**“Estate Planning for Retirement Benefits”**

By Alvin J. Golden
Ikard & Golden, P.C.
400 West 15th Street, Suite 975
Austin, Texas 78701
(512) 472-5675 FAX (512) 472-3669
ajg@ikardgolden.com
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# Estate Planning for Retirement Benefits

**I. PURPOSE AND SCOPE.** Recently there have been several important developments in the area of estate planning with retirement benefits – some statutory as interpreted by an IRS Notice, one by published revenue ruling (a rarity), and some by private letter rulings. This paper will highlight some of such developments by discussing the development, analyzing its effect, and, where applicable, discussing planning opportunities. What this paper will not deal with are the structural changes to pensions made by the Pension Protection Act of 2006.

**II. A LITTLE BACKGROUND.** At the end of 2005, according to the U. S. Board of Governors of the Federal Reserve System, there were $8,452.2 *billion* dollars in retirement plans in the United States. Of that amount, 43.4% is in IRAs, 33.9% is in defined contribution plans, and only 22.7% is in defined benefit (traditional) pension plans. Overall returns from 1988-2004 have been in inverse order; *i.e.*, defined benefit plans have performed best, with IRAs coming in last. There is no way to determine why that is so, but one theory holds that (i) 94% of IRA funds are in rollover IRAs and (ii) older investors tend to be more conservative, thereby producing lower returns.[1] This trend does not bode well for the retirement assets of many Americans, and this is compounded by the continuing reduction in the traditional defined benefit pension plans, which trend has been accelerated by the Pension Protection Act of 2006 in that it requires full funding of pension benefits and at the same time encourages contributions to 401(k) plans.

**III. LIFETIME CHARITABLE CONTRIBUTIONS.**[2] In addition to instituting the most massive charitable reforms since 1969, §1201 of the Pension Protection Act of 2006 ("PPA") adds a new §408(d)(8), which allows, for a limited time and on a limited basis, something for which charities have long been salivating – the ability to receive charitable contributions directly from a retirement plan. However, such

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1 The financial data was taken from Munnell, Soto, Libby and Prinzivalli, "Investment Returns: Defined Benefit vs. 401(k) Plans," Center for Retirement Research at Boston College (2006). The entire study may be found at www.bc.edu/crr.

2 Note that charitable contributions by beneficiary designation at death are still available and make the IRD taxable to the exempt organization. *See* PLR 199939039 (June 30, 1999), PLR 199930052 (May 11, 1999), PLR 9341008 (July 14, 1993). *See also* Rev. Rul 92-47, 1992-1 C.B. 198.

contributions can only be made for a limited time, in a limited amount and only directly from an IRA, with the consent of the IRA administrator. The IRS has published Notice 2007-7 interpreting the statute in Section IX, Q&A 34 through 44. It will be cited where the statute is unclear or does not deal directly with the issue.

A. EXCLUSION FROM GROSS INCOME. A qualified charitable distribution, as defined below, is limited to $100,000 0 per person[3] and is excluded from gross income. The exclusion has several important benefits in holding down the amount of social security benefits which may be subject to income tax, preserving itemized deductions or conversely, allowing non-itemizers the ability (in effect) to deduct this contribution. Obviously, since the distributions are not included in gross income, there is no deduction allowed for such distribution. It is important to note that even though the QCD is not included in gross income, it can be used to satisfy the minimum required distribution, thereby further depressing adjusted gross income.

> **CAVEAT:** The present Form 1099 does not have a space dealing with qualified charitable contributions. Several major providers have indicated that they will report the entire contribution as a distribution to the participant, essentially because the provider does not want the responsibility of determining whether the distribution is a qualified charitable distribution.[4] IRS has indicated that it will publish a Form 1099 that will allow reporting of the contribution as such, but as of the date of this writing, no such form has been promulgated. Consider requesting that the plan administrator note on written instructions from the participant that the qualified charitable contributions have been made in accordance with such instructions.

B. QUALIFIED CHARITABLE CONTRIBUTIONS. In order to take advantage of the newly enacted direct charitable contribution, the contribution must be a qualified charitable distribution ("QCD") as defined in IRC §408(d)(8)(B).

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A-34. The Notice provides that the limitation for married individuals filing a joint return is $100,000 per individual IRA owner. In a community property state is the non-participant spouse treated as an owner? The answer is probably "no," even without a reliance on IRC §408(g).

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Notice 2007-7, 2007-5 IRB 1 provides "the IRA trustee, custodian or issuer may rely upon reasonable representations made by the IRA owner." A-40.

1. Only From IRAs. The QCD can only be made from an IRA. Thus, it cannot be made from a qualified plan. More surprisingly perhaps, a QCD cannot be made from a Simple Plan or from a SEP, even though those plans are usually thought of in the same categories as IRAs. Notice 2007-7, A-36, notes that this restrictions on SEPs and Simples applies only to "ongoing" plans, which are defined as those to which employer contributions are for the plan year ending in the taxable year of a participant in which the contribution was made.

2. Must Be Made Directly from the IRA. The QCD must be made directly from the IRA by the plan administrator. A distribution to the participant followed immediately by a contribution by the participant will NOT qualify.[5] The import of this is that the participant wishing to utilize a QCD must contact the plan administrator or trustee and secure their agreement to make the contribution directly to the charity. Thus, as a practical matter, this provision cannot be used to make small contributions because of the administrative burden such contributions would create. (This is particularly true in light of the short time for which the QCD is available, as discussed below.)

3. Must Be Made to Public Charity. The QCD must be made to a public charity as described in IRC §170(b)(1)(A), but contributions to a donor advised fund or a §509(a)(3) supporting organization do not qualify. The probable reason for that exception is that the charitable reform provisions of the PPA focus on correcting certain perceived abuses with respect to donor advised funds and supporting organizations.

> **CAVEAT:** Some charitable organizations use supporting organizations as their principal fund raising arm or have foundations which function as supporting organizations. Care must be taken that a QCD is made to the charity itself.

4. Only After Participant Attains Age 70-1/2. A QCD can only be made *after* the participant attains age 70-1/2 rather than at any time during the year that the participant attains such age. This differs from the minimum required

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5 However, A-41provides that if a check payable to the charity is delivered to the participant who delivers it to the charity, the requirements of a QCD are met.

distribution rules which allow any distribution made during that year to qualify as a minimum required distribution. There does not seem to be any real reason for this limitation which creates a trap for the unwary and creates problems for those turning 70-1/2 very late in the year.

