owner, you determine the required minimum distribution (if any) as if you were the owner beginning with the year you elect or are deemed to be the owner. However, if you become the owner in the year your deceased spouse died, you are not required to determine the required minimum distribution for that year using your life; rather, you can take the deceased owner's required minimum distribution for that year (to the extent it was not already distributed to the owner before his or her death).

Taking balance within 5 years.

A beneficiary who is an individual may be required to take the entire account by the end of the fifth year following the year of the owner's death. If this rule applies, no distribution is required for any year before that fifth year.

Owner Died On or After Required Beginning Date

If the owner died on or after his or her required beginning date, and you are the designated beneficiary, you generally must base required minimum distributions for years after the year of the owner's death on the longer of:

- Your single life expectancy as shown on Table I, or
- The owner's life expectancy as determined under *Death on or after required beginning date,* under *Beneficiary not an individual.*

Owner Died Before Required Beginning Date

If the owner died before his or her required beginning date, base required minimum distributions for years after the year of the owner's death generally on your single life expectancy. If the owner's beneficiary is not an individual (for example, if the beneficiary is the owner's estate), see *Beneficiary not an individual,* later.

Date the designated beneficiary is determined.

Generally, the designated beneficiary is determined on September 30 of the calendar year following the calendar year of the IRA owner's death. In order to be a designated beneficiary, an individual must be a beneficiary as of the date of death. Any person who was a beneficiary on the date of the owner's death, but is not a beneficiary on September 30 of the calendar year following the calendar year of the owner's death (because, for example, he or she disclaimed entitlement or received his or her entire benefit), will not be taken into account in determining the designated beneficiary.

Death of a beneficiary.

If a person who is a beneficiary as of the owner's date of death dies before September 30 of the year following the year of the owner's death without disclaiming entitlement to benefits, that individual, rather than his or her successor beneficiary, continues to be treated as a beneficiary for determining the distribution period.

Death of surviving spouse.

If the designated beneficiary is the owner's surviving spouse, and he or she dies before he or she was required to begin receiving distributions, the surviving spouse will be treated as if he or she were the owner of the IRA. However, this rule does not apply to the surviving spouse of a surviving spouse.

More than one beneficiary.

If an IRA has more than one beneficiary or a trust is named as beneficiary, see *Miscellaneous Rules for Required Minimum Distributions,* later.

Figuring the Beneficiary's Required Minimum Distribution

How you figure the required minimum distribution depends on whether the beneficiary is an individual or some other entity, such as a trust or estate.

Beneficiary an individual.

If the beneficiary is an individual, to figure the required minimum distribution for 2017, divide the account balance at the end of 2016 by the appropriate life expectancy from Table I (Single Life Expectancy) in IRS Pub 590. Determine the appropriate life expectancy as follows.

- Spouse as sole designated beneficiary. Use the life expectancy listed in the table next to the spouse's age (as of the spouse's birthday in 2017). If the owner died before the year in which he or she reached age 70½, distributions to the spouse do not need to begin until the year in which the owner would have reached age 70½.

- Other designated beneficiary. Use the life expectancy listed in the table next to the beneficiary's age as of his or her birthday in the year following the year of the owner's death, reduced by one for each year since the year following the owner's death.

Beneficiary not an Individual.

If the beneficiary is not an individual, determine the required minimum distribution for 2016 as follows.

- Death on or after required beginning date. Divide the account balance at the end of 2015 by the appropriate life expectancy from Table I (Single Life Expectancy) in IRS Pub 590. Use the life expectancy listed next to the owner's age as of his or her birthday in the year of death, reduced by one for each year since the year of death.
- Death before required beginning date. The entire account must be distributed by the end of the fifth year following the year of the owner's death. No distribution is required for any year before that fifth year.

Which Table Do You Use to Determine Your Required Minimum Distribution?

There are three different tables. You use only one of them to determine your required minimum distribution for each traditional IRA. Determine which one to use as follows.

In using the tables for lifetime distributions, marital status is determined as of January 1 each year. Divorce or death after January 1 is generally disregarded until the next year. However, if you divorce and change the beneficiary designation in the same year, your former spouse cannot be considered your sole beneficiary for that year.

Table I (Single Life Expectancy)

Use Table I for years after the year of the owner's death if either of the following apply.

- You are an individual and a designated beneficiary, but not both the owner's surviving spouse and sole designated beneficiary.
- You are not an individual and the owner died on or after the required beginning date.

Surviving Spouse

If you are the owner's surviving spouse and sole designated beneficiary, and the owner had not reached age 70½ when he or she died, and you do not elect to be treated as the owner of the IRA, you do not have to take distributions (and use *Table I*) until the year in which the owner would have reached age 70½.

Table II (Joint Life and Last Survivor Expectancy).

Use Table II if you are the IRA owner and your spouse is both your sole designated beneficiary and more than 10 years younger than you. Use this table in the year of the owner's death if the owner died after the required beginning date and this is the table that would have been used had he or she not died.

Table III (Uniform Lifetime).

Use Table III if you are the IRA owner and your spouse is not both the sole designated beneficiary of your IRA and more than 10 years younger than you. Use this table in the year of the owner's death if the owner died after the required beginning date and this is the table that would have been used had he or she not died.

No Table. Do not use any of the tables if the designated beneficiary is not an individual and the owner died before the required beginning date. In this case, the entire distribution must be made by the end of the fifth year following the year of the IRA owner's death. This rule also applies if there is no designated beneficiary named by September 30 of the year following the year of the IRA owner's death.

5-Year Rule

If you are an individual, you can elect to take the entire account by the end of the fifth year following the year of the owner's death. If you make this election, do not use a table.

What Age(s) Do You Use with the Table(s)?

Table I (Single Life Expectancy).

If you are a designated beneficiary figuring your first distribution, use your age as of your birthday in the year distributions must begin. This is usually the calendar year immediately following the calendar year of the owner's death. If you are the owner's surviving spouse and the sole designated beneficiary, this is the year in which the owner would have reached age 70½. After the first distribution year, reduce your life expectancy by one for each subsequent year.

No Designated Beneficiary

In some cases, you need to use the owner's life expectancy. You need to use it when the owner dies on or after the required beginning date and there is no designated beneficiary as of September 30 of the year following the year of the owner's death. In this case, use the owner's life expectancy for his or her age as of the owner's birthday in the year of death and reduce it by one for each subsequent year.

Table II (Joint Life and Last Survivor Expectancy)

For your first distribution by the required beginning date, use your age and the age of your designated beneficiary as of your birthdays in the year you become age 70½. Your combined life expectancy is at the intersection of your ages. If you are figuring your required minimum distribution for 2005, use your ages as of your birthdays in 2005. For each subsequent year, use your and your spouse's ages as of your birthdays in the subsequent year.

Table III (Uniform Lifetime)

For your first distribution by your required beginning date, use your age as of your birthday in the year you become age 70½. If you are figuring your required minimum distribution for 2005, use your age as of your birthday in 2005. For each subsequent year, use your age as of your birthday in the subsequent year.

Miscellaneous Rules for Required Minimum Distributions

Installments Allowed

The yearly required minimum distribution can be taken in a series of installments (monthly, quarterly, etc.), as long as the total distributions for the year are at least as much as the minimum required amount.

More than one IRA

If you have more than one traditional IRA, you must determine a separate required minimum distribution for each IRA. However, you can total these minimum amounts and take the total from any one or more of the IRAs.

Example: Sara, born August 1, 1933, became 70½ on February 1, 2004. She has two traditional IRAs. She must begin receiving her IRA distributions by April 1, 2005. On December 31, 2003, Sara's account balance from IRA A was $10,000; her account balance from IRA B was $20,000. Sara's brother, age 64 as of his birthday in 2004, is the beneficiary of IRA A. Her husband, age 78 as of his birthday in 2004, is the beneficiary of IRA B.

Sara's required minimum distribution from IRA A is $377 ($10,000 ÷ 26.5 (the distribution period for age 71 per Table III)). The amount of the required minimum distribution from IRA B is $755 ($20,000 ÷ 26.5). The amount that must be withdrawn by Sara from her IRA accounts by April 1, 2005, is $1,132 ($377 + $755).

