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Federal Estate, Gift and Income Tax Implications of Certain Options Under the Pennsylvania Employees' Retirement System as Affected by the Internal Revenue Code of 1954, As Amended

Edward N. Polisher

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EDWARD N. POLISHER*

Preface

The Tax Reform Act of 1969[1] wrought several changes in the federal tax implications of the benefits accruing to members of the judiciary under the State Employes' Retirement System of the Commonwealth of Pennsylvania. This Article is adapted from an Opinion[2] prepared to reflect these changes, as well as those made by treasury regulations and revenue rulings since the date of a prior Opinion of July 1, 1961.[3] The Tax Reform Act of 1969 applies to

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1. 26 U.S.C. (1970).

2. Opinion of June 15, 1972. The author gratefully acknowledges the research and assistance of his partners, Sidney Margulies, Esquire, and Dennis E. Kapustin, Esquire, in the preparation of this material.

The Opinion dealt only with the federal estate, gift and income taxes affecting benefits to the judiciary under the Pennsylvania Employes' Retirement System. The benefits available to participating employees are not subject to Pennsylvania transfer, inheritance or personal income taxes. *See* State Employes' Retirement Code of 1959, as amended, PA. STAT. ANN. tit. 71, § 1725-1803 (Supp. 1972).

3. On three previous occasions, the author rendered separate opinions

contributions made and benefits received on and after January 1, 1970.

The State Employes' Retirement System of the Commonwealth of Pennsylvania, under which members of the judiciary receive their retirement benefits, has been ruled a "qualified pension plan"[4] by the Internal Revenue Service. Under this system, two principal options, among others, are available to members of the judiciary upon retirement.

I. Option 1

A state employee has the right to pension payments during his lifetime from the date of his retirement, with the undistributed balance payable in a lump sum at his death to the beneficiary designated by him.

If Option 1 is exercised, the following federal income, gift and estate tax consequences will result:

A. *Income Tax*

1. The installment payments, when received by the retired employee during his lifetime, will be taxable in the same manner as annuities.[5]

Under Option 1, the employee's contribution to the retirement fund will be divided by his life expectancy at the time he begins to receive payments, and the amount thus arrived at will represent the portion of the annual payment recoverable income tax free. This tax free amount remains constant throughout the lifetime of the annuitant, even though he lives beyond his life expectancy. The balance of the annual installment is taxable as ordinary income in the year received.[6] There is, however, one exception—if the total payments to be received by the employee during the first three years of retirement will equal or exceed his total contributions, the entire amount received is non-taxable until the employee has recovered all he contributed. Thereafter, the total payment is subject to tax.[7]

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on this subject. The first, at the request of the late Chief Justice, then Justice Horace Stern, was on January 21, 1954, prior to the enactment of the Internal Revenue Code of 1954. The second, on April 6, 1955, was published after the adoption of the Code. The third, and the one most recent to the 1972 Opinion from which this article was adapted, was dated July 1, 1961, and reflected changes which had occurred in the federal tax laws, by legislation, treasury regulations and revenue rulings from the date of the second opinion.

4. See Appendix A, Opinion Letter of the Internal Revenue Service, January 14, 1954, addressed to Edward N. Polisher, Esquire, of Philadelphia, Pennsylvania *infra*.

5. INT. REV. CODE of 1954, § 402(a)(1); Treas. Reg. § 1.402(a)-1(a)(1) (1956).

6. INT. REV. CODE of 1954, § 72.

7. *Id.* § 72(d); Treas. Reg. § 1.72-13(a) and (c) (1956).

The income tax payable on the taxable portion of the annuity may be further reduced by the retirement income credit.[8] The I.R.C. provides that a person retired under a publicly administered retirement program is entitled to a credit against any income tax he might otherwise incur, of up to 15% of his retirement income not in excess of $1,524.00, for a maximum credit of $228.60. In the event husband and wife file jointly, the maximum credit is $342.90. The receipt of other forms of retirement income, such as interest, dividends, rents and annuity payments will not affect the taxpayer's right to, or the extent of, the credit; but in the event the taxpayer receives social security benefits or income for services rendered during the year involved, the credit may be reduced or wiped out.

