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Death Benefits under Deferred Profit Sharing Plans

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DEATH BENEFITS UNDER DEFERRED PROFIT SHARING PLANS

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During the past few years, the growth of government approved deferred profit sharing plans has been spectacular. Management has realized that here is a means whereby all employees, particularly key employees, can build substantial estates with important tax savings. Those who participate in successfully managed plans can accumulate very large sums which in many instances will comprise significant parts of their estates. It is important, therefore, that estate planners be familiar with the sections of the Internal Revenue Code applicable to profit sharing plans, and particularly those sections affecting the distribution of such profit shares.

Under deferred profit sharing plans, the company agrees to make an annual contribution, based upon profits, to a trustee. (Employees may contribute to the plan, but herein I have assumed a non-contributory plan.) The contribution is generally allocated by a committee of company employees from among those participating in the plan, in direct proportion to their salaries, although in some instances allocations are made not only on the basis of salary but also on length of service. The contributions are invested by the trustee and paid to the participant when he retires or becomes disabled, either in one lump sum, in installments over a period of years, or by the purchase of an annuity contract, as the committee determines. If a participant dies prior to receiving complete distribution of his share, that which remains is paid to his named beneficiary. It is important that such plans be approved by the Internal Revenue Service so that they may qualify for important tax benefits. Qualification requirements, contained in section 401 (a) of the 1954 Internal Revenue Code, are liberal, being essentially that the plan cover a reasonable classification of employees, and that the plan not discriminate by its terms or its operation in favor of the more highly compensated employees.[1] Among the tax advantages are these:

[1] Int. Rev. Code of 1954, § 401(a).

1) The company contribution will be deductible in the tax year for which it is made.

2) The trust fund to which the company makes its contribution will compound and accumulate earnings tax free.

3) The employee for whose benefit the contribution is made will pay no tax on that contribution in the year in which it is made, but rather at a later time (normally at retirement) upon receipt of his share. Then he may receive his share either in one lump sum or in payments over a period of years either from the trust fund or under an annuity contract. If payment is made within one taxable year, generally one lump sum, the distribution is taxed as a long-term capital gain.[2] If paid over a period of years, it is taxed as ordinary income as received.[3]

4) Although regulations have not yet been published, it appears that an employee's share, should he die, will not be includible in his estate for federal estate tax purposes as long as the beneficiary designation is other than the employee's estate.[4]

The last mentioned tax benefit was incorporated in section 2039 (c) of the Internal Revenue Code of 1954 and it is this section which is particularly significant for those in the estate planning field. Essentially, it provides that for federal estate tax purposes the gross estate shall not include "the value of an annuity or other payment" (except where payable to the executor) under a qualified deferred profit sharing (or pension) plan to the extent that the annuity or other payment is attributable to employer contributions (usually the entire amount). Although the estate tax treatment of annuities appears to be certain, a clarification of the language "other payment" must await the appearance of Treasury Regulations which should be available soon. However, it is felt that the language "other payment" is intended to include lump sum distributions from profit sharing plans. If this is the case, very careful consideration should be given by a participating employee in selecting the beneficiary to receive his share in the event of death prior to retirement, and by the committee which makes the decision as to the method of paying the accumulated benefits when a participant reaches retirement age.

Typically under deferred profit sharing plans, the participating employee names his wife as beneficiary of his share should he die a participant under the plan. It appears reasonably certain that in the event of the employee's death before retirement, the share would escape inclusion in his estate for federal estate tax purposes. Since the distribution is made outright, however, if the accumulation is substantial, the widow will be faced with a burdensome management problem. In addition, since the profit share has been reduced to possession in the hands of the wife, at her subsequent death it will be includible in her estate for federal estate tax purposes.

An alternative, which might be desirable in many instances, would be for the participating employee to name a trustee as beneficiary of his profit share, providing in the trust agreement that income only be payable to the wife with discretion in the trustee to pay principal if the wife's

[2] Id. § 402(a)(2).

[3] Assuming the plan is non-contributory; if contributory, payments are taxed under Id. § 72. relating to annuities.