More Than Minimum Received

If, in any year, you receive more than the required minimum amount for that year, you will not receive credit for the additional amount when determining the minimum required amounts for future years. This does not mean that you do not reduce your IRA account balance. It means that if you receive more than your required minimum distribution in one year, you cannot treat the excess (the amount that is more than the required minimum distribution) as part of your required minimum distribution for any later year. However, any amount distributed in your 70½ year will be credited toward the amount that must be distributed by April 1 of the following year.

Example: Justin became 70½ on December 15, 2004. Justin's IRA account balance on December 31, 2003, was $38,400. He figured his required minimum distribution for 2004 was $1,401 ($38,400 ÷ 27.4). By December 31, 2004, he had actually received distributions totaling $3,600, $2,199 more than was required. Justin cannot use that $2,199 to reduce the amount he is required to withdraw for 2005, but his IRA account balance is reduced by the full $3,600 to figure his required minimum distribution for 2005. Justin's reduced IRA account balance on December 31, 2004, was $34,800. Justin figured his required minimum distribution for 2005 is $1,313 ($34,800 ÷ 26.5). During 2005, he must receive distributions of at least that amount.

Multiple Individual Beneficiaries

If as of September 30 of the year following the year in which the owner dies there is more than one beneficiary, the beneficiary with the shortest life expectancy will be the designated beneficiary if both of the following apply.

- All of the beneficiaries are individuals, and
- The account or benefit has not been divided into separate accounts or shares for each beneficiary.

Separate Accounts

Separate accounts with separate beneficiaries can be set up at any time, either before or after the owner's required beginning date. If separate accounts with separate beneficiaries are set up, the separate accounts are not combined for required minimum distribution purposes until the year after the separate accounts are established, or if later, the date of death. As a general rule, the required minimum distribution rules separately apply to each account.

However, the distribution period for an account is separately determined (disregarding beneficiaries of the other account(s)) only if the account was set up by the end of the year following the year of the owner's death. The separate account rules cannot be used by beneficiaries of a trust.

Trust as Beneficiary

A trust cannot be a designated beneficiary even if it is a named beneficiary. However, the beneficiaries of a trust will be treated as having been designated as beneficiaries if all of the following are true.

- The trust is a valid trust under state law, or would be but for the fact that there is no corpus.
- The trust is irrevocable or will, by its terms, become irrevocable upon the death of the owner.
- The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the owner's benefit are identifiable from the trust instrument.
- The IRA trustee, custodian, or issuer has been provided with either a copy of the trust instrument with the agreement that if the trust instrument is amended, the administrator will be provided with a copy of the amendment within a reasonable time, or all of the following.
    - A list of all of the beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement).
    - Certification that, to the best of the owner's knowledge, the list is correct and complete and that the requirements of (1), (2), and (3) above, are met.
    - An agreement that, if the trust instrument is amended at any time in the future, the owner will, within a reasonable time, provide to the IRA trustee, custodian, or issuer

corrected certifications to the extent that the amendment changes any information previously certified.
    - An agreement to provide a copy of the trust instrument to the IRA trustee, custodian, or issuer upon demand.

The deadline for providing the beneficiary documentation to the IRA trustee, custodian, or issuer is October 31 of the year following the year of the owner's death. If the beneficiary of the trust is another trust and the above requirements for both trusts are met, the beneficiaries of the other trust will be treated as having been designated as beneficiaries for purposes of determining the distribution period. The separate account rules cannot be used by beneficiaries of a trust.

DIVORCE & PENSIONS

Qualified Domestic Relation Orders (QDRO)
Introduction

More than 48 million private wage and salary workers are currently covered by employer-sponsored pension plans in the United States. For many of these Americans, pension savings represent one of their most significant assets. For this reason, whether and how to divide a participant's interest in a pension plan are often important considerations in separation, divorce, and other domestic relations proceedings.

While the division of marital property generally is governed by state domestic relations law, any assignments of pension interests must also comply with Federal law, namely the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 (the Code). Under ERISA and the Code, pension interests may be assigned only if the judgment, decree, or order creating or recognizing a spouse's, former spouse's, child's, or other dependent's interest in an individual's pension benefits constitutes a "qualified domestic relations order" or "QDRO."

Qualified Domestic Relations Orders: An Overview

This section includes a general overview of the provisions of Federal law governing the assignment of pension benefits in a domestic relations proceeding and the requirements that apply in determining whether a domestic relations order is a QDRO. The following areas are addressed:

- Who can be an "alternate payee"?
- What information must be included in a domestic relations order in order for it to be "qualified"?
- Who determines whether a domestic relations order is a QDRO?

In general, ERISA and the Code do not permit a participant to assign or alienate the participant's interest in a pension plan to another person. These "anti-assignment and alienation" rules are intended to ensure that a participant's pension benefits are actually available to provide financial support during the participant's retirement years. A limited exception to the anti-assignment and alienation rules is provided for assignments of pension benefits through qualified domestic relations orders (QDROs).

Under the QDRO exception, a domestic relations order may assign some or all of a participant's pension benefits to a spouse, former spouse, child, or other dependent to satisfy family support or marital property obligations if and only if the order is a "qualified domestic relations order." ERISA requires that each pension plan pay benefits in accordance with the applicable requirements of any "qualified domestic relations order" that has been submitted to the plan administrator. The plan administrator's determinations on whether a domestic relations order is a QDRO, therefore, have significant implications for both the parties to a domestic relations proceeding and the plan. The following questions and answers are intended to provide an overview of the Federal requirements a domestic relations order must satisfy to be considered a QDRO.

What is a Qualified Domestic Relations Order?

A "qualified domestic relation order" (QDRO) is:

- A domestic relations order that creates or recognizes the existence of an "alternate payee's" right to receive or assigns to an alternate payee the right to receive, all or a portion of the benefits payable with respect to a participant under a pension plan, and that includes certain information and meets certain other requirements.

What is a "domestic relations order"?

To be recognized as a QDRO, an order must be a "domestic relations order." A domestic relations order is:

- A judgment, decree, or order (including the approval of a property settlement)
- That is made pursuant to state domestic relations law (including community property law)
- That relates to the provision of child support, alimony payments, or marital property rights for the benefit of a spouse, former spouse, child, or other dependent of a participant

A state authority, generally a court, must actually issue a judgment, order, or decree or otherwise formally approve a property settlement agreement before it can be a "domestic relations order" under ERISA. The mere fact that a property settlement is agreed to and signed by the parties will not, in and of itself, cause the agreement to be a domestic relations order.

There is no requirement that both parties to a marital proceeding sign or otherwise endorse or approve an order. It is also not necessary that the pension plan be brought into state court or made a party to a domestic relations proceeding for an order issued in that proceeding to be a "domestic relations order" or a "qualified domestic relations order." Indeed, because state law is generally preempted to the extent that it relates to pension plans, the DOL takes the position that pension plans cannot be joined as a party in a domestic relations proceeding pursuant to state law. Moreover, pension plans are neither permitted nor required to follow the terms of domestic relations orders purporting to assign pension benefits unless they are QDROs.

Reference: ERISA §§ 206(d)(3)(B)(ii), 514(a), 514(b)(7); IRC § 414(p)(1)(B)

Must a "domestic relations order" be issued by a state court?

No. A domestic relations order may be issued by any state agency or instrumentality with the authority to issue judgments, decrees, or orders, or to approve property settlement agreements, pursuant to state domestic relations law (including community property law).

Reference: ERISA § 206(d)(3)(B)(ii); IRC § 414(p)(1)(B)

Who can be an "alternate payee"?

A domestic relations order can be a QDRO only if it creates or recognizes the existence of an alternate payee's right to receive or assigns to an alternate payee the right to receive, all or a part of a participant's benefits. For purposes of the QDRO provisions, an alternate payee cannot be anyone other than a spouse, former spouse, child, or other dependent of a participant. Reference: ERISA § 206(d)(3)(K), IRC § 414(p)(8)

What information must a domestic relations order contain to qualify as a QDRO under ERISA?

QDROs must contain the following information:

- The name and last known mailing address of the participant and each alternate payee
- The name of each plan to which the order applies
- The dollar amount or percentage (or the method of determining the amount or percentage) of the benefit to be paid to the alternate payee
- The number of payments or time period to which the order applies
  Reference: ERISA § 206(d)(3)(C)(i)-(iv); IRC § 414(p)(2)(A)-(D)

Are there other requirements that a domestic relations order must meet to be a QDRO?