A new factor has been introduced by the Tax Reform Act of 1969, namely, a maximum tax rate of 50% on "earned income" for 1972 and subsequent years.[9] "Earned income" is defined to include compensation in the form of wages, salaries and professional fees and to exclude interest income, dividend income and lump-sum distributions from qualified retirement plans. There does not appear to be a clear-cut answer to the question of whether annuity payments from a qualified retirement plan are within the favored class. However, at least one respected author has concluded that such annuities are within the definition of the term "earned income."[10] In any event, the concept is relevant only to those married taxpayers filing joint returns with taxable income in excess of $52,000.00, and unmarried taxpayers with taxable income in excess of $38,000.00. In addition, the amount of earned income actually subject to the new maximum rate is dependent upon the amount of "tax preference" income in excess of $30,000.00 received during the year.[11] Unearned income will remain taxable at the top rate (as high as 70%) that the taxpayer would have incurred had the relief provision not been in effect. A further decrease in taxable income for a taxpayer over age 65 is the result of the increased double personal exemption now totalling $1,500.00.[12]

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8. INT. REV. CODE of 1954, § 37.

9. *Id.* § 1348. This is a reduction from 1971, in which the maximum was 60%.

10. Asimow, *The Maximum Tax on Earned Income: Tax Planning for the Seventies*, TWENTY-THIRD U.S.C. TAX INSTITUTE 19, 73 (1971).

11. "Tax preference" income is essentially the same as unearned income with the exclusion of tax-free interest and the addition of the untaxed portion of long term capital gains. *See* INT. REV. CODE of 1954, § 57.

12. *Id.* § 151(c). The double taxation exemption in 1971 totaled only $1,350.00.

2. The tax treatment of a lump sum payment received by the employee's designated beneficiary after his death has been changed drastically by the Tax Reform Act of 1969. That portion of the payment that represents a return of the employee's contributions, if any such balance remains unpaid, is still completely excluded from taxable income.[13] In addition, the next $5,000.00 will be excluded from the recipient's gross income.[14] With respect to the remainder of the lump sum payment, that portion which represents benefits accrued prior to 1970, and benefits accrued for years after 1969 not attributable to the employer's contributions, continue to be taxable as long term capital gain income.[15] The first $50,000.00 of the lump sum payment continues to be taxed at a maximum rate of 25%, but any excess will now be taxed at rates up to 35%.[16]

However, the amount of the lump sum payment representing benefits accrued for years after 1969 attributable to the Commonwealth's contribution for such years, will be treated as ordinary income, subject to either a 5-year or a 7-year income averaging provision.[17] The Commonwealth is obligated to provide this breakdown of plan benefits into its various component parts.[18]

The right to use the 7-year averaging tax computation is dependent upon the employee having been a participant in the plan for at least 5 years, and the receipt of the lump sum payment by reason of retirement, death or disability.[19] In the alternative, any individual taxpayer may use the 5-year averaging option, if this would produce the least tax. In most cases, the 7-year averaging technique will result in the smallest tax, but a taxpayer who has a large amount of taxable income other than the lump sum payment may find the 5-year averaging technique a better tax-saving device. Caution dictates that both calculations be made at the time of the preparation of the tax return. One way of eliminating most of the problems, while retaining the use of the 7-year averaging benefits, is to have the post-death lump sum made payable to an intervivos or testamentary trust under the employee's will.[20]

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13. *Id.* § 402(a)(2); Treas. Reg. § 1.402(a)-1(a)(6) (1956).
14. INT. REV. CODE of 1954, § 101(b).
15. *Id.* § 402(a)(5). This was added by the Tax Reform Act of 1969.
16. *Id.* § 1201(b)(c) and (d). These were added by the Tax Reform Act of 1969. In 1971, the maximum rate was only 32.5%.
17. *Id.* § 72(n)(2) and (4). This was added by the Tax Reform Act of 1969.
18. Proposed Treas. Reg. § 1.402(a)-2(f), 36 Fed. Reg. 11450 (1971).
19. INT. REV. CODE of 1954, § 72(n)(1); Proposed Treas. Reg. § 1.72-19(b), 36 Fed. Reg. 3823 (1971). If the employee has attained age 59½, any compensation for personal services received during the taxable year of the receipt of the lump sum benefit is excluded from the 7-year averaging computation.
20. Since the trust has no other outside income, the 7-year averaging formula can be applied without the inclusion of the employee's or beneficiary's other taxable income or salary. *See* Rev. Rul. 58-423, 1958-2 CUM. BULL. 15 (1958). While this ruling antedates the Tax Reform Act of 1969 and deals solely with an inter vivos trust, the conclusion of the ruling is

Lastly, the employee's beneficiary will be allowed a limited deduction against gross income for the federal estate tax payable by reason of the inclusion in the employee's estate of that portion of the value of the lump sum payable at death, attributable to the employee's contributions to the plan.[21]

B. *Gift Tax*

The exercise or non-exercise by an employee of an election or option, whereby an annuity or other payment will become payable to any beneficiary at or after the employee's death, is not considered a transfer subject to gift tax, if the election or option is provided for under a qualified pension plan, as defined under Section 401(a) of the I.R.C.[22] The Pennsylvania State Employes' Retirement Fund is such a qualified pension plan.[23]