5. Applies to Beneficiaries Also. A-37 QCD exclusions from income are also available to the beneficiary for whose benefit an IRA is maintained after the death of the owner if the beneficiary has attained 70-1/2 at the date of the distribution.

6. Must Have Been Includible in Gross Income. A QCD must have been includible in gross income absent the exclusion in §408(d)(8)(A). Thus, distributions of after-tax contributions do not qualify as a QCD.

C. CONTRIBUTION MUST BE OTHERWISE DEDUCTIBLE. To be a QCD, a contribution must be wholly deductible. §408(d)(8)(C). Thus, a contribution whereby some benefit is received (such as a ticket to a fund raising dinner) does not qualify.

D. TAXABLE FUNDS TREATED AS SATISFYING QCD REQUIREMENTS. A generous provision allows distributions from a plan which contains both deductible and after-tax plan contributions to be treated as coming first from distributions which would otherwise be taxable. §408(d)(8)(D).

E. CONTRIBUTIONS LIMITED TO 2006 AND 2007. This provision applies only to contributions made for years ending on or before December 31, 2007. Undoubtedly, the short time frame is one of the reasons that administrators will no doubt insist that the contributions be substantial and infrequent.

F. WHEN TO USE QCDS. There are several situations in which the use of QCDS can produce beneficial results, but, as with any technique, it is not for everyone.

1. General Considerations. Just because Congress permits a new method of generating tax deductions does not mean that a taxpayer should immediately avail herself of it. As with any kind of charitable planning, there should be a charitable intent before the QCD is utilized. And, of course, each individual must analyze the impact of such a gift on his or her own situation. Remember that

the result of using a QCD is still a reduction in the amount of funds in the IRA available for future use.

2. Non-Itemizers. Perhaps the biggest winners under the QCD regime (other than public charities, of course) are those taxpayers who do not itemize deductions. Almost two-thirds of taxpayers do not itemize, and, while most are middle and low income, approximately 5.7 million are higher income taxpayers who derive no tax benefit from charitable contributions.[6] And, of course, the number of persons over age 70-1/2 contain a higher percentage of non-itemizers than the general population. Even though the QCD is not an itemized deduction, it allows a gift to charity which reduces the overall tax burden as compared to a withdrawal from an IRA followed by a contribution.

3. State Income Taxes. There are nine states which do not permit itemized deductions. In those states, of course, the ability to make charitable contributions which reduce what would be gross income has an added tax benefit.

4. Adjusted Gross Income Phase Outs. The income tax system penalizes higher income taxpayers by causing a loss of percentages of deductions as income increases – most notably the 2% phase out above $75,250 for singles and $150,500 for married persons. There are additional phase outs based upon adjusted gross income which the exclusion avoids; *e.g.,* the 7.5% floor for medical deductions and the 2% floor on "miscellaneous itemized deductions".

5. Social Security. As income increases, the percentage of social security payments which are subject to income tax also increases. And, since QCDS are only available to persons of social security age, the ability to hold down gross income produces a double benefit, especially for middle income non-itemizers.

6. No Gross Income Limitations on Contributions. Deductible contributions to public charities are limited to 50% of adjusted gross income. QCDS, because they are not a deduction, are not so limited. In fact, they can be fairly described as an "unlimited" charitable deduction, at least up to $100,000 per year for the rest of this year.

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Balkovic, Brian, "Individual Income Tax Returns, Preliminary Data", 2001, SOI Bulletin, Data Release 2002-2003, p. 136, cited by Professor Christopher Hoyt in Steve Leimberg's Charitable Planning Newsletter, Archive #101 (8/7/06).

7. Other Considerations. As with any other planning opportunity, one must run the numbers to see whether a QCD would produce the best overall result. How does the contribution affect the calculation of the Alternative Minimum Tax? For example, would a contribution of appreciated securities produce a better overall result? Is there a charitable carryforward that may be about to expire? And, even though the participant is required to take distributions, would a continued deferral still produce a better result?

G. THE CHARITABLE PLEDGE NON-PROBLEM. Some very skilled and knowledgeable practitioners have raised questions as to whether the use of a QCD to satisfy a pre-existing pledge raise tax or self-dealing issues. Notice 2007-7, A-44 seems to confirm the belief of most practitioner, including the author, that use of a QCD to satisfy a preexisting pledge is not somehow a constructive receipt, and clearly confirms that it is not a prohibited transaction.

1. Constructive Receipt. The argument goes that if the QCD is used to satisfy a pre-existing legal obligation[7], then the donor may be treated as having received the funds for tax purposes. The problem with this concern is that Congress has made it very clear what the tax treatment of a QCD is, and, while it put several limitations on QCDs, using them to satisfy a pre-existing pledge was not one of them. While the Notice does not specifically deal with this question, it is a reasonable inference that there is no problem.

2. Prohibited Transaction. There has also been a concern expressed that the use of IRA funds to satisfy a charitable pledge. The transaction is equivalent to a withdrawal and a payment of a debt with the withdrawn funds. How can a withdrawal from an IRA, irrespective of the purpose, be a prohibited transaction? All the PPA does is allow special tax treatment for such a transaction. This is the theory adopted by Department of Labor (which has authority over prohibited transactions) in A-44 of the Notice.

H. PERSONAL PHILOSOPHICAL AND POLICY CONSIDERATIONS. As a predicate, I recognize that charities provide many benefits and services and fulfill a vital role in our society. I also acknowledge that charities must depend on the largesse of the general public to a very great extent, and

[7]It is assumed for this purpose that the charitable pledge is legally enforceable.

thus they cannot be bashful in their fund raising efforts. Having said that, however, I am unequivocally opposed to techniques such as a QCD as bad tax policy and as exposing retirees to additional pressure from aggressive (maybe even predatory) charities.[8]

1. No Unlimited Charitable Deduction. As a general policy matter, if there is to be a limit on the deductibility of charitable contributions, then there is no reason to denominate one specific class of assets as an exception to that rule, particularly an asset (and the earnings thereon) on which no tax has ever been collected. I will concede that a dollar limit would ameliorate that to some extent, but I question why that should exist and how you determine what the right amount should be.