Yes. There are certain provisions that a QDRO must not contain:

- The order must not require a plan to provide an alternate payee or participant with any type or form of benefit, or any option, not otherwise provided under the plan
- The order must not require a plan to provide for increased benefits (determined on the basis of actuarial value)
- The order must not require a plan to pay benefits to an alternate payee that are required to be paid to another alternate payee under another order previously determined to be a QDRO
- The order must not require a plan to pay benefits to an alternate payee in the form of a qualified joint and survivor annuity for the lives of the alternate payee and his or her subsequent spouse

Reference: ERISA §§ 206(d)(3)(D)(i)-(iii), 206(d)(3)(E)(i)(III); IRC §§ 414(p)(3)(A)-(C), 414(p)(4)(A)(iii)

May a QDRO be part of the divorce decree or property settlement?

Yes. There is nothing in ERISA or the Code that requires that a QDRO (that is, the provisions that create or recognize an alternate payee's interest in a participant's pension benefits) be issued as a separate judgment, decree, or order. Accordingly, a QDRO may be included as part of a divorce decree or court-approved property settlement, or issued as a separate order, without affecting its "qualified" status. The order must satisfy the requirements described above to be a QDRO. Reference: ERISA § 206(d)(3)(B); IRC § 414(p)(1)

Must a domestic relations order be issued as part of a divorce proceeding to be a QDRO?
No. A domestic relations order that provides for child support or recognizes marital property rights

may be a QDRO, without regard to the existence of a divorce proceeding. Such an order, however, must be issued pursuant to state domestic relations law and create or recognize the rights of an individual who is an "alternate payee" (spouse, former spouse, child, or other dependent of a participant).

An order issued in a probate proceeding begun after the death of the participant that purports to recognize an interest with respect to pension benefits arising solely under state community property law, but that doesn't relate to the dissolution of a marriage or recognition of support obligations, is not a QDRO because the proceeding does not relate to a legal separation, marital dissolution, or family support obligation. Reference: ERISA § 206(d)(3)(B); IRC § 414(p)(1); Advisory Opinion 90-46A (Appendix A); see Boggs v. Boggs, No. 97-79 (S. Ct. June 2, 1997)

May a QDRO provide for payment to the guardian of an alternate payee?

Yes. If an alternate payee is a minor or is legally incompetent, the order can require payment to someone with legal responsibility for the alternate payee (such as a guardian or a party acting in loco parentis in the case of a child, or a trustee as agent for the alternate payee). Reference: See Staff of the Joint Committee on Taxation, Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation, 100th Cong., 1st Sess. (Comm. Print 1987) at 222.

Can a QDRO cover more than one plan?

Yes. A QDRO can assign rights to pension benefits under more than one pension plan of the same or different employers as long as each plan and the assignment of benefit rights under each plan are clearly specified. Reference: ERISA § 206(d)(3)(C)(iv); IRC § 414(p)(2)(D)

Must all QDROs have the same provisions?

No. Although every QDRO must contain certain provisions, such as the names and addresses of the participant and alternate payee(s) and the name of the plan(s), the specific content of the rest of the QDRO will depend, on the type of pension plan, the nature of the participant's pension benefits, the purposes behind issuing the order, and the intent of the drafting parties.

Who determines whether an order is a QDRO?

Under Federal law, the administrator of the pension plan that provides the benefits affected by an order is the individual (or entity) initially responsible for determining whether a domestic relations order is a QDRO. Plan administrators have specific responsibilities and duties with respect to determining whether a domestic relations order is a QDRO. Plan administrators, as plan fiduciaries, are required to discharge their duties prudently and solely in the interest of plan participants and beneficiaries. Among other things, plans must establish reasonable procedures to determine the qualified status of domestic relations orders and to administer distributions pursuant to qualified orders.

Administrators are required to follow the plan's procedures for making QDRO determinations. Administrators also are required to furnish notice to participants and alternate payees of the receipt of a domestic relations order and to furnish a copy of the plan's procedures for determining the qualified status of such orders.

It is the view of the DOL of Labor that a state court (or other state agency or instrumentality with the authority to issue domestic relations orders) does not have jurisdiction to determine whether an issued domestic relations order constitutes a "qualified domestic relations order." In the view of the DOL, jurisdiction to challenge a plan administrator's decision about the qualified status of an order lies exclusively in Federal court. Reference: ERISA §§ 206(d)(3)(G)(i)(II), 404(a), 502(a)(3), 502(e), 514; IRC § 414(p)(6)(A)(ii)

Who is the "administrator" of the plan?

The "administrator" of an employee benefit plan is the individual or entity specifically designated in the plan documents as the administrator. If the plan documents do not designate an administrator, the administrator is the employer maintaining the plan, or, in the case of a plan maintained by more than one employer, the association, committee, joint board of trustees, or similar group representing the parties maintaining the plan.

The name, addresses, and phone number of the plan administrator is required to be included in the plan's summary plan description. The summary plan description is a document that the administrator is required to furnish to each participant and to each beneficiary receiving benefits. It summarizes the rights and benefits of

participants and beneficiaries and the obligations of the plan. Reference: ERISA §§ 3(16), 102(b), 29 CFR § 2520.102-3(f); IRC § 414(g), Treas. Reg. § 1.414(g)-1

Will the DOL of Labor issue advisory opinions on whether a domestic relations order is a QDRO?

No. A determination of whether an order is a QDRO necessarily requires an interpretation of the specific provisions of the plan or plans to which the order applies and the application of those provisions to specific facts, including a determination of the participant's actual pension benefits under the plan(s). The DOL will not issue opinions on such inherently factual matters. Reference: See ERISA Procedure 76-1, 41 Fed. Reg. 36281 (1976)(Appendix B)

Administration of QDROs: Determining Qualified Status and Paying Benefits

This section describes the duties of a plan administrator in determining the qualified status of domestic relations orders and administering distributions under QDROs. The following areas are addressed:

- What are the plan administrator's responsibilities in furnishing information to a participant and alternate payee?
- What measures must a plan administrator take to protect the plan participant's benefits upon receipt of a domestic relations order?
- What procedures must a plan administrator follow in determining whether a domestic relations order is a QDRO?

ERISA imposes a number of responsibilities on the plan administrator relating to the handling of domestic relations orders. As a plan fiduciary, the administrator is required to discharge these responsibilities prudently and solely in the interest of the plan's participants and beneficiaries. It is the view of the DOL that the prudent discharge of a fiduciary's responsibilities with respect to the handling of domestic relations orders, like other areas of plan administration, requires plan administrators to take steps to avoid unnecessary and excessive administrative burdens and costs to the plan.
The DOL believes that the adoption of procedures and policies designed to facilitate, rather than impede, the timely processing and perfection of domestic relations orders generally will serve to minimize plan burdens and costs attendant to QDRO determinations.

The following questions and answers are intended to provide guidance on the discharge of administrator's obligations under the QDRO and fiduciary responsibility provisions of ERISA.

What information is an administrator required to provide a prospective alternate payee before the administrator receives a domestic relations order?

Congress conditioned an alternate payee's right to an assignment of a participant's pension benefit on the prospective alternate payee's obtaining a domestic relations order that satisfies specific informational and other requirements. It is the view of the DOL that Congress therefore intended prospective alternate payees -- spouses, former spouses, children, and other dependents of a participant who are involved in a domestic relations proceedings -- to have access to plan and participant benefit information sufficient to prepare a QDRO. Such information might include the summary plan description, relevant plan documents, and a statement of the participant's benefit entitlements.

The DOL believes that Congress did not intend to require prospective alternate payees to submit a domestic relations order to the plan as a prerequisite to establishing the prospective alternate payee's rights to information in connection with a domestic relations proceeding. However, it is the view of the DOL that a plan administrator may condition disclosure of such information on a prospective alternate payee's providing

information sufficient to reasonably establish that the disclosure request is being made in connection with a domestic relations proceeding.

It is the DOL's understanding that many domestic relations orders fail initially to qualify when submitted to the plan because they fail to take into account the plan's provisions or the participant's actual benefit entitlements. Affording prospective alternate payees access to plan and participant information in a timely manner will, in the view of the DOL, help drafters avoid making such obvious errors in preparing orders and, thereby, facilitate plan administration. Reference: ERISA §§ 206(d)(3)(A) -(C), 404(a); IRC § 414(p)(1) - (3)

What are the duties of a plan administrator upon receipt of a domestic relations order by the plan?