However, where the designation is irrevocable, and if any annuity or other payment, referred to above, is attributable to payments or contributions by the employee, then that part of the value of such annuity or other payment, which bears the same proportion to the total value of the annuity or other payment, as the total payments or contributions by the employee bear to the total payments or contributions made by both employer and employee, is considered a transfer subject to gift tax.[24]

Inasmuch as the Pennsylvania State Employes' Retirement Plan requires contributions by the employee during his tenure in office, the gift tax implications referred to above have application. It should be pointed out, however, that any such gift tax paid will be allowed as a credit, subject to certain limitations, against the estate tax, which afterwards becomes payable in the estate of the employee, and that was attributable to the inclusion in his estate of that portion of his benefits related to his own contributions.[25]

C. *Estate Tax*

The lump sum balance payable at death to the employee's designated beneficiary, other than his executor, is not includible in the

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that the character or nature of the beneficiary does not affect the *income* tax treatment of the distribution.

21. INT. REV. CODE of 1954, § 691(c).
22. *Id.* § 2517(a). This was added by the Technical Amendment Act of 1958.
23. *See* Appendix A *infra.*
24. INT. REV. CODE of 1954, § 2517(b). This was added by the Technical Amendment Act of 1958.
25. *Id.* § 2012.

employee's gross estate for federal estate tax purposes, except in the proportion that his contributions to the retirement fund bear to the total contributions made thereto by him and the Commonwealth.[26] The portion attributable to the Commonwealth's contributions is disregarded. If the lump sum is made payable to the employee's executor, the full amount will be includible in the gross estate.[27]

D. Example 1

1. Let us assume the following facts:

(a) Judge X paid $50,000.00 into the State Retirement Fund.

(b) The Commonwealth contributed $50,000.00, of which $2.500.00 was paid after 1969.

(c) Judge X's benefits amount to $150,000.00, including interest on contributions made both by the Judge and the Commonwealth.

(d) Judge X exercised Option 1, under which he received retirement payments of $15,000.00 per annum for the remainder of his life.

(e) At retirement, age 72, Judge X's life expectancy was 10 years; he actually lived for two years after he retired.

(f) The Judge was married and his wife was also 72 at the time of retirement.

(g) In each of the 2 years after retirement, the Judge and his wife received $2,000.00 of taxable interest and dividends and $3,000.00 of social security benefits.

(h) Judge X and his wife had tax deductible payments in the amount of $4,000.00 consisting of charitable contributions, medical expenses and other allowable items.

(i) Upon the Judge's death, his widow would then receive the undistributed balance of $120,000.00 in a lump sum.

Under these assumed facts, the following would be the federal income, gift and estate tax consequences:

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26. *Id.* § 2039. The question of whether the interest paid on the employee's contributions is deemed to be made by him or the Commonwealth for the purpose of this calculation is not a settled matter. In *Bryant v. United States*, the taxpayer was successful in resisting the Internal Revenue Service Commissioner's attempt to treat the interest earned on the decedent's contribution as fully includible in the decedent's gross estate. The court ruled that such interest was partially excludible by reason of the use of a formula which used as its numerator only the actual contributions made by the employee and the employer. *Bryant v. United States*, 69-2 U.S.T.C. ¶ 12,636 (D. Md. 1969). The Internal Revenue Service, however, has taken a middle ground by including interest earned on the employee's contributions in the numerator of the fraction, thereby insuring that some portion of the interest earned on the employee's contributions will be included in the gross estate. Rev. Rul. 71-481 (1971).

27. INT. REV. CODE of 1954, § 2039(c); Treas. Reg. § 20.2039-2 (1961).

2. Income tax. During the two years that the Judge lived after retirement, he would be obliged to pay an income tax determined as follows:

His contribution to the fund of $50,000.00 would be divided by his life expectancy of 10 years and the sum of $5,000.00 out of his $15,000.00 annual payment would be received tax free during his lifetime. The balance of $10,000.00 would be subject to income tax. Were the annual payments larger, so that the entire $50,000.00 contributed by the Judge would be recovered in 3 years or less, no tax would be paid until the entire $50,000.00 was received. Thereafter the entire amount would be subject to tax.

As the Judge and his wife were 72 years of age, the retirement income credit calculation is not affected by any earnings for services rendered during the year by either of them. However, the receipt of $3,000.00 of social security benefits does reduce the amount of credit to $78.60 from the maximum of $342.90.