2. Susceptibility to Pressure. Although I am sure that there are studies which scientifically demonstrate that, as persons become more elderly they become more susceptible to pressure, any experienced estate planner, drawing on his or her own knowledge, can confirm that proposition. Many elderly persons want nothing so much from relationships as to avoid confrontation. This desire leads them to agree to do things just to get along. While the use of influence is certainly not limited to charities, many charities (even highly reputable ones) use high pressure tactics and aggressively mount campaigns to persuade donors to include them in their dispositive documents. How much more temptation is there to use pressure for immediate dollars?[9]

3. Good Points of Current Approach. If some sort of lifetime contribution directly from IRAs is to be adopted, the QCD approach has much to recommend it.

a. *Dollar Limit.* There is a dollar limit, though one could

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There are a couple of reasons that these tactics are employed. One, of course, is that the fund raiser is judged on the amount of money the fund raiser generates. Second, the fund raiser is convinced of the really great work that the charity does, and loses focus on the means used to achieve the ends. Those religious organizations which hold the keys to the kingdom of heaven may be particularly susceptible to this approach.

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I recognize that this is true of IRA designations at death, but at least the decedent had the use of all of his or her retirement funds during his or her life.

argue as to whether the limit is the proper one.

b. *Limited to Retirees*. The age limitation (while it might make the participant more susceptible to pressure) at least requires that they attain what is largely regarded as retirement age (or beyond) before giving away their retirement.

c. *Limit to Direct Contributions*. This technique puts some sort of buffer between the decision and the implementation so that the retiree cannot simply write the check while the fund raiser is in the living room. And, in some cases, where the administrator personally knows the participant, it injects a second opinion into the process. The benefits of this approach outweigh the administrative inconvenience that it may cause.

**IV. NON-SPOUSAL ROLLOVERS.** In a much needed change, §829 of the PPA permits direct transfers from qualified plans to IRAs even though the beneficiary is not a spouse by adding a new paragraph (11) to IRC §402(c). The necessity for non-spousal "rollovers" arises because many, if not most, qualified retirement plans require lump sum distributions as the only option. Thus, in those cases in which the beneficiary was not a spouse, the ability to stretch out the benefits was lost. However, Notice 2007-7 really muddies up the water, although ultimately it may be construed to carry out the above intent.

A. APPLIES TO DISTRIBUTIONS AFTER DECEMBER 31, 2006. This provision applies to *distributions* made after December 31, 2006.

B. MUST BE DIRECT TRANSFER. To qualify for non-spousal rollover treatment, there must be a direct trustee to trustee transfer. The beneficiary may NOT receive a distribution of the benefits and roll the benefits over to an IRA (even within 60 days of the distribution) and have such rollover treated as a qualified non-spousal rollover.

C. DIFFERS FROM SPOUSAL ROLLOVER. The non-spousal rollover differs from the spousal rollover in more ways than the requirement of a direct transfer.

1. Maintained in Name of Participant. The rollover must be

maintained in the name of the deceased participant for the benefit of the beneficiary and not in the name of the beneficiary.

2. Minimum Distribution Rules Apply Differently. If the life expectancy rule applies, the beneficiary must begin taking distributions from the IRA no later than December 31 of the year following the year of the participant's death, irrespective of the age of the participant at his or her death, or the age of the beneficiary.

D. APPLICABILITY OF PROVISION. The direct rollover rules apply not only to qualified plans under IRC §401, but also to tax sheltered annuities (§403(b) plans) and to government deferred compensation plans (§457 plans).

E. APPLICABILITY TO TRUST AS BENEFICIARY. New §402(c)(11)(B) titled "Certain Trusts Treated as Beneficiaries" provides, somewhat tersely: "For purposes of this paragraph, to the extent of rules prescribed by the Secretary, a trust maintained for the benefit of one or more designated beneficiaries shall be treated in the same manner as a trust designated beneficiary." Initially, it may be worth noting that "trust designated beneficiary" is not defined in the Code or Regulations. Additionally, the section is unclear whether the "rules prescribed by the Secretary" are those in the existing §401(a)(9) Regulations, or whether we must await new regulations. Unfortunately, the Joint Committee Report adds no clarity to this issue. The Technical Explanation of the Pension Protection Act of 2006, prepared by the Joint Committee on Taxation, states at page 179, "To the extent provided by the Secretary, the provision applies to benefits payable to a trust maintained for a designated beneficiary to the same extent it applies to the beneficiary." It is, perhaps, worth noting that in several other instances under the Act, the Secretary is given a time limit in which to issue regulations. Can it thus be inferred that the reference in paragraph (11)(B) is to the existing regulations dealing with trusts as designated beneficiaries, as the same may be amended from time to time.

Notice 2007-7, A-16 says nothing about waiting for Regulations. Rather, it allows a direct rollover where the beneficiaries of the trust meet the designated beneficiary requirements of IRC §401(a)(9)(E) and if the trust meets the requirements of Treas. Regs. §1.401(a)(9)-4, Q&A 5. This Notice may well be the "rules prescribed by the Secretary" to which the statute refers.

F. CONFUSION CREATED BY NOTICE 2007-7. It was simply

assumed by all the commentators that if there was a direct rollover, the benefits could be paid out over the life of the designated beneficiaries under the life expectancy rule, without regard for the distribution options under the plan. However, the Notice raises questions about this by its language, even though it may actually reach that result.

1. Q&A 19. This question is the general rule and deals with the determination of required minimum distributions ("RMD") of the rollover IRA if there is a designated beneficiary ("DB"). The answer first acknowledges that the IRA is to be treated as an inherited IRA, so that §401(a)(9) and the regulations thereunder apply. The Notice then adds, "The rules for determining the required minimum distributions under the plan *with respect to the nonspouse beneficiary* also apply to the IRA." (Emphasis added.) Thus, apparently, if the five year rule under §401(a)(9)(B)(ii) applied to the nonspouse DB under the plan, the five year rule applies to the IRA also.[10] If the life expectancy rule applies *with respect to the nonspouse beneficiary*, then the applicable distribution period is that which would have been applicable under the plan had the rollover not occurred; *i.e.*, the life expectancy rule measured by the life of the nonspousal DB. (Emphasis added.)