Upon receipt of a domestic relations order, the plan administrator is required to promptly notify the affected participant and each alternate payee named in the order of the receipt of the order and to provide a copy of the plan's procedures for determining whether a domestic relations order is a QDRO. Notification should be sent to the address included in the domestic relations order.

The administrator is required to determine whether the order is a QDRO within a reasonable period of time after receipt of a domestic relations order and to promptly notify the participant and each alternate payee of such determination. Reference: ERISA § 206(d)(3)(G)(i); IRC § 414(p)(6)(A)

Is a plan required to have procedures for determining whether a domestic relations order is qualified?

- Yes. Every pension plan is required to establish written procedures for determining whether domestic relations orders are QDROs and for administering distributions under QDROs. Reference: ERISA § 206(d)(3)(G)(ii);
IRC § 414(p)(6)(B)

What requirements must a plan's QDRO procedures meet?

The QDRO procedures must:

- Be in writing
- Be reasonable
- Provide that each person specified in a domestic relations order received by the plan as entitled to payment of benefits under the plan will be notified (at the address specified in the domestic relations order) of the plan's procedures for making QDRO determinations upon receipt of a domestic relations order
- Permit an alternate payee to designate a representative for receipt of copies of notices and plan information that are sent to the alternate payee with respect to a domestic relations orders

[ERISA § 206(d)(3)(G)(ii); IRC § 414(p)(6)]

Are there other matters that should be addressed in a plan's QDRO procedures?

Yes. It is the view of the DOL of Labor that a plan's QDRO procedures should be designed to ensure that QDRO determinations are made in a timely, efficient, and cost-effective manner, consistent with the administrator's fiduciary duties under ERISA. The DOL believes that unnecessary administrative burdens and costs attendant to QDRO determinations and administration can be avoided with clear explanations of the plan's determination process, including:

- An explanation of the information about the plan and benefits that is available to assist prospective alternate payees in preparing QDROs, such as summary plan descriptions, plan documents, individual benefit and account statements, and any model QDROs developed for use by the plan
- A description of any time limits set by the plan administrator for making determinations
- A description of the steps the administrator will take to protect and preserve pension assets or benefits upon receipt of a domestic relations order (for example, a description of when and under what circumstances plan assets will be segregated or benefit payments will be delayed or suspended)
- A description of the process provided under the plan for obtaining a review of the administrator's determination as to whether an order is a QDRO

It is the view of the DOL that the plan administrator's adoption and use of clear QDRO procedures, coupled with the administrator's provision of information about the plan and benefits upon request, will significantly reduce the difficulty and expense of obtaining and administering QDROs by minimizing confusion and uncertainty about the process. Reference: ERISA §§ 206(d)(3)(G), 206(d)(3)(H), 404(a); IRC §§ 414(p)(6), 414(p)(7)

May a plan administrator charge a participant or alternate payee for determining the qualified status of a domestic relations order?

The DOL has taken the position that in the context of a defined contribution plan, an administrator may assess reasonable expenses attributable to a QDRO determination against the individual account of the participant who is a party to the domestic relations order. The document of the plan should be reviewed to determine how plan expenses are allocated.

Reference: ERISA § 404(a); see Field Assistance Bulletin 2003-3 (Appendix A)

May plan administrators provide parties with a model form or forms to assist in the preparation of a QDRO?

Yes. Although they are not required to do so, plan administrators may develop and make available "model" QDRO forms to assist in the preparation of a QDRO. Such model forms may make it easier for the parties to prepare a QDRO and reduce the time and expenses associated with a plan administrator's determination of the qualified status of an order.

Plan administrators are required to honor any domestic relations order that satisfies the requirements to be a QDRO. In the view of the DOL, therefore, a plan may not condition its determinations of QDRO status on the use of any particular form.

In determining the qualified status of a domestic relations order, is the administrator required to determine the validity of the order under state domestic relations law?

No. A plan administrator is generally not required to determine whether the issuing court or agency had jurisdiction to issue an order, whether state law is correctly applied in the order, whether service was properly made on the parties, or whether an individual identified in an order as an alternate payee is in fact a spouse, former spouse, child, or other dependent of the participant under state law. Reference: See Advisory Opinion 92-17A (Appendix A)

Is a plan administrator required to reject a domestic relations order as defective if the order fails to specify factual identifying information that is easily obtainable by the plan administrator?

No. In many cases, an order that is submitted to a plan may clearly describe the identity and rights of the parties, but may be incomplete only with respect to factual identifying information within the plan administrator's knowledge or easily obtained through a simple communication with the alternate payee or the participant. For example, an order may misstate the plan's name or the names of participants or alternate payees, and the plan administrator can clearly determine the correct names, or an order may omit the addresses of participants or alternate payees, and the plan administrator's records include this information.

In such a case, the plan administrator should supplement the order with the appropriate identifying information, rather than rejecting the order as not qualified. Reference: ERISA §§ 206(d)(3)(C), 206(d)(3)(I); IRC § 414(p)(2); see S. Rep. 575, 98th Cong., 2d Sess. at 20

How long may the plan administrator take to determine whether a domestic relations order is a QDRO?

Plan administrators must determine whether a domestic relations order is a QDRO within a reasonable period of time after receiving the order. What is a reasonable period will depend on the specific circumstances. For example, a domestic relations order that is clear and complete when submitted should require less time to review than an order that is incomplete or unclear.

Plans are required to adopt reasonable procedures for determining the qualified status of domestic relations orders. Compliance with such procedures should ensure that determinations of the qualified status of an order take place within a reasonable period of time. Procedures that unduly inhibit or hamper the QDRO determination process will not be considered reasonable procedures. Reference: ERISA § 206(d)(3)(G)(i)(II); IRC § 414(p)(6)(A)(ii)

What must the plan administrator do during the determination process to protect against wrongly paying pension benefits to the participant that would be paid to the alternate payee if the domestic relations order had been determined to be a QDRO?

During any period in which the issue of whether a domestic relations order is a QDRO is being determined (by a plan administrator, by a court of competent jurisdiction, or otherwise), ERISA requires that the plan administrator separately account for the amounts that would be payable to an alternate payee under the terms of the order during such period if the order had been determined to be qualified. These amounts are referred to as "segregated amounts."

During the period in which the status of a domestic relations order is being determined, the plan administrator must take steps to ensure that amounts that would have been payable to the alternate payee, if the order were a QDRO, are not distributed to the participant or any other person.

The plan administrator's duty to separately account for and to preserve the segregated amounts is limited in time. ERISA provides that the plan administrator must preserve the segregated amounts for not longer than the end of an "18-month period." This "18-month period" does not begin until the first date (after the plan receives the order) that the order would require payment to the alternate payee.

It is the view of the DOL that, in order to ensure the availability of a full 18- month protection period, the 18 months cannot begin before the plan receives a domestic relations order. Rather, the "18-month period" will begin on the first date on which a payment would be required to be made under an order following receipt by the plan. Reference: ERISA §§ 206(d)(3)(H), 404(a); IRC § 414(p)(7)

What are an administrator's duties with respect to a domestic relations order received by the plan before the beginning of the "18-month period"?

A plan administrator must determine whether a domestic relations order is a QDRO within a reasonable period following receipt. In the view of the DOL, the "18-month period" during which a plan administrator must preserve the "segregated amounts" is not the measure of the reasonable period for determining the qualified status of an order and in most cases would be an unreasonably long period of time to take to review an order.

It is further the view of the DOL that, during the determination period, the administrator, as a plan fiduciary, may not permit distributions to the participant or any other person of any amounts that would be payable to the alternate payee if the domestic relations order were determined to be a QDRO. If the domestic relations order is determined to be a QDRO before the first date on which benefits are payable to the alternate payee, the plan administrator has a continuing duty to account for and to protect the alternate payee's interest in the plan to the same extent that the plan administrator is obliged to account for and to protect the interests of the plan's participants. The plan administrator also has a fiduciary duty to pay out benefits in accordance with the terms of the QDRO.