Judge X and his wife were over 65, thus, they both enjoyed double exemption of $1,500.00 each. Since taxable income did not approach $52,000.00, the earned income maximum tax rate is not applicable. The tax would be computed as follows:

Gross Income—annuity	$15,000.00
Less: return of employee contribution	5,000.00
Taxable portion	$10,000.00
Interest and dividends	3,000.00
Adjusted Gross Income	$13,000.00
Less: tax deductible contribution, medical expenses, etc.	4,000.00
	$ 9,000.00
Personal exemptions	3,000.00
Taxable Income	$ 6,000.00
Tax	$ 1,000.00
Less: Retirement Income Credit	78.60
Net Tax Due	$ 921.40

The lump sum payment of $120,000.00 to the widow would be subject to income tax as follows:

(a) The portion of the decedent's contribution to the retirement fund, for which he had not been repaid up to the time of his death; namely $50,000.00, less $10,000.00 received by the Judge during his lifetime, or $40,000.00, would be received free of income tax.

(b) The next $5,000.00 would be received free of income tax as a death benefit.

(c) The next $75,000.00 must be divided into a long term capital gain portion and an ordinary income portion. Assuming that the State Employes' Retirement Board indicates that $4,000.00 is the amount of the benefit accrued by the Commonwealth's contributions after 1969, the Internal Revenue Service's proposed regulations[28] indicate that the ordinary income and capital gain portions must be reduced by a ratable allocation of the $5,000.00 death benefit, tax-exempt portion. Thus, the ordinary income and capital gains portions would be calculated as follows:

Total distribution	$120,000.00	
Less return of Judge's contribution	40,000.00	
	$ 80,000.00	
Ordinary income portion before $5,000.00 tax-free death benefit =	$ 4,000.00 / $ 80,000.00	= 5%
Ordinary income amount after $5,000.00 tax-free death benefit =	5% of $ 75,000.00	= $ 3,750.00
Capital gain portion after $5,000.00 tax-free death benefit =	95% of $ 75,000.00	= $71,250.00

The beneficiary has the option of calculating the tax on $3,750.00, the ordinary income portion of the lump sum payment using the ordinary tax calculation, the 5-year averaging, or the 7-year averaging tax calculation. At the present time, the amount of the ordinary income portion of a lump sum payment will be relatively small. However, this portion will continue to grow each year after 1969, and become an increasingly more important and complex factor to be considered.

The balance of the lump sum payment, $71,250.00, may be subject to a capital gains tax at two rates; that portion up to $50,000.00 would be taxed at not more than 25% and the balance of $21,250.00 may be subject to a tax rate not in excess of 35%.

The calculation of the widow's income tax in the year of this lump sum payment would be extremely complex and no purpose would be served by outlining the tax calculations in this Article. In contrast to the previous Opinions,[29] wherein the tax calculations were relatively clear, the best advice that can be given is to make certain that the tax returns are prepared or reviewed by a competent expert tax technician.

3. Gift tax. If the designation of his wife as the benficiary of the balance in his account at his death was irrevocable, the Judge has made a taxable gift to his wife at the time of exercising the option. The value of the gift is one-third (1/3) of the present

28. Proposed Treas. Regs. §§ 1.402(a)-2(b)(6) and 1.402(a)-2(d)(6), 36 Fed. Reg. 11445, 11448-9 (1971).

29. *See* note 3 *supra*.

value, at the time the option is exercised, of the survivor's benefit, which represents the proportion which the Judge's contributions bear to the total contributions made to his account. The present value of this benefit would be actuarially computed with the aid of the tables contained in the regulations, and its determination would depend on the respective ages of the Judge and his wife. The value, so computed, would not qualify for the present interest annual exclusion, since there is no present enjoyment of this benefit by the wife. Because the interest granted to the wife is contingent upon her surviving the Judge within the ten-year period, the gift tax marital deduction is also not available.[30]

If the designation of the wife as beneficiary was a revocable one, there has been no completed transfer upon which gift tax liability could be imposed.

4. Estate tax. $40,000.00, one-third (1/3) of the $120,000.00 received by the widow would be includible in the Judge's estate for federal estate tax purposes.

II. *Option 2*

Another option, available to a member of the judiciary upon retirement, is the right to receive installment payments during his lifetime from date of retirement, with the undistributed balance at his death payable in installments to the beneficiary designated by him, for the latter's lifetime. Upon the beneficiary's death, no further payments are to be made. This option creates a joint and survivor annuity.