2. Q&A 17. As a general rule, RMDs are not subject to rollover, and the nonspousal rollover is no exception. This question deals with the calculation of the RMD if there is a nonspousal rollover, stating as a general proposition that no RMD with respect to the rollover is required in the year of the employee's death. This Q&A is an exception to the general rule of Q&A-19.

a. *Five Year Rule.* If the 5 year rule is applicable, then no minimum distributions are required and the entire amount may be rolled over. During the year beginning January 1of the fifth year following the death of the employee, no rollover is allowed, and, if there has been an earlier rollover, the entire amount must be

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10 Although the statute does not seem to apply when there is a designated beneficiary, Treas. Regs. §1.401(a)(9)-3, Q&A4 gives the plan the ability to impose the five year rule even if there is a DB.

distributed in that year.[11]

b. *Life Expectancy Rule.* Under the life expectancy rule, the RMDs begin the year following the year of the employee's death.

G. MORE CLARIFICATION. In a special edition of its "employee plan news" dated February 13, 2007, the IRS issued further clarification to clear up "the confusion over the nonspouse rollover rules recently published in Notice 2007-7." The publication makes clearer the interaction of the general rule under A-19 and the exception to the general rule under A-17. If the plan provides only for the five year rule, the nonspouse DB can nonetheless avoid the application of that rule by rolling over the plan assets no later than December 3he1 of the year following the year of the employee's death. Failure to complete such rollover will result in the application of the general rule and will require a distribution from the IRA within 5 years.

1. Death Before RBD. If the employee dies before his RBD, and the rollover occurs in the year of death, the entire account can be rolled over and the MRDs begin in the following year. If the rollover is not completed until the following year, then the RMD must be distributed and cannot be rolled over. (One problem is that the plan may be unwilling to make two distributions. Rolling the entire amount over and then withdrawing the RMD may be a potential answer, but that is not certain.)

2. Death After RBD. If death occurs after the employee's RBD, and the employee has not taken his or her RBD, then the MRD for the year of death must be taken and the balance rolled over if the five year rule is to be avoided.

3. Death Before 2006. If the participant dies before 2006 and the plan requires a five year rule, then such rule cannot be avoided by a rollover because the rollover cannot be accomplished in the year following the year of death.

H. PLR22717023. This PLR, released 4/27/2007, is an unusual fact situation which, while apparently pro-taxpayer, probably reinforces the Service's position that MRDs must begin no later than December 31 of the year following the

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[11] This requirement arises from A-19 which is referenced in a parenthetical in A-17 – "(but, as described in Q&A 19 in this notice, the 5-year rule must also apply to the IRA to which the rollover contribution is made.

year of the employee's death. In this ruling, the plan was being terminated in 2005, and the employee submitted all paperwork necessary to do a lifetime direct rollover to an IRS he had already established of his terminating distribution. The participant died before the terminating distribution and prior to his RBD. His daughter was the named beneficiary of the IRA, his estate and his sole personal representative. The plan distributed all of its accounts other than the account of the deceased participant. The plan also made MRDs to the daughter in 2006 and 2007 based upon the decedent's life expectancy. The ruling request represented that she would take MRDs based on her life expectancy beginning in 2008. The IRS ruled that the transfer from the account in the terminated plan to the IRA was a qualified rollover distribution if made in 2007. It would appear that the basis for the conslusions in the PLR was that the 2006 MRD (they year following the year of the employee's death) was made and that the 2007 MRD would also be made prior to the rollover to the IRA. There is no apparent justification for this position by the IRS, but, it is clearly the Service's position.[12]

I. PLAN MAY PERMIT. Under Q&A-14 of Notice 2007-7, a plan may, but is not required to offer a direct nonspousal rollover. It is unclear whether a plan amendment is required, whether the distribution options may simply be changed, or whether the plan may just allow such a transfer with no further formalities. This issue awaits further clarification.

**V. DIRECT ROLLOVERS TO ROTH IRAS.** Under current law, if a participant wishes to rollover a distribution from a qualified plan to a Roth IRA, the participant must first roll such distribution into a regular IRA, and then roll such distribution to a Roth IRA. For years beginning after December 31, 2007, taxpayers will be able to do a direct rollover from certain retirement plans to a Roth IRA and skip the intermediate step. This is beneficial for several reasons, not the least of which is that it eliminates one more opportunity for the financial institution to make an administrative error.

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Interestingly enough, Department of Labor published an interim final rule amending its Regulations under ERISA §404 creating a safe harbor to meet the duty of prudence for distributions from terminated individual account plans where the designated nonspouse beneficiary is missing. The duty of prudence is satisfied if a distribution is directly rolled over to an individual retirement plan established to receive distributions for the account of the beneficiary. This rule is made to take advantage of the favorable tax treatment accorded nonspouse beneficiaries under PPA. .

A. MUST BE TRANSFER FROM ELIGIBLE RETIREMENT PLAN. PPA §824 amends IRC §408A(e) by adding a distribution from an eligible retirement plan, as defined in §402(c)(8)(B), to the definition of "qualified rollover contribution". This includes employer plans, §403(b) plans and §457 plans.

B. STILL SUBJECT TO INCOME LIMITATION RULES. The PPA does not change the income limitations under existing law. Thus, if modified adjusted gross income exceeds $100,000, no Roth conversion is permitted under §408A(c)(3)(B). Note that section is amended by the Tax Increase Prevention and Reconciliation Act of 2005 to remove the income limitation for years beginning in 2010, so that the $100,000 limitation is in effect for only 2008 and 2009.

C. ELIMINATES AGGREGATION RULES. Present rules under §408(d)(2) require that all IRAs be aggregated when determining the tax consequences of a distribution. This includes a distribution made to accomplish a Roth conversion of an IRA. If a qualified plan contains substantial after-tax contributions, the ability to avoid aggregation can be very valuable. Suppose John Smith has 401(k) plan containing $150,000, $30,000 of which represents after-tax contributions. He also has an IRA of $500,000 with no after-tax contributions.[13]

1. Existing Law. Under current law, if he desires to do a Roth conversion of his 401(k), he must first roll the 401(k) to a conventional IRA. Thus, for distribution purposes he is treated as having one $650,000 IRA. When he converts the 401(k) rollover to a Roth IRA, 4.615% of the $150,000 rollover distribution ($30,000 divided by $650,000) will be treated as a recovery of principal, and the balance will be taxable. This results in taxable income of $143,077.