[4] Int. Rev. Code of 1954, § 2039(c).

well-being so requires. The trust normally would be dormant, since only the employee's interest in the profit share is transferred to the trust. It would be possible, however, and in some instances advisable, to name the trustee of an existing life insurance or other trust as beneficiary of the profit share. Since a beneficiary other than the employee's estate is named, the requirements of section 2039 (c) are met and the profit share will not be includible in the employee's estate for federal estate tax purposes. Further, at the wife's subsequent death the share would escape the federal estate tax again, and during the period between their deaths the wife will have been relieved of the management responsibilities of the property and will have benefited from the other advantages inherent in the trust arrangement.

For example, assume an employee participating in a plan, who has named his wife as beneficiary, and who dies with a profit share amounting to $100,000. Further assume that he owned other property having a value of $200,000. His will provides that half of his other property be left in trust in a manner which will qualify for the estate tax marital deduction and the other half in a remainder trust under the terms of which the income will be payable to the wife with remainder to his children. Federal estate taxes at his death and at his wife's subsequent death will be approximately as follows (administration expenses disregarded):

At husband's death: (Since profit share is payable outright to wife, it is not included as an asset of his estate.)

Husband's gross estate:	$200,000	
Less marital deduction:	100,000	
	$100,000	
Less specific exemption:	60,000	
Subject to Tax:	$ 40,000	
Tax:		$4,800
At wife's death:		
Wife's gross estate: Wife's trust:	$100,000	
Profit share:	76,250[5]	
	$176,250	
Less specific exemption:	60,000	
Subject to Tax:	$116,250	
Tax:		$24,750
Total Taxes:		$29,550

If a trustee had been named beneficiary of the profit share and the property in the husband's estate, other than that passing into the marital trust, were added to that trust, taxes at his death would remain the same. Taxes at the wife's subsequent death, however, would be reduced to $4,800 since only the assets of the marital trust ($100,000) would be subject to tax. Thus the result would be a tax saving, passed on to the children, of almost $20,000.

Similarly, careful consideration should be given by the committee to the method of paying the accumulated benefit when a participant

[5] $23,750 income taxes paid when profit share is distributed to wife. Int. Rev. Code of 1954, §§ 101(b), 402(a)(2).

reaches retirement age. Frequently, to take advantage of section 402(a)(2), which provides for long-term capital gain treatment, the committee directs that the payment be made in one lump sum (within one taxable year) to the employee. Thus reduced to possession, it will be included for tax purposes in his estate at his subsequent death, like all other property owned by the employee. It may be advisable in many instances to receive the share in payments over a period of years since then, at the employee's death, that portion which has not been distributed will escape federal estate taxation. For example, in the illustration used above, if the employee attained retirement age and received his entire accumulation in one lump sum, he would pay a long-term capital gain tax of $23,750.[6] At his subsequent death the remaining $76,250 would be included in his estate for federal estate tax purposes. Assuming the same provisions in his will as in the preceding illustration, taxes at his death and at his wife's subsequent death would be as follows:

Husband's gross estate:	$276,250	
Less marital deduction:	138,125	
	$138,125	
Less specific exemption:	60,000	
Subject to tax:	$ 78,125	
Tax:		$14,250
Wife's gross estate	$138,125	
Less specific exemption:	60,000	
Subject to tax:	$ 78,125	
Tax:		14,250
Plus capital gains tax paid on distribution of profit share:		23,750
Total taxes:		$52,250

Now let us assume, as in the above illustration, that a trustee is named beneficiary of the profit share and that the will provides that the property in the husband's estate, other than that passing into the marital trust, is to be added to that trust. Further, let us assume that rather than receiving a lump sum distribution at retirement, the employee is to receive his profit share in equal installments over a period of ten years. Let us look at the tax situation should the employee die five years later:

[6] Int. Rev. Code of 1954, §§ 101(b), 402(a)(2).

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Husband's gross estate:	$235,400[7]	
Less marital deduction:	117,700	
	$117,000	
Less specific exemption:	60,000	
Subject to tax:	$ 57,700	
Tax:		$8,750
Wife's gross estate:	$117,700	
Less specific exemption:	60,000	
Subject to tax:	$ 57,700	
Tax:		8,750
Income tax on profit share distributicns:		
To husband while living:		14,600
To trustee at husband's death:		11,250
Total taxes:		$43,350

Thus, in our example, receiving payments over a period of years rather than in one lump sum saved almost $10,000 in taxes.

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[7] Represents $200,000 plus the $50,000 distributed under the profit sharing plan, after tax (estimated) on each of the five installment distributions.

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Further information may be obtained by writing

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