If Option 2 is exercised, the following federal income, gift and estate tax consequences will result:

A. *Income Tax*

The installment payments received by the employee during his lifetime, as well as the payments received by his beneficiary after his death, will be taxed as annuities, as described under Option 1, paragraph A1, except that the combined life expectancies of the employee and his beneficiary will be used to determine the amount of the annual exclusion recoverable income tax free, and this amount will remain constant throughout the lives of both.[31]

A widow, whose husband was entitled to the retirement income credit, previously referred to, also qualifies so that the credit will be available to both.[32] Similarly, if the amounts payable in

30. Rev. Rul. 72-61, INT. REV. BULL. No. 1972-7 (1972).
31. INT. REV. CODE of 1954, § 72(c)(3)(A); Treas. Regs. §§ 1.72-5(b) and 1.72-7(c) (1956).
32. INT. REV. CODE of 1954, § 37(b); Treas. Reg. § 1.37-2(d) (1956).

three years or less equal the employee's contributions, the payments are not taxed until the total of such contributions are recovered. Thereafter, the entire amount is received subject to income tax.

In addition, as previously indicated, the employee's beneficiary will be allowed a limited deduction against gross income for the federal estate tax, payable by reason of the inclusion in the employee's estate of the value of the post-death payments attributable to the employee's contribution to the plan.[33]

If the employee dies after the date of the first payment, the $5,000.00 exclusion from the income of the surviving beneficiary, previously referred to, will not be available.[34]

B. *Gift Tax*

See discussion under Gift Tax, included in Option 1, paragraph B.

C. *Estate Tax*

The undistributed balance payable upon the employee's death to his designated beneficiary in installments for the balance of her life will be includible in the employee's gross estate for federal estate tax purposes, only in the proportion that his contributions to the retirement fund bear to the total contributions made thereto by him and the Commonwealth. The portion attributable to the Commonwealth's contributions is disregarded.[35]

D. *Example 2*

Let us assume the same facts as in Example 1, except that Judge X exercised Option 2, under which he received retirement payments of $10,000.00 per year for the remainder of his life (2 years) and his widow thereafter received $10,000.00 per year for the balance of her life. At the time the payments commenced, their combined life expectancies amounted to 15 years.

1. Income tax. The Judge's contribution to the fund of $50,000.00 would be divided by his and his wife's combined life expectancies of 15 years. The sum of $3,333.33 thus arrived at, will at all times be received free of income tax until the death of the surviving annuitant, even if she lives beyond her life expectancy. The balance of $6,666.67 will be subject to income tax. The retirement income credit, double personal exemptions, the possible effect of the maximum earned income tax rate and the deduction for federal estate tax previously discussed, will be applicable equally throughout.

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33. INT. REV. CODE of 1954, § 691(d).
34. *Id.* § 101(b) (2) (C); Treas. Reg. § 1.101-2(e) (1957).
35. *See* notes 26 and 27 *supra.*

2. Gift tax. See Option 1.

3. Estate tax. One-third (1/3) of the value of the installments to be paid to the surviving wife for the remainder of her life would be taxable in the Judge's estate for federal estate tax purposes. The valuation of these future installments would be determined in accordance with the annuity tables included in the treasury regulations.[36]

III. Effect of Marital Deduction

The marital deduction allows a deduction, for federal estate tax purposes, for property includible in the gross estate passing from the decedent to the surviving spouse, not exceeding one-half of the adjusted gross estate. The adjusted gross estate is arrived at by subtracting from the gross estate, expenses of last illness and burial, costs of administration and debts.

However, in order to take advantage of the marital deduction, the property must pass to the surviving spouse in a manner which will qualify it for that purpose. When this requirement is met, the effect is to allow one-half of the decedent's estate to escape federal estate taxation at the time of his death, but to subject the property passing to the surviving spouse to federal estate tax at the time of the death of the surviving spouse, if such spouse has not consumed the property or disposed of it.[37]

The result of the marital deduction is to relieve from estate taxation, at the highest tax brackets for which the decedent's estate would be liable, that portion of the decedent's property which passes to the surviving spouse and qualifies for the marital deduction, leaving the other one-half taxable, after allowing $60,000.00 exemption available to all estates, at the lower rates. With respect to the retirement benefits, the effect of the use of the marital deduction is to render taxable only one-half of the portion includible in the estate of the deceased employee, as previously described.

Applying these rules to the options discussed, the following results follow:

If Option 1 is exercised by the state employee, and the balance is made payable at his death to his surviving spouse in a lump sum, the proceeds payable to her, to the extent includible in the employee's estate, will qualify for the marital deduction.

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36. Treas. Reg. § 1.72-9 (1956).

37. Int. Rev. Code of 1954, § 2056; Treas. Reg. §§ 20.2056(a)-1 and 20.2056(a)-2 (1958). *See also* Polisher, Estate Planning and Estate Tax Savings 609 *et seq.* (2d ed. 1948) and 81 *et seq.* (Supp. 1955).