2. Under PPA The 401(k) plan is rolled directly to the Roth IRA. Since it never creates a standard IRA, it is not subject to the aggregation rules. Thus, the entire $30,000 is treated as a recovery of principal, and only $120,000 of the rollover is taxable.

D. CAVEATS. Just because the ability to rollover directly from an

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This example is taken from Steve Leimberg's Employee Benefits and Retirement Planning E-Mail Newsletter #383 by Michael E. Kitces (9/6/06).

eligible retirement plan exists does not mean it is a good idea. All of the considerations that go into the Roth conversion of an IRA still apply in the direct rollover situation – payment of tax now versus deferral and the ability to pay the tax on the conversion. Note that the early withdrawal penalty under §72(t) for participants under 59-1/2 only applies to the distribution for conversion, not to future distributions.

**VI. FINAL DRAC REGULATIONS.** The Service has issued final regulations under Code §402A, Treas Regs. 1.402A-1. These regulations generally track the proposed regulations. The below summary is not intended to be a complete discussion of the Regulations, but reports solely on sections selected by the author.

A. QUALIFIED DISTRIBUTIONS. A qualified distribution from a Roth IRA or a Roth account is tax free. A qualified distribution is one that is made from a plan after five years **and** after the participant has reached age 59-1/2, died or become disabled. If the distribution is not a qualified distribution, then such distribution is taxable.

1. IRAs. If the distribution is not a qualified distribution, then it is nontaxable to the extent that it is a return of investment in the contract, and such funds are treated as coming out first.

2. Roth IRA Accounts in Qualified Plans. To the extent that a distribution is not a qualified distribution, it is treated as an annuity; *i.e.,* a portion of the distribution is treated as a recovery of basis and a portion is treated as taxable earnings on the account.

B. THE FIVE YEAR RULES. Roth IRAs and Roth 401(k) accounts have different measurements for the 5 year period. The 5 year period for any Roth IRA begins when a contribution is made to any Roth IRA. On the other hand, the 5 year period for contributions to a Roth account begins when the first contribution is made to that account under the plan (Regs. §1.402A-1, A-4).

1. No Tacking on Rollovers from Roth Account to IRA. If an amount is rolled over from a Roth account to a Roth IRA, the date the Roth Account was established is immaterial, and the rules for determining the five year period are determined by the IRA. For example, if the participant did not have a Roth IRA prior to the rollover, a new five year period begins with the date of the rollover. If the

participant had already established and contributed to an IRA, that IRA determines the beginning of the five year period even if the rollover is made to a different IRA.

2. Investment in Contract. If a nonqualified distribution is rolled over to an IRA, the entire rollover is obviously tax free. However, the portion representing investment in the contract is treated in the same manner in the IRA as investment in the contract. If the entire distribution is a qualified distribution, then the entire distribution is treated as investment in the contract. Note that the effect of this rule is to render somewhat moot the 5 year period because of the ordering rules on distributions from IRAs. Regs. §1.402A-1, A-5.

**VII. THE MORE THINGS CHANGE – REVENUE RULING 2006-26.** The Internal Revenue Service issued Rev. Rul 2006-26, 2006-22 I.R.B. 939 (5/30/2006), to deal with marital deduction issues raised (at least in the Service's view) by the adoption of the Uniform Principal and Income Act. In actuality, the Ruling does nothing more than reiterate the Service's long-standing position first set forth in Rev. Rul. 89-89, 1989-2 C.B. 231, obsoleted by Rev. Rul 2002-2, that both the IRA and the QTIP trust must meet the all income requirements.

A. A LITTLE HISTORY.

1. Revenue Ruling 89-89. In Rev. Rul 89-89, the Service postulated an irrevocable beneficiary designation which required that the account balance as of decedent's death must be distributed to the trust in equal annual installments over the surviving spouse's life expectancy. The income earned on the undistributed portion of the account balance received during the calendar year was required to be distributed to the trust annually, by the close of the calendar year. On the surviving spouse's death, any undistributed balance of the IRA was required to be distributed to the trust. Under this set of facts, the Service ruled that both the IRA and the QTIP Trust qualified for the marital deduction since all of the income on both the undistributed portion of the IRA and the distributed portion were payable to the surviving spouse. There was no comment about the provision which required that the IRA be paid to the trust at the surviving spouse's death.

2. Revenue Ruling 2002-2. Rev. Rul. 89-89 was obsoleted by Rev. Rul. 2002-2, 2000-3 I.R.B. 305 (1/18/2000). In that Ruling, the decedent's IRA was payable to the trustee of a QTIP trust over the life expectancy of the surviving spouse in accordance with the Treas. Regs. §1.401(a)(9). The trust also met the

requirements of the Regulations to make the QTIP trust a "designated beneficiary".[14] The spouse had the ability to compel the trustee to withdraw from the IRA any amount of income in excess of the required minimum distribution and to pay such amount to her. The Service states its conclusion as follows:

> Under the terms of the testamentary trust, [spouse] is given the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all the income earned on the assets held in the IRA and pay that amount to [spouse]. If [spouse] exercises this power, the trustee must withdraw from the IRA the greater of the amount of income earned on the IRA assets during the year or the annual minimum required distribution. Nothing in the IRA instrument prohibits the trustee from withdrawing such amount from the IRA. If [spouse] does not exercise this power, the trustee must withdraw from the IRA only the annual minimum required distribution.
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> [Spouse's] power to compel the trustee's action meets the standard set forth in section20.2056(b)-5(f)(8) for the surviving spouse to be entitled to all the income for life payable annually. Thus, [spouse] has a qualifying income interest for life within the meaning of section 2056(b)(7) in both the IRA and the testamentary trust. Furthermore, [spouse] has a qualifying income interest for life in the IRA and the testamentary trust for purposes of sections 2519 and 2044 . Because the trust is a conduit for payments equal to income from the IRA to [spouse], decedent's executor needs to make the QTIP election under section 2056(b)(7) for both the IRA and the testamentary trust.