The DOL understands that orders that are initially rejected by the plan administrator as not qualified are frequently revised and resubmitted within a short period of time. The DOL also recognizes that in some instances plan administrators who reject an order may receive requests from participants for immediate distribution of benefits under circumstances that suggest that the rejected order is being revised and will shortly be resubmitted to the plan. In such circumstances, the plan administrator may be subject to conflicting claims for either paying the benefit or failing to pay the benefit.

The DOL suggests that plan administrators may wish to consider the establishment of a process for providing preliminary or interim review of orders, and postponing final determinations for limited periods, to permit parties to correct defects within the 18-month segregation period. Such a process would reduce the likelihood of conflicting claims. Reference: ERISA §§ 206(d)(3)(H), 404(a)

What are an administrator's duties with respect to a domestic relations order received on or after the date on which benefits would be payable to an alternate payee under the order?

Upon receipt of a domestic relations order, the administrator must separately account for and preserve the amounts that would be payable to an alternate payee until a determination is made with respect to the status of the order. Refer to questions 2-11, 2-12. If, within the "18-month period" -- beginning with the date (after receipt of the order by the plan) on which the first payment would be required to be made to an alternate payee under the order -- the plan administrator determines that the order is a QDRO, the plan administrator must pay the segregated amounts to the alternate payee in accordance with the terms of the QDRO.

If, however, the plan administrator determines within the "18-month period" that the order is not a QDRO, or if the status of the order is not resolved by the end of the "18-month period," the plan administrator must pay out the segregated amounts to the person or persons who would have been entitled to such amounts if there had been no order. If the order is later determined to be a QDRO, the order will apply only prospectively; that is, the alternate payee will be entitled only to amounts payable under the order after the subsequent determination. Reference: ERISA §§ 206(d)(3)(H), 404(a); IRC § 414(p)(7); but see H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-858 (describing 1986 amendments to the Retirement Equity Act of 1984, including clarification of the procedures to be followed during the 18-month segregation period for QDRO determinations)

What kind of notice is required to be provided by a plan administrator following a QDRO determination?

The plan administrator is required to notify the participant and each alternate payee of the administrator's determination as to whether the order constitutes a QDRO. This notice should be in writing and furnished promptly following a determination.

In the case of a determination that an order is not qualified, the notice should include the reasons for the rejection. It is the view of the DOL that, in most instances where there has been a reasonable good faith effort to prepare a qualified domestic relations order, the parties will attempt to correct any deficiencies in the order and resubmit a corrected order for the plan administrator to review. The DOL believes that, where a reasonable good faith effort has been made to draft a QDRO, prudent plan administration requires the plan administrator to furnish to the parties the information, advice, and guidance that is reasonably required to understand the reasons for a rejection, either as part of the notification process or otherwise, if such information, advice, and guidance could serve to reduce multiple submissions of deficient orders and therefore the burdens and costs to plans attendant on review of such orders.

The notice of the plan administrator's determination should be written in a manner that can be understood by the parties. Multiple submissions and unnecessary expenses may be avoided by clearly communicating in the rejection notice:

- The reasons why the order is not a QDRO;
- References to the plan provisions on which the plan administrator's determination is based;
- An explanation of any time limits that apply to rights available to the parties under the plan (such as the duration of any protective actions the plan administrator will take); and
- A description of any additional material, information, or modifications necessary for the order to be a QDRO and an explanation of why such material, information, or modifications are necessary.

Reference: ERISA §§ 206(d)(3)(G)(i)(II), 206(d)(3)(I);IRC § 414(p)(6)(A)(ii)

What effect does an order that a plan administrator has determined to be a QDRO have on the administration of the plan?

The plan administrator must act in accordance with the provisions of the QDRO as if it were a part of the plan. In particular, if, under a plan, a participant has the right to elect the form in which benefits will be paid, and the QDRO gives the alternate payee that right, the plan administrator must permit the alternate payee to exercise that right under the circumstances and in accordance with the terms that would apply to the participant, as if the alternate payee were the participant. Reference: ERISA §§ 206(d)(3)(A), 206(d)(3)(E)(i)(III); IRC §§ 401(a)(13)(B), 414(p)(4)(A)(iii)

What disclosure rights does an alternate payee have under a QDRO?
ERISA provides that a person who is an alternate payee under a QDRO generally shall be considered a beneficiary under the plan for purposes of ERISA. Accordingly, the alternate payee must be furnished, upon written request, copies of a variety of documents, including the latest summary plan description, the latest annual report, any final annual report, and the bargaining

agreement, trust agreement, contract, or other instrument under which the plan is established or operated.

The administrator may impose a reasonable charge to cover the cost of furnishing such copies. It is the view of the DOL that, at such time as benefit payments to the alternate payee commence under the QDRO, the alternate payee must be treated as a "beneficiary receiving benefits under the plan" and automatically furnished the summary plan description, summaries of material plan changes, and the plan's summary annual report. Reference: ERISA §§ 104, 105, 206(d)(3)(J), 404(a); 29 CFR § 2520.104b-1 et seq.

What happens to the rights created by a QDRO if the plan to which the QDRO applies is amended, merged into another plan, or is maintained by a successor employer?

The rights of an alternate payee under a QDRO are protected in the event of plan amendments, a plan merger, or a change in the sponsor of the plan to the same extent that rights of participants or beneficiaries are protected with respect to benefits accrued as of the date of the event. Reference: ERISA §§ 204(g), 206(d)(3)(A), 403(c)(1); IRC §§ 401(a)(13)(B), 411(d)(6).

What happens to the rights created by a QDRO if a plan is terminated?

In the view of the DOL, the rights granted by a QDRO must be taken into account in the termination of a plan as if the terms of the QDRO were part of the plan. To the extent that the QDRO grants the alternate payee part of the participant's benefits, the plan administrator, in terminating the plan, must provide the alternate payee with the notification, consent, payment, or other rights that it would have provided to the participant with respect to that portion of the participant's benefits. Reference: ERISA §§ 206(d)(3)(A), 403(d)

What happens to the rights created by a QDRO if a defined benefit plan is terminated and the Pension Benefit Guaranty Corporation becomes trustee of the Plan?

The Pension Benefit Guaranty Corporation (PBGC) is a Federal agency that insures pension benefits in most private-sector defined benefit pension plans. It is important to note that not all plans are insured by PBGC and not all plans that terminate become trusteed by PBGC. For example, defined contribution plans (including 401(k) plans) are generally not covered by PBGC's insurance. In addition, most defined benefit plans that terminate have sufficient assets to pay all benefits. PBGC does not trustee these plans.

When an insured plan terminates without enough money to pay all guaranteed benefits, PBGC becomes trustee of the terminating plan and pays the plan benefits subject to certain limits on amount and form. For instance, PBGC does not pay certain death and supplemental benefits. In addition, benefit amounts paid by PBGC are limited by ERISA, and the forms of benefit PBGC pays are also limited.

PBGC has special rules that apply to payment of benefits under QDROs. For example, if a QDRO is issued prior to plan termination, PBGC will not modify the form of benefit payable to an alternate payee specified in the QDRO. If, in contrast, a QDRO is issued after plan termination, PBGC will generally limit the form of benefit that PBGC will pay under the QDRO to the form permitted by PBGC in other circumstances (generally a single life annuity). There are other special rules that apply to the administration by PBGC of QDROs.

Drafting QDROs

- What are the most common and useful ways of dividing pension benefits?
- What are survivor benefits, and why are they important?
- When can an alternate payee receive the benefits assigned by a QDRO?
- In what form will the alternate payee receive the assigned benefits?

Although domestic relations orders that involve pension plans are issued under and governed by state law, Federal law (ERISA and the Code) and the terms of the relevant pension plan determine whether these orders can be QDROs. This section discusses how to draft orders that will qualify as QDROs while accomplishing the purposes for which the pension benefits are being divided.

This section also discusses the most common methods of dividing pension benefits under the two separate types of pension plans: defined benefit plans and defined contribution plans. The following questions and answers emphasize the importance of understanding the nature of a participant's pension benefits and of making decisions about the assignment of any survivor benefits payable under the pension plan.

What is the best way to divide a participant's pension benefits in a QDRO?

There is no single "best" way to divide pension benefits in a QDRO. What will be "best" in a specific case will depend on many factors, including the type of pension plan, the nature of the participant's pension benefits, and why the parties are seeking to divide those benefits.

In deciding how to divide a participant's pension benefits in a QDRO, it is also important to consider two aspects of a participant's pension benefits: the benefit payable under the plan directly to the participant for retirement purposes (referred to here as the "retirement benefit"), and any benefit that is payable under the plan on behalf of the participant to someone else after the participant dies (referred to here as the "survivor benefit"). These two aspects of a participant's pension benefits are discussed separately in this booklet only in order to emphasize the importance of considering how best to divide pension benefits.

How much can be given to an alternate payee through a QDRO?

A QDRO can give an alternate payee any part or all of the pension benefits payable with respect to a participant under a pension plan. However, the QDRO cannot require the plan to provide increased benefits (determined on the basis of actuarial value); nor can a QDRO require a plan to provide a type or form of benefit, or any option, not otherwise provided under the plan. The QDRO also cannot require the payment of benefits to an alternate payee that are required to be paid to another alternate payee under another QDRO already recognized by the plan. Reference: ERISA §§ 206(d)(3)(B)(i)(I), 206(d)(3)(D), 206(d)(3)(E); IRC §§ 414(p)(1)(A)(i), 414(p)(3), 414(p)(4)

Why are the reasons for dividing the pension benefits important?

Generally, QDROs are used either to provide support payments (temporary or permanent) to the alternate payee (who may be the spouse, former spouse or a child or other dependent of the participant) or to divide marital property in the course of dissolving a marriage. These differing goals often result in different choices in drafting a QDRO. This answer describes two common different approaches in drafting QDROs for these two different purposes.

One approach that is used in some orders is to "split" the actual benefit payments made with respect to a participant under the plan to give the alternate payee part of each payment. This approach to dividing retirement benefits is often called the "shared payment" approach. Under this approach, the alternate payee will not receive any payments unless the participant receives a payment or is already in pay status. This approach is often used when a support order is being drafted after a participant has already begun to receive a stream of payments from the plan (such as a life annuity).

An order providing for shared payments, like any other QDRO, must specify the amount or percentage of the participant's benefit payments that is assigned to the alternate payee (or the manner in which such amount or percentage is to be determined). It must also specify the number of payments or period to which it applies. This is particularly important in the shared payment QDRO, which must specify when the alternate payee's right to share the payments begins and ends. For example, when a state authority seeks to provide support to a child of a participant, an order might require payments to the alternate payee to begin as soon as possible after the order is determined to be a QDRO and to continue until the alternate payee reaches maturity.

Alternatively, when support is being provided to a former spouse, the order might state that payments to the alternate payee will end when the former spouse remarries. If payments are to end upon the occurrence of an event, notice and reasonable substantiation that the event has occurred must be provided for the plan to be able to comply with the terms of the QDRO.

Orders that seek to divide a pension as part of the marital property upon divorce or legal separation often take a different approach to dividing the retirement benefit. These orders usually divide the participant's retirement benefit (rather than just the payments) into two separate portions with the intent of giving the alternate payee a separate right to receive a portion of the retirement benefit to be paid at a time and in a form different from that chosen by the participant. This approach to dividing a retirement benefit is often called the "separate interest" approach.

An order that provides for a separate interest for the alternate payee must specify the amount or percentage of the participant's retirement benefit to be assigned to the alternate payee (or the manner in which such amount or percentage is to be determined). The order must also specify the number of payments or period to which it applies, and such orders often satisfy this requirement simply by giving the alternate payee the right that the participant would have had under the plan to elect the form of benefit payment and the time at which the separate interest will be paid. Such an order would satisfy the requirements to be a QDRO.

Federal law does not require the use of either approach for any specific domestic relations purpose, and it is up to the drafters of any order to determine how best to achieve the purposes for which pension benefits are being divided. Further, the shared payment approach and the separate interest approach can each be used for either defined benefit or defined contribution plans. However, it is important in drafting any order to understand and follow the terms of the plan. An order that would require a plan to provide increased benefits (determined on an actuarial basis) or to provide a type or form of benefit, or an option, not otherwise available under the plan cannot be a QDRO.

In addition to determining whether or how to divide the retirement benefit, it is important to consider whether or not to give the alternate payee a right to survivor benefits or any other benefits payable under the plan. Reference: ERISA § 206(d)(3)(C)(ii) - (iv); IRC § 414(p)(2)(B) - (D)

In deciding how to divide the participant's pension benefits, why is understanding the type of pension plan important?

Understanding the type of pension plan is important because the order cannot be a QDRO unless its assignment of rights or division of pension benefits complies with the terms of the plan. Parties drafting a QDRO should read the plan's summary plan description and other plan documents to understand what pension benefits are provided under the plan.

Pension plans may be divided generally into two types:

- Defined benefit plans
- Defined contribution plans

A defined benefit plan promises to pay each participant a specific benefit at retirement. This basic retirement benefit is usually based on a formula that takes into account factors like the number of years a participant works for the employer and the participant's salary. The basic retirement benefit is generally provided in the form of periodic payments for the participant's life beginning at what the plan calls "normal retirement age." This stream of periodic payments is generally known as an "annuity."

A participant's basic retirement benefit under a defined benefit plan may increase over time, either before or after the participant begins receiving benefits, due to a variety of circumstances, such as increases in salary or the crediting of additional years of service with the employer (which are taken into account under the plan's benefit formula), or through amendment to the plan's provisions, including some amendments to provide cost of living adjustments.

Defined benefit plans may promise to pay benefits at various times, under certain circumstances, or in alternative forms. Benefits paid at those times or in those forms may have a greater actuarial value than the basic retirement benefit payable by the plan at the participant's normal retirement age. When one form of benefit has a greater actuarial value than another form, the difference in value is often called a "subsidy."

A defined contribution plan, by contrast, is a type of pension plan that provides for an individual account for each participant. The participant's benefits are based solely on the amount contributed to the participant's account and any income, expenses, gains or losses, and any forfeiture of accounts of other participants that may be allocated to such participant's account. Examples of defined contribution plans include profit-sharing plans (like "401(k)" plans), employee stock ownership plans ("ESOPs"), and money purchase plans. A participant's basic retirement benefit in a defined contribution plan is the amount in his or her account at any given time. This is generally known as the participant's "account balance." Defined contribution plans commonly provide for retirement benefits to be paid in the form of a lump sum payment of the participant's entire account balance. Defined contribution plans by their nature do not offer subsidies.

It should be noted, however, that some defined benefit plans provide for lump sum payments, and some defined contribution plans provide for annuities. Reference: IRS Notice 97-11, 1997-2 IRB 49 (Jan. 13, 1997)

What are "survivor benefits," and why should a QDRO take them into account?

Federal law requires all pension plans, whether they are defined benefit plans or defined contribution plans, to provide benefits in a way that includes a survivor benefit for the participant's spouse. The provisions creating these protections are contained in section 205 of ERISA and sections 401(a)(11) and 417 of the Code.

The type of survivor benefit that is required by Federal law depends on the type of pension plan. Plans also may provide for survivor (or "death") benefits that are in addition to those required by Federal law. Participants and alternate payees drafting a QDRO should read the plan's summary plan description and other plan documents to understand the survivor benefits available under the plan.

Federal law generally requires that defined benefit plans and certain defined contribution plans pay retirement benefits to participants who were married on the participant's "annuity starting date" (this is the first day of the first period for which an amount is payable to the participant) in a special form called a "qualified joint and survivor annuity" (QJSA) unless the participant elects a different form and the spouse consents to that election. When benefits are paid as a QJSA, the participant receives a periodic payment (usually monthly) during his or her life, and the surviving spouse of the participant receives a periodic payment for the rest of the surviving spouse's life upon the participant's death.

Federal law also generally requires that, if a married participant with a non-forfeitable benefit under one of these types of plans dies before his or her "annuity starting date," the plan must pay the surviving spouse of the participant a monthly survivor benefit. This benefit is called a "qualified preretirement survivor annuity" (QPSA). Appendix C also describes the QPSA.

Those defined contribution plans that are not required to pay pension benefits to married participants in the form of a QJSA or QPSA (like most 401(k) plans) are required by Federal law to pay any balance remaining in the participant's account after the participant dies to the participant's surviving spouse. If the spouse gives written consent, the participant can direct that upon the participant's death any balance remaining in the account will be paid to a beneficiary other than the spouse, for example, the couple's children. Under these defined contribution plans, Federal law does not require a spouse's consent to a participant's decision to withdraw any portion (or all) of his or her account balance during the participant's life.

If a participant and his or her spouse become divorced before the participant's annuity starting date, the divorced spouse loses all right to the survivor benefit protections that Federal law requires be provided to a participant's spouse. If the divorced participant remarries, the participant's new spouse may acquire a right to the Federally mandated survivor benefits. A QDRO, however, may change that result.

To the extent that a QDRO requires that a former spouse be treated as the participant's surviving spouse for all or any part of the survivor benefits payable after the death of the participant, any subsequent spouse of the participant cannot be treated as the participant's surviving spouse. For example, if a QDRO awards all of the survivor benefit rights to a former spouse, and the participant remarries, the participant's new spouse will not receive any survivor benefit upon the participant's death.

If such a QDRO requires that a defined benefit plan, or a defined contribution plan subject to the QJSA and QPSA requirements, treat a former spouse of a participant as the participant's surviving spouse, the plan must pay the participant's benefit in the form of a QJSA or QPSA unless the former spouse who was named as surviving spouse in the QDRO consents to the participant's election of a different form of payment.

It should also be noted that some pension plans provide that a spouse of a participant will not be treated as married unless he or she has been married to the participant for at least a year. If the pension plan to which the QDRO relates contains such a one-year marriage requirement, then the QDRO cannot treat the alternate payee as a surviving spouse if the marriage lasted for less than one year.

In addition, it is important to note that some pension plans may provide for survivor benefits in addition to those required by Federal law for the benefit of the surviving spouse. Generally, however, the only way to establish a former spouse's right to survivor benefits such as a QJSA or QPSA is through a QDRO. A QDRO may provide that a part or all of such other survivor benefits shall be paid to an alternate payee rather than to the person who would otherwise be entitled to receive such death benefits under the plan.

As discussed above, a spouse or former spouse can also receive a right to receive (as a separate interest or as shared payments) part of the participant's retirement benefit as well as a survivor's benefit. Reference: ERISA §§ 205, 206(d)(3)(F); IRC §§ 401(a)(11), 414(p)(5), 417

How may the participant's retirement benefit be divided if the pension plan is a defined contribution plan?

An order dividing a retirement benefit under a defined contribution plan may adopt either a "separate interest" approach or a "shared payment" approach (or some combination of these approaches).

Orders that provide the alternate payee with a separate interest, either by assigning to the alternate payee a percentage or a dollar amount of the account balance as of a certain date, often also provide that the separate interest will be held in a separate account under the plan with respect to which the alternate payee is entitled to exercise the rights of a participant. Provided that the order does not assign a right or option to an alternate payee that is not otherwise available under the plan, an order that creates a separate account for the alternate payee may qualify as a QDRO.

Orders that provide for shared payments from a defined contribution plan should clearly establish the amount or percentage of the participant's payments that will be allocated to the alternate payee and the number of payments or period of time during which the allocation to the alternate payee is to be made. A QDRO can specify that any or all payments made to the participant are to be shared between the participant and the alternate payee.

In drafting orders dividing benefits under defined contribution plans, parties should also consider addressing the possibility of contingencies occurring that may affect the account balance (and therefore the alternate payee's share) during the determination period. For example, parties might be well advised to specify the source of the alternate payee's share of a participant's account that is invested in multiple investments because there may be different methods of determining how to derive the alternate payee's share that would affect the value of that share.

The parties should also consider how to allocate any income or losses attributable to the participant's account that may accrue during the determination period. If an order allocates a specific dollar amount rather than a percentage to an alternate payee as a shared payment, the order should address the possibility that the participant's account balance or individual payments might be less than the specified dollar amount when actually paid out. Reference: ERISA §§ 206(d)(3)(C); IRC § 414(p)(2)

How may the participant's retirement benefit be divided if the pension plan is a defined benefit plan?

As indicated earlier, an order may adopt either the shared payment or the separate interest approach (or a combination of the two) in dividing pension benefits in a defined benefit plan. If shared payments are desired, the order should specify the amount of each shared payment allocated to the alternate payee either by percentage or by dollar amount. If the order describes the alternate payee's share as a dollar amount, care should be taken to establish that the payments to the participant will be sufficient to satisfy the allocation, and the order should indicate what is to happen in the event a payment is insufficient to satisfy the allocation.

The order must also describe the number of payments or period of time during which the allocation to the alternate payee is to be made. This is usually done by specifying a beginning date and an ending date (or an event that will cause the allocation to begin and/or end). If an order specifies a triggering event that may occur outside the plan's knowledge, notice of its occurrence must be given to the plan before the plan is required to act in accordance with the order. If the intent is that all payments made under the plan are to be shared between the participant and the alternate payee, the order may so specify.

A defined benefit plan may provide for subsidies under certain circumstances and may also provide increased benefits or additional benefits either earned through additional service or provided by way of plan amendment. A QDRO that uses the "shared payment" method to give the alternate payee a percentage of each payment may be structured to take into account any such future increases in the benefits paid to the participant. Such a QDRO does not need to address the treatment of future subsidies or other benefit increases, because the alternate payee will automatically receive a share of any subsidy or other benefit increases that are paid to the participant. If the parties do not wish to provide for the sharing of such subsidies or increases, the order should so specify.

If a separate interest is desired for the alternate payee, it is important that the order be based on adequate information from the plan administrator and the plan documents concerning the participant's retirement benefit and the rights, options, and features provided under the plan. In particular, the drafters of a QDRO should consider any subsidies or future benefit increases that might be available with respect to the participant's retirement benefit. The order may specify whether, and to what extent, an alternate payee is to receive such subsidies or future benefit increases. Reference: ERISA §§ 206(d)(3)(C), 206(d)(3)(D); IRC §§ 414(p)(2), 414(p)(3)

May the QDRO specify the form in which the alternate payee's benefits will be paid?

A QDRO that provides for a separate interest may specify the form in which the alternate payee's benefits will be paid subject to the following limitations:

- The order may not provide the alternate payee with a type or form of payment, or any option, not otherwise provided under the plan
- The order may not provide any subsequent spouse of an alternate payee with the survivor benefit rights that Federal law requires be provided to spouses of participants under section 205 of ERISA
- For any tax-qualified pension plan, the payment of the alternate payee's benefits must satisfy the requirements of section 401(a)(9) of the Code respecting the timing and duration of payment of benefits. In determining the form of payment for an alternate payee, an order may substitute the alternate payee's life for the life of the participant to the extent that the form of payment is based on the duration of an individual's life. However, the timing and forms of benefit available to an alternate payee under a tax-qualified plan may be limited by section 401(a)(9) of the Code.

Alternatively, a QDRO may (subject to the limitations described above) give the alternate payee the right that the participant would have had under the plan to elect the form of benefit payment. For example, if a participant would have the right to elect a life annuity, the alternate payee may exercise that right and choose to have the assigned benefit paid over the alternate payee's life. However, the QDRO must permit the plan to determine the amount payable to the alternate payee under any form of payment in a manner that does not require the plan to pay increased benefits (determined on an actuarial basis).

A plan may by its own terms provide alternate payees with additional types or forms of benefit, or options, not otherwise provided to participants, such as a lump-sum payment option, but the plan cannot prevent a QDRO from assigning to an alternate payee any type or form of benefit, or option, provided generally under the plan to the participant. Reference: ERISA §§ 206(d)(3)(A), 206(d)(3)(D), 206(d)(3)(E)(i)(III); IRC §§ 401(a)(9), 401(a)(13)(B), 414(p)(3), 414(p)(4)(A)(iii)

When can the alternate payee get the benefits assigned under a QDRO?

A QDRO that provides for shared payments must specify the date on which the alternate payee will begin to share the participant's payments. Such a date, however, cannot be earlier than the date on which the plan receives the order. With respect to a separate interest, an order may either specify the time (after the order is received by the plan) at which the alternate payee will receive the separate interest or assign to the alternate payee the same right the participant would have had under the plan with regard to the timing of payment. In either case, a QDRO cannot provide that an alternate payee will receive a benefit earlier than the date on which the participant reaches his or her "earliest retirement age," unless the plan permits payments at an earlier date.

The plan itself may contain provisions permitting alternate payees to receive separate interests awarded under a QDRO at an earlier time or under different circumstances than the participant could receive the benefit. For example, a plan may provide that alternate payees may elect to receive a lump sum payment of a separate interest at any time. Section 401(a)(9) of the Code may affect when benefits must be paid under tax-qualified pension plans. Reference: ERISA §§ 206(d)(3)(C), 206(d)(3)(D), 206(d)(3)(E); IRC §§ 401(a)(9), 414(p)(2), 414(p)(3), 414(p)(4)

What is "earliest retirement age," and why is it important?

For QDROs, Federal law provides a very specific definition of "earliest retirement age," which is the earliest date as of which a QDRO can order payment to an alternate payee (unless the plan permits payments at an earlier date). The "earliest retirement age" applicable to a QDRO depends on the terms of the pension plan and the participant's age. "Earliest retirement age" is the earlier of two dates:

- The date on which the participant is entitled to receive a distribution under the plan, or
- The later of either
- The date the participant reaches age 50, or
- The earliest date on which the participant could begin receiving benefits under the plan if the participant separated from service with the employer.

Drafters of QDROs should consult the plan administrator and the plan documents for information on the plan's "earliest retirement age." The following examples illustrate the concept of "earliest retirement age."

Example 1 -The pension plan is a defined contribution plan that permits a participant to make withdrawals only when he or she reaches age 59½ or terminates from service. The "earliest retirement age" for a QDRO under this plan is the earlier of:

- When the participant actually terminates employment, or reaches age 59½, or
- The later of the date the participant reaches age 50 or the date the participant could receive the account balance if the participant terminated employment.

Since the participant could terminate employment at any time and thereby be able to receive the account balance under the plan's terms, the later of the two dates described above is "age 50." The "earliest retirement age" formula for this plan can be simplified to read the earlier of:

- Actually reaching age 59½ or terminating employment or
- Age 50. Since age 50 is earlier than age 59½, the "earliest retirement age" for this plan will be the earlier of age 50 or the date the participant actually terminates from service.

Example 2 -The pension plan is a defined benefit plan that permits retirement benefits to be paid beginning when the participant reaches age 65 and terminates employment. It does not permit earlier payments. The "earliest retirement age" for this plan is the earlier of:

- The date on which the participant actually reaches age 65 and terminates employment, or
- The later of age 50 or the date on which the participant reaches age 65 (whether he or she terminates employment or not).

Because age 65 is later than age 50, the second part of the formula can be simplified to read "age 65" so that the formula reads as follows: the "earliest retirement age" is the earlier of:

- The date on which the participant reaches age 65 and actually terminates or
- The date the participant reaches age 65. Under this plan, therefore, the "earliest retirement age" will be the date on which the participant reaches age 65.

Reference: ERISA § 206(d)(3)(E); IRC § 414(p)(4)

MILITARY PENSIONS IN DIVORCE

- **HISTORY**

- The Uniformed Services Former Spouses' Protection Act (USFSPA) was passed by Congress in 1982. The USFSPA gives a State court the authority to treat military retired pay as marital property and divide it between the spouses. Congress' passage of the USFSPA was prompted by the United States Supreme Court's decision in McCarty v. McCarty in 1981.

  The McCarty decision effectively precluded state courts from dividing military retired pay as an asset of the marriage. Justice Blackmun, writing for the majority, stated that allowing a state to divide retired pay would threaten "grave harm to 'clear and substantial' federal interests."

  Accordingly, the Supremacy Clause of Article VI preempted the State's attempt to divide military retired pay. Congress, by enacting the USFSPA, clarified its intent that State courts have the power to divide what can be the largest asset of a marriage.

  With the passage of the USFSPA, Congress took the opportunity to set forth various requirements to govern the division of military retired pay. Congress sought to make a fair system for military members, considering that their situation often exposes them to difficulties with civil litigation. Therefore, if a member is divorced while on active duty, the requirements of the Soldiers' and Sailors' Civil Relief Act (SSCRA) must be met before an award dividing military retired pay can be enforced under the USFSPA. The USFSPA contains its own jurisdictional requirement.

  It limits the amount of the member's retired pay which can be paid to a former spouse to 50% of the member's disposable retired pay (gross retired pay less authorized deductions). It requires that the parties must have been married for at least 10 years while the member performed at least 10 years of active duty service before a division of retired pay is enforceable under the USFSPA. It specifies how an award of military retired pay must be expressed.

- **DOCUMENTS NEEDED TO DIVIDE MILITARY RETIRED PAY.**

  - The USFSPA defines a "court order" dividing military retired pay enforceable under the Act as a "final decree of divorce, dissolution, annulment, or legal separation issued by a court, or a court ordered, ratified, or approved property settlement incident to such a decree." This also includes an order modifying a previously issued "court order."

- **Since military retired pay is a Federal entitlement, and not a qualified pension plan**, there is no requirement that a Qualified Domestic Relations Order (QDRO) be used. As long as the award is set forth in the divorce decree or other court order in an acceptable manner, that is sufficient. It is also not necessary to judicially join the "member's plan" as a part of the divorce proceeding. There is no Federal statutory authority for this. The award may also be set forth in a court ratified or approved separation agreement, or other court order issued incident to the divorce.

  In order to submit an application for payments under the USFSPA, a former spouse needs to submit a copy of the applicable court order certified by the clerk of court within 90 days immediately preceding its service on the designated agent, along with a completed application form (DD Form 2293). Instructions, including designated agent names and addresses, are on the back of the DD Form 2293. The Defense Finance and Accounting Service (DFAS) is the designated agent for all uniformed military services.

REQUIREMENTS FOR ENFORCEABILITY UNDER USFSPA

- **Soldiers' and Sailors' Civil Relief Act**

  The provision of the SSCRA that has primary application to the USFSPA and the division of military retired pay is the section concerning default judgments against active duty service members. This section requires that if an active duty defendant fails to make an appearance in a legal proceeding, the plaintiff must file an affidavit with the court informing the court of the member's military status.

  The court shall appoint an attorney to represent the interests of the absent defendant. Since a member has 90 days after separation from active duty service to apply to a court rendering a judgment to re-open a case on SSCRA grounds, the SSCRA is not a USFSPA issue where a member has been retired for more than 90 days.

- **The 10/10 requirement**

  This is a "killer" requirement. For a division of retired pay as property award to be enforceable under the USFSPA, the former spouse must have been married to the member for a period of 10 years or more during which the member performed at least 10 years of service creditable towards retirement eligibility. This requirement does not apply to the Court's authority to divide military retired pay, but only to the ability of the former spouse to get direct payments from DFAS. This is a statutory requirement, and not a personal right of the member that can be waived.

  Although this requirement was probably included in the USFSPA to protect members, we have had more complaints about it from members than from former spouses. Assuming that a member intends to meet his or her legal obligations, the member would much rather have us pay the former spouse directly rather than have to write a check each month. It would lessen contact with the former spouse, and the former spouse would receive her or his own IRS Form 1099, instead of the member being taxed on the entire amount of military retired pay.

If we cannot determine from the court order whether the 10/10 requirement has been met, we may ask the former spouse to provide a copy of the parties' marriage certificate. A recitation in the court order such as, "The parties were married for 10 years or more while the member performed 10 years or more of military service creditable for retirement purposes" will satisfy the 10/10 requirement.

USFSPA Jurisdiction

The USFSPA's jurisdictional requirement is found in 10 U.S.C. § 1408(c)(4). This is another "killer" requirement. If it is not met, the former spouse's application for retired pay as property payments under the USFSPA will be rejected. For a court to have the authority to divide military retired pay, the USFSPA requires that the court have "C-4" jurisdiction over the military member in one of three ways. One way is for the member to consent to the jurisdiction of the court. The member indicates his or her consent to the court's jurisdiction by taking some affirmative action with regard to the legal proceeding, such as filing any responsive pleading in the case. Simply receiving notice of filing of the divorce complaint or petition is not sufficient. Consent is the most common way for a court to have "C-4" jurisdiction over a member.

The other ways for the court to have C-4 jurisdiction is for the member to be a resident of the State other than because of his or her military assignment, or for the court to find that the member was domiciled in the particular State. Now, the key with regard to domicile is that it should be the court making this determination, and it should be noted in the divorce decree.