If Option 2 is exercised by the state employee, and the beneficiary is his wife, who is to receive the balance in installments for her lifetime, the commuted value of the post-death payments, to the extent includible in the employee's estate, will also qualify for the marital deduction.

IV. An Estate Planning Opportunity—Trust to Receive Death Benefits

For estate planning to perform completely its function of determining the most economical method of disposing of family wealth, the estate tax problems confronting the widow of a deceased employee must also be considered. Property received by the widow from the estate of her husband under the marital deduction, to the extent it is not consumed or disposed of during her lifetime, will be includible in her estate for tax purposes upon her subsequent death. In most cases, the widow will not have remarried, so that at her death there will be no marital deduction available to minimize the impact of estate taxes.

This burden of estate taxes in the estate of the surviving spouse can be entirely avoided by having made payable to an intervivos trust created by the employee. The terms of this trust would provide that the widow would receive the income therefrom for life, and be entitled, in the discretion of the trustees, to the principal, in the event of accident, illness, emergency or a decline of her standard of living below a stated level. These powers should not be held by the wife, as trustee, but by some other party.[38]

The effect of the existence of this trust would be to provide the wife during her lifetime with the economic benefit of the funds paid by the Retirement System upon the death of the employee, but at the same time to exclude the unconsumed principal from her gross estate upon her subsequent death. Thus, they would avoid estate tax at her death, and would pass to the successive beneficiaries designated under the trust, free of such tax.

A disadvantage of this plan is that because the widow's interest under the suggested trust will not meet the requirements for qualification as part of the marital deduction, the portion of the retirement benefits, attributable to the Judge's own contributions to the retirement fund, which would qualify for the marital deduction in his estate if they were paid directly to the widow, will no longer be eligible for the marital deduction. This, however, can be overcome by the Judge providing in his will for the maximum marital deduction to pass to or for the benefit of his widow, and by directing his executors to utilize any other assets in his estate eligible for this purpose.

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38. Int. Rev. Code of 1954, § 2041; Treas. Reg. § 20.2041-1(b) (1961).

APPENDIX A

U. S. TREASURY DEPARTMENT

WASHINGTON 25

JAN 14 1954

Office of
COMMISSIONER OF INTERNAL REVENUE

Address Reply to
Commissioner of Internal Revenue
and refer to
T:R:P
FEM

Mr. Edward M. Polisher
1429 Walnut Street
Philadelphia 2, Pennsylvania

In re: Pennsylvania Retirement Fund
Taxability of Benefits

Dear Mr. Polisher:

This is in reply to your letter dated December 23, 1953 requesting information as to taxability of a lump sum distribution upon retirement or death of a beneficiary under the above-mentioned trust.

You ask whether, in such a case, the beneficiary could treat the total proceeds, less his own contributions to the fund, as a gain from the sale or exchange of a capital asset held for more than six months.

The State Employees' Retirement System created by Act of June 27, 1923, P. L. 858, of the Commonwealth of Pennsylvania, as amended, has been held as qualified under the provisions of section 165(a) of the Internal Revenue Code, and the trust established under such system to be entitled to exemption from tax. Eligibility under the system, as defined in Section 1, thereof, extends to "all judges of the several courts of this Commonwealth whose salaries are paid by the Commonwealth." It is assumed, therefore, that the fund referred to in your letter is identical with the trust fund established under such Act as amended.

In the case of a trust exempt under section 165(a) of the Internal Revenue Code, distributions are taxable in accordance with the provisions of section 165(b) thereof. When the total distribution is made in one taxable year of the distributee on account of the employee's separation from the service, the long-term capital gain treatment applies. Death while in service constitutes separation from service within the purview of section 165(b) of the Code.

You ask also whether the aforesaid tax treatment would be affected by the fact that the proceeds are payable, not to the widow upon death of the participant, but to the trustees under a testamentary trust providing income for life to the widow and corpus thereafter to the children of the deceased employee.

Under the circumstances described, the payment into the testamentary trust would continue taxable income to such trust in the year received by it, in accordance with the provisions of section 165(b) of the Code. The application of the principle of long-term capital gain would not be affected by reason of the fact that in such case the distributee would be the testamentary trust instead of the widow or the decedent's estate.