B. THE PRESENT RULES. In Rev. Rul. 2006-26, modifying and superseding Rev. Rul. 2002-2, the Service still clings tenaciously to the concept of the IRA as a "trust" separate from the QTIP trust and that the IRA must itself qualify as a QTIP trust which requires a separate election. This ruling postulates three different situations and then determines the effect of each of them.

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14 The Ruling states that the remainder beneficiaries under the trust were the children of the decedent, and that "no other person had a beneficial interest in the trust." That would seem irrelevant to the trust's status as a designated beneficiary since the trust is a "conduit" trust.

1. Facts. *A* dies, survived by spouse *B* with an IRA which names the trustee of a testamentary trust designed to qualify as a QTIP trust as beneficiary of the IRA. *B* is the income beneficiary of the trust, with children as remainder beneficiaries.[15] The trust meets all the technical requirements of Treas. Regs. §1.401(a)(9)-4, Q&A- 4 and 5. The spouse has a power, as in Rev. Rul. 2002-2, to compel the trustee to withdraw all the income from the IRA and to distribute such income to *B*. If the required minimum distribution exceeds the income of the IRA, any excess is allocated to principal, so that the trust in this ruling is not a conduit trust.

2. Situation 1 - Authorized Adjustment Between Principal and Income. The trust in this situation is governed by the laws of a state which has adopted the Uniform Principal and Income Act (UPIA) as well as the Uniform Prudent Investor Act.

a. *Facts*. The state's version of UPIA contains §104(a) allowing the trustee to make adjustments between principal and income, if such adjustments are necessary to fulfill the trustee's duty of impartiality. The state's UPIA also incorporate §409(c) which provides that required distributions from an IRA to a trust which are not characterized as interest, dividends or rent[16] are to be allocated 10% to income and the balance to principal. UPIA also directs in §409(d) that, if additional allocations of income are required to qualify the trust for the marital deduction, such excess allocation shall be made.[17] For each tax year, the trustee determines the income

[15] Once again, the Service asserts that no person other than *B* and the children have an interest in the trust adding "(including any contingent beneficial interest)". My unconfirmed suspicion is that the gift to the children is on a *per stirpes* basis. At least in this Ruling, the trust is not a conduit, so that may be a relevant fact in determining whether the trust can have a designated beneficiary and who is the measuring life.

[16] Minimum required distributions from a custodial IRA are never characterized as to source.

[17] The Ruling characterizes UPIA §409(d) as a "savings clause" and questions whether it would be effective absent the requirement in the Ruling that the income of the IRA be separately determined so that allocation to principal or interest of the amount distributed

of the trust without regard to the income of or the distributions from the IRA.

b. *Analysis*. Because the trustee determines the income of the QTIP separately and in accordance with state law and distributes all such income to the spouse, the Ruling determines that the trust qualifies for the marital deduction. Similarly, since the spouse has the authority to require the trustee to withdraw and distribute the income of the IRA (determined separately) to *B*, the IRA also qualifies for QTIP treatment. In brief, state law provisions, coupled with the power of the spouse to compel distributions of the IRA "income", creates a situation in which the marital deduction is available.

c. *Caveat.* The Service cautions, however, that, if the trust does not direct that the income of the IRA must be distributed if the spouse compels withdrawal from the IRA, then the requirements for the marital deduction "*may* not be satisfied" (emphasis added) unless the trust waives the application of UPIA §409(c).

3. Situation 2 – Unitrust Income Determination. Under state law, if the instrument so provides or all beneficiaries agree, income of a trust may be 4% of the value of the assets in a trust, determined annually.

a. *Facts.* In this situation, the trust is a 4% unitrust. The trustee determines 4% of the value of the assets of the trust without regard to the value of the IRA assets. If *B* exercise *B*'s withdrawal right, the trustee will withdraw the greater of 4% of the value of the IRA or the minimum required distribution and distribute at least 4% unitrust amount to *B*.

b. *Analysis*. The state law unitrust amount satisfies the

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by the IRA is irrelevant in determining the income to which the spouse is entitled. Ironically, Example 5 of §104 of UPIA contemplates that the power to adjust will be exercised taking into consideration the overall return of the trust, treating the IRA as an asset of the trust and not a separate trust. *See also* official comment to UPIA §409(d).

all income requirement of Treas. Regs. §20.2056(b)-5(f)(1) and the reasonable apportionment requirement of Treas. Regs. §1.643(b)-1. Thus, both the IRA and the marital trust qualify as QTIPs. The Service goes on to note that if the state also had the right to adjust in UPIA §104(a), and if the income of the trust were determined under that standard while the income of the IRA were determined under the unitrust standard, or *vice-versa*, each would still qualify.

4. <u>Situation 3 – "Traditional" Definition of Income</u>. The state law in this situation does not include UPIA. The right of withdrawal in *B* and the income of the trust and the IRA are separately determined.

a. *Facts*. The income of both the IRA and the trust are determined based upon a reasonable allocation between income and principal under state law. If *B* exercise *B*'s withdrawal right, the trustee will withdraw the greater of the income of the IRA or the minimum required distribution and distribute at least the income of the IRA to *B*.

b. *Analysis*. Since income is determined under state law, and since *B* has an unfettered right to access the income of the IRA, both the IRA and the trust qualify for QTIP treatment. The Service notes that the same would be true even if the state law incorporated UPIA §104(a) and the trustee determined not to make the adjustments allowed by such provision.

