SELECTED ISSUES IN ESTATE ADMINISTRATION (DEALING WITH QUALIFIED PLANS AND IRAS)

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CHAPTER 5.1

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DISTRIBUTION RULES FOR QUALIFIED PLANS AND IRAS

I. OVERVIEW OF FINAL REGULATIONS

A. Disclaimer And Scope Of Outline.

This paper is not intended to be an exhaustive treatise on the various tax and other aspects of all qualified plans and Individual Retirement Accounts, or "IRAs" (hereinafter sometimes referred to collectively as "retirement plans" where a distinction between the two is not necessary). The rules discussed in this outline will relate primarily to minimum distributions from defined contribution plans and traditional IRAs. An important date for estate planning practitioners is April 17, 2002. That is the date when the Treasury Department released final regulations relating to defined contribution plans and IRAs (sometimes referred to as the "new rules" in this paper, even though these rules are now eleven years old). The primary focus of this paper will be on these "new" rules.

B. Minimum Distribution Rules.

The amount and timing of distributions from retirement plans are prescribed by the "minimum distribution rules." These rules are generally contained in Section 401(a)(9) of the Internal Revenue Code (hereinafter sometimes referred to as "IRC" or the "Code"). These rules were initially set out in proposed regulations published on July 27, 1987, which were subsequently modified in December 1997 and again in January 2001. The final regulations released in April 2002 further modified the minimum required distribution (sometimes referred to as the "MRD") rules, providing much needed simplification and clarification of some issues, but also leaving many questions still unanswered.

1. Purpose Of Minimum Distribution Rules.

There are at least two purposes of the minimum distribution rules