Very truly yours,

W. V. Shreve

Chief, Pension Trust Branch

APPENDIX B

ILLUSTRATIONS OF FEDERAL AND PENNSYLVANIA TAX CONSEQUENCES UNDER THE PENNSYLVANIA STATE EMPLOYEES RETIREMENT CODE OF 1959

I. ASSUMED GENERAL INFORMATION

A. Proposed date of Judge's retirement	June 30, 1973
B. Total value of the Judge's retirement account on proposed date of his retirement	$260,000.00
C. (1) Judge's actual contributions	48,000.00
(2) Interest paid by the Commonwealth on such contributions	32,000.00
(3) (1) and (2) above represent about 31% of the total fund	80,000.00
D. Commonwealth's contributions and interest thereon accrued prior to 1970	168,000.00
E. Commonwealth's contributions made after 1969	10,000.00
F. Interest on Commonwealth's contributions made after 1969	2,000.00
G. Judge's age as of 6/30/73	71 years
H. Judge's wife's age as of 6/30/73	69 years
I. Judge's life expectancy as of 6/30/73	9 years
J. Judge's other assets	$111,000.00

II. Assume the Judge dies before retirement and elects the basic plan to have the total fund paid in a lump sum to his wife, his designated beneficiary.

A. *Federal Estate and Pennsylvania Inheritance Tax Consequences.*

(1) *Federal Estate Tax*

The lump sum balance, $260,000.00, payable at death to the Judge's wife, is includible in the Judge's gross estate for federal estate tax in the proportion that his contributions to the retirement fund bear to the total contributions made thereto by him and the Commonwealth. Thus, $80,873.00, representing the Judge's contributions to the fund and interest thereon is includible as an asset in his estate. However, if the entire lump sum had been made payable to the Judge's estate, the full amount of $260,000.00 would have been includible in the gross estate and subject to the federal estate tax.

(2) *Pennsylvania Inheritance Tax*

No portion of the lump sum benefit of $260,000.00 is subject to Pennsylvania inheritance tax. Section 803 of the State Employees Retirement Code of 1959[1] exempts all benefits under this Act from any state and municipal tax, including that portion attributable to the Judge's contributions to the plan.

(3) *Estate Planning Opportunities*

If the benefits are payable in a lump sum to his widow, the unconsumed balance at her death will be taxable in her estate for federal estate and Pennsylvania inheritance tax purposes.

However, if these benefits accruing at the Judge's death are made payable to an inter vivos or testamentary trust for the benefit of the widow for her life, from which she is to receive the income and use of principal, if necessary, for illness, emergency or to maintain her accustomed standard of living, any undistributed balance remaining at her death will pass tax free to the successive beneficiaries named in the trust.

B. *Federal and Pennsylvania Income Tax Consequences*

(1) The tax treatment of a lump sum payment received by the Judge's designated beneficiary after his death has been changed drastically by the Federal Tax Reform Act of 1969. That portion of the payment that represents a return of the Judge's contributions, $48,000.00, remains completely excluded from taxable income. That portion of the lump sum payment which represents the interest paid on the Judge's contributions by the Commonwealth ($32,000.00), plus benefits accrued prior to 1970 contributed by the Commonwealth, $168,000.00, and benefits accrued for years after 1969, other than the Commonwealth's actual contributions of $10,000.00, total $202,000.00. From this, $5,000.00 will be excluded as a death benefit under the Code. The balance of $197,000.00 will be taxed as long term capital gain income. The first $50,000.00 of that portion of the lump sum payment continues to be taxed at a maximum rate of 25%, but the excess, $147,000.00, will now be taxed at 35%.

However, the remaining portion of the lump sum payment equal to the Commonwealth's actual contributions after 1969 of $10,000.00 will be treated as ordinary income, subject to either a 5-year or a 7-year income averaging provision.

The right to use the 7-year income averaging tax computation is dependent upon the Judge having been a participant in

1. PA. STAT. ANN. tit. 71, § 1275-803 (Supp. 1972).

the plan for at least 5 years and the receipt of the lump sum payment by reason of retirement, death or disability. Moreover, since the Judge's age is over 59½ years at retirement, he may disregard his salary as a judge, received in the year of retirement, in computing the tax under the 7-year income averaging formula. In the alternative, the Judge may use the 5-year averaging option, if this would produce the lesser tax. In most cases, the 7-year averaging technique will result in the smaller tax, but a taxpayer who has a large amount of taxable income other than the lump sum payment may find the 5-year income averaging technique a better tax saving device.

Lastly, the Judge's beneficiary will be allowed a deduction for the amount of the federal estate tax payable by reason of the inclusion in the Judge's estate of $80,000.00, that portion of the value of the lump sum payment equal to his own contributions and interest thereon.

(2) There will be no Pennsylvania state income tax upon the lump sum received by the beneficiary, because of the provision in the State Employes Retirement Code of 1959.

III. Assume the Judge retires and elects Option 1, under which the Judge would receive an annuity of $32,000.00 per year for his life, after which no further payments will be made. If he lives less than nine years, his wife will receive a lump sum payment of the balance of his account.