5. <u>Other Observations</u>.

a. *By the IRS*. The IRS also notes that the result would be the same if the trustee were required to withdraw and distribute all income of the IRA rather than the spouse having a power to compel such action. The same rules apply to defined contribution qualified retirement plans (*e.g.,* a 401(k) plan). At the end of the PLR, the Service reiterates that if distributions from the IRA or qualified plan are accumulated in the trust (*i.e.,* the excess of the minimum required distribution over the income of the trust no matter how determined), then the spouse is not the sole beneficiary, and remainder beneficiaries must be taken into account in determining the oldest

beneficiary and whether all beneficiaries are individuals.

b. *By the Author.* For 17 years, since Rev. Rul. 89-89, the Service has maintained that the IRA is to be treated as a separate trust from the QTIP rather than an asset of the QTIP. This position makes no more sense today than when it was first promulgated. Perhaps the biggest flaw in the "logic" of this position is that the vast majority of IRAs are custodial accounts, and the custodians do not allocate receipts and disbursements between income and principal, thereby making it difficult if not impossible for the trustee to know what to withdraw. Is it the trustee or custodian's duty to determine the income of the IRA? Additionally, the Service "neatly" solves the problem of taking remainder beneficiaries into account by reciting as a fact that "no other person has an interest in the trust." Those of us who draft trusts or beneficiary designations would have provided for what happens if a child predeceases the surviving spouse.[18]

c. *Other State Laws.* Not all states that have adopted UPIA have adopted §409(c) as it exists in the Uniform Act. Pennsylvania has adopted a statute which looks at income inside the IRA to determine what portion of a distribution is income. 20 PA. C.S. §8149(c). This would be irrelevant under the Ruling's approach which requires that all income of the IRA, whether distributed by the IRA custodian or not, be available to the spouse. And, this approach does not solve the problems that the custodian does not allocate between income and principal. Texas has adopted a unitrust approach in determining what portion of a *required* distribution constitutes income. Texas Trust Code §116.072(c).

6. Prospective Application. The Ruling provides that it will be applied prospectively only for taxable years beginning after May 30, 2006 with respect to Situations 1 and 2. It is strange that the effective date is couched in terms of taxable years when the issue is not an income tax issue, but rather qualification as a QTIP trust.

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18 A detailed discussion of Treas. Regs. §1.401(a)(9) is beyond the scope of this paper, particularly as the regulations concern the identity of trust beneficiaries.

7. Drafting Considerations. A draftsman should take care that the following provisions are included in the QTIP trust provisions if a qualified plan or IRA is to be paid to the trustee of the QTIP:

a. *Withdrawal of IRA Income.* The QTIP must direct the trustee to withdraw all the income from the IRA and distribute same to the beneficiary spouse, or, alternatively authorize the spouse to compel the trustee to withdraw and distribute all income from the IRA. To be on the safe side, income should be determined in accordance with the state law governing trusts. (This is the problem, as noted before, with the approach of treating the trust as a separate "trust".)

b. *Decision as to "Conduit" Approach.* The trustee will be obligated to withdraw the required minimum distribution from the IRA whether it exceeds the income or not. If all the distributions from the IRA are payable to the spouse, then the identity of remainder beneficiaries is irrelevant in determining the qualification of the spouse as a designated beneficiary. If the amount of the required minimum distribution is not to be distributed, care must be taken in identifying the remainder beneficiaries.

c. *Unitrust.* Defining the income of the IRA in terms of a unitrust amount, if permitted by state law, could solve several issues. First, it obviates the problem of trying to figure out the income. Second, if only income is to be distributed to the spouse, a 3% unitrust limits the amount of income required to be distributed. (A 5% unitrust would, of course, be more generous.)

**VIII. THE KINDER AND GENTLER IRS.** Under Treas. Regs. §1.401(a)(9)-4, Q&A-4(a), a designated beneficiary is a person named in a beneficiary designation or by the plan who remains a designated beneficiary on September 30 of the year following the year of death of the participant (known as the "beneficiary determination date"). This delayed determination allows for post-mortem planning to correct deficiencies which may deprive a beneficiary of the status of a designated beneficiary. Only a designated beneficiary is allowed to take distributions over his or her life expectancy, and all beneficiaries of the IRA or plan must be designated

beneficiaries.

A. STATEMENT OF THE PROBLEM. In almost every case involving payment of retirement benefits after the death of the participant, one of the primary goals is assuring that the recipients of the benefits are "designated beneficiaries".[19] The rules for identifying designated beneficiaries, especially where a trust is involved, can be, at best, a tricky task. And, many times, the draftsman fails to provide a beneficiary designation and/or trust provisions that will result in designated beneficiaries. The question then becomes whether there is anything that can be done to cure the problem.

B. THE CURE FOR THE PROBLEM. Recently, the IRS has issued several private letter rulings indicating that it will honor timely post-mortem judicial reformations to trusts and beneficiary designations to modify provisions that prevent the beneficiary being as designated beneficiary ("DB").

1. Bosch. In *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), the Supreme Court stated that the IRS is not bound by lower state court orders. However, where state law is clear, the federal courts and the IRS are bound thereby. Thus, in the reformation cases discussed below, *Bosch* should not apply where there is no issue that the reformation is permitted under state law.

2. IRS Ruling Position. Irrespective of whether *Bosch* technically applies, the IRS has chosen to ignore it in a recent spate of letter rulings. Additionally, the IRS has recognized post-mortem amendments made pursuant to the terms of the instrument where the amendment is for the purpose of qualifying the trust as a designated beneficiary.

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The failure to have a designated beneficiary results in a much more rapid payout than necessary. If the participant dies before attaining the required beginning date of age 70-1/2, the benefits must be distributed within five years. IRC §401(a)(9)(B)(i). If the participant dies after the required beginning date, then the benefits must be distributed not less rapidly than the participant was required to withdraw such benefits (usually over the participant's life expectancy). IRC §401(a)(9)(B)(ii). Payments to a designated beneficiary are made over the designated beneficiary's life expectancy whether the participant had reached the required beginning date or not. IRC §401(a)(9)(B)(iii).

3. Why This Is the Right Result. In the latest set of "Final" regulations in 2002, the concept of a "beneficiary determination date" was introduced. Treas. Regs. §1.401(a)(9)-4, A-4. A beneficiary must be named in either a beneficiary designation or under the plan, but the final determination ass to who counts as a beneficiary is made on September 30 of the year following the year of death of the participant. A judicial reformation or modification permitted by the instrument can be employed to create a situation which permits ceratin beneficiaries (including remainder and contingent beneficiaries) to be excluded from the class of beneficiaries used to determine the existence of a DB.

C. THE CONDUIT TRUST SOLUTION. If a trust is the beneficiary of the retirement plan, and if all distributions from the retirement plan must be distributed so that no amount of distributions can be accumulated in the trust, then any subsequent beneficiary is treated as a "mere successor" and is not counted in determining designated beneficiaries. Treas. Regs. §1.401(a)(9)-5, A-7(c)(1). This type of trust is commonly referred to as a "conduit" trust, even though such term is not used in the regulations.

1. Power of Appointment. If retirement benefits are payable to a trust over which the beneficiary has a power of appointment, and if the trust is not a conduit trust, then it may not qualify as a designated beneficiary because the potential appointees must be taken into account. Only a very carefully drafted special power of appointment limiting appointees to individuals younger than the current beneficiary will solve that problem. And, of course, if the trust is a non-exempt trust for GST purposes, then a general power is used. A conduit trust solves this problem. If the trust is not drafted as a conduit trust, then a modification prior to the beneficiary determination date could solve the problem. While there are no specific letter rulings dealing with this technique, the PLRs discussed below give ample comfort that this will work.[20]

2. Judicial Modification.

a. *PLR 200620026*. This PLR approves a court

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*See* PLR 200537044 in which the Service approved a post-mortem modification which limited a power of appointment to individual beneficiaries who were younger than the beneficiary as satisfying the requirements to make the beneficiary a DB. The reasoning is somewhat convoluted (and not totally accurate), but the result is correct.

modification without really stating what the reformation was. It simply says, "Subsequent to the death of Taxpayer A, Court W, County V, State U, represented to be a court of competent jurisdiction, modified and reformed Trust T effective as of Date 2 [the date of A's death]." The PLR holds, "That Trust T, as amended, is a qualified 'See-Through Trust' within the meaning of section 1.401(a)(9)-4 of the 'Final' Income Tax Regulations, Question and Answer-5."[21] One can only assume that the amendment was to create a see-through trust, but that is nowhere stated in the PLR.

b. *PLR 200608032.* As in PLR 200620026, PLR 200608032 does not state what amendments were made to Trust T created by the decedent, but does give the terms of Trust T after the amendments. One can only assume that the terms given in the ruling were the ones placed there as a result of the amendments. Taxpayer G, the youngest of six children, is a beneficiary of Trust T, which, in turn is the beneficiary of decedent's IRA. She has no children, and at her death the trust beneficiary becomes H, her husband. If H does not survive, or at H's death, the trust passes to the decedent's descendants, none of whom may be older than the decedent's oldest child. The IRA was divided into separate shares for each Trust T beneficiary. All shares except Taxpayer G's share were distributed outright from Trust T. (The Service, in keeping with its longstanding position that one cannot create separate shares if a single trust is the beneficiary, denied separate share treatment and thus the oldest child of the decedent was the measuring life over which G's trust could be distributed, irrespective of the fact that the oldest child's share of the IRA was distributed outright.)

After amendment, "Provisions of Taxpayer G's Trust provide for payment to her of income, principal (at the Trustee's discretion), and indicate that

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The cited regulation does not really deal with the determination of designated beneficiaries, but only states that beneficiaries of a trust, not the trust itself, may be treated as designated beneficiaries. Question and Answer-5(a). For convenience, the trust itself is often referred to as a designated beneficiary. It is interesting that when the IRS refers to the 2002 §1.401(a)(9) regulations in PLRs, it consistently refers to them as the "Final" regulations.

Decedent's intent in creating the trust was to provide for Taxpayer G's education, health, maintenance, comfort and general welfare during her lifetime." The IRS concludes, "That Trust T, as amended, is a qualified 'See-Through Trust' within the meaning of section 1.401(a)(9)-4 of the 'Final' Income Tax Regulations, Question and Answer-5."

3. Non-Judicial Modification. In PLR 200607031, the IRS determined that a post-mortem amendment by an individual trustee to require payment to then current beneficiaries of all distributions from the retirement benefits of the decedent qualified the trust as a conduit trust. Prior to the amendment, the trust employed a HEMS standard. Curiously, the only persons interested in the trust were the current beneficiaries, who were the spouse, two children, and a grandchild, and the ruling does not give any indication that there were other beneficiaries. This, I guess, is consistent with the fact situation in Rev. Rul. 2006-26, *supra*, in which the Service blithely declared that no other person had an interest in the trust. Indeed, if that is the case, the amendment would appear unnecessary.

D. ELIMINATION OF CERTAIN BENEFICIARIES. Under Treas. Regs. §1.401(a)(9)-4, A-3, if there are multiple beneficiaries of a trust, any of whom cannot be a DB, then there is no DB at all. If the gifts to non-qualifying beneficiaries, such as charities, can be satisfied prior to the beneficiary determination date, commonly referred to as the "shake-out period", then the qualifying beneficiaries can be treated as DBs. This technique was employed successfully in PLR 200608032 by use of a judicial reformation. The Trustee of the trust directed the custodian of the IRA to divide the IRA into separate shares for each beneficiary (including each of the charitable beneficiaries). One amendment to the trust prohibited the payment to the charities after the beneficiary designation date. One wonders why the amendment was made, since satisfaction of the charitable gifts before the beneficiary determination date would have accomplished the same result.[22]

E. REFORMING BENEFICIARY DESIGNATION. In PLR 200616041, a beneficiary designation was judicially reformed, retroactive to the creation of the transferee IRA. In this situation, the participant had executed a trustee to trustee

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22 The Service declined to rule on the income tax effect of the payment of a pecuniary gift from a trust. As noted above, gifts directly from the IRA to a charity clearly avoid IRD problems. *See* Christopher Hoyt, "IRA Bequests to Charities," Vol. 145, No. 9 *Trusts and Estates* 38 (September, 2006).

transfer prior to his death. The spouse, who died shortly after the decedent, was the primary beneficiary of both IRAs. Decedent's daughters had been the contingent beneficiaries prior to the transfer, but no contingent beneficiaries were named in the new beneficiary designation. The personal representative of the deceased spouse wished to disclaim. State law provided that a trust can be reformed after the death of the creator for a unilateral drafting mistake if there is clear and convincing evidence. (Evidently, the court and the IRS treated the IRA beneficiary designation as the equivalent of a revocable trust.) A person who assisted decedent in effectuating the transfer provided an affidavit that the custodian of the IRA was instructed to add the daughters as contingent beneficiaries, but simply failed to do so. This seems to be sufficient evidence for the court and for the IRS to accept the court's decision. Since there were contingent beneficiaries, the Service held that the disclaimer by the personal representative was a qualified disclaimer.