A. *Federal Estate and Pennsylvania Inheritance Tax Consequences*

If the Judge lives nine years or more after retirement, the entire fund will be exhausted at his death, and nothing remains to be paid to his wife. If he lives less than nine years the unused balance will be payable in a lump sum to his wife. The tax consequences of the receipt of such a balance are identical to that under the basic plan.

B. *Federal and Pennsylvania Income Tax Consequences*

(1) The Judge has contributed $48,000.00 to his retirement fund, excluding the interest paid by the Commonwealth on his contributions. He will receive $32,000.00 per year, or $96,000.00, within three years. Under Section 72 of the Internal Revenue Code, all payments received by the Judge and his wife within three years, up to $48,000.00, will be income tax free, but the balance, $48,000.00, received during the first three years, will be taxed as ordinary income to the extent of $16,000.00 in the second year and $32,000.00 in the third year. Thereafter, all future payments will be taxed as ordinary income.

(2) There would be no Pennsylvania state income tax upon the receipt of the annuity by the Judge because of the provision in the State Employes' Retirement Code of 1959.

C. *Gift Tax*

There would be no gift tax consequences, if the Judge elected Option 1.

D. *A Variation of Option 1*

There is still another option, which actually is a variation of Option 1. This would permit the Judge at retirement to receive periodic payments in an agreed amount, less than an annual annuity based upon his life expectancy. Any balance in the fund remaining at the time of the Judge's death would be paid in a lump sum to the Judge's designated beneficiary. The tax consequences under this plan would be the same as in sub-paragraphs A, B and C.

(1) The same estate planning opportunities as mentioned previously in paragraph IID, will be available if the balance at the Judge's death is paid over to either an inter vivos or testamentary trust.

IV. Assume the Judge retires and elects Option 2, under which the Judge, for his life, and after his death his wife, would receive an annuity for her lifetime. Both annuities will be of equal amounts, but will be in lesser amounts than that which the Judge would have received had he elected Option 1, where the annuity would terminate upon his death.

A. *Federal Estate and Pennsylvania Inheritance Tax Consequences.*

(1) The value of the annuity payments to the Judge's wife, computed at the time of the Judge's death, will be includible in his gross estate in the same proportion as the Judge's contributions bear to the total annuity fund.

Example:

If the Judge retires and lives until age 79, his wife will be 77 years old, at his death. The actuarial value of the annuity for the surviving wife will be about \$154,000.00. The percentage of the Judge's contribution to the total pension fund is approximately 31% $\frac{(\$\ 80{,}000.00)}{(\$260{,}000.00)}$. Therefore, 31% of \$154,000.00, or \$47,740.00, will be includible in the Judge's estate.

(2) There will be no Pennsylvania inheritance tax consequences.[2]

B. *Federal and Pennsylvania Income Tax Consequences*

(1) Since under Option 2 the Judge receives a reduced amount, he would not recover the amount of his contributions, \$48,000.00, within the three year period after his retirement. Therefore, the alternative provisions of Section 72 of the Internal Revenue Code would be applied. This rule apportions part of each annuity payment to a return of the Judge's contribution, based on the joint life expectancies of the Judge and his wife. This portion will always be received tax free, even if the Judge and his wife live longer than their life expectancies. Amounts received in excess of the excluded portion are reportable as ordinary income.

(2) There would be no Pennsylvania state income tax.

C. *Gift Tax*

When the Judge elects Option 2, a joint and survivor annuity, he will have made a gift under Section 2511 of the Internal Revenue Code. Section 2517 of the Code provides for an exclusion from gift tax of the benefits of a "qualified plan" which are not at-

2. *See* ¶ IIA(2) *supra.*

tributable to the contributions of the Judge. However, that portion of the benefits derived from the Judge's contributions to the plan will be subject to gift tax. Therefore, 31% (the ratio of the Judge's contributions to the total contributions) of the actuarial value of the wife's annuity, as computed on the date the Judge's election of Option 2, will be a taxable gift. This gift will not be entitled to an annual exclusion but his wife's portion will qualify for the gift tax marital deduction. The actuarial value of the wife's annuity should be obtained from the State.

D. *A Variation of Option 2*

The Judge may wish to provide for his children after his death and his wife's. This is permitted under this option. The effect will be to reduce substantially the payments to the Judge's wife.

The tax consequences of this variation are essentially the same as stated for Option 2, in paragraphs A, B. and C. above.

V. Assume the Judge elects Option 3, under which he would receive annuity payments in annual amounts twice those which his wife would be paid after his death for her lifetime.

A. *Tax Consequences*

The tax consequences of this option are identical to those stated with reference to Option 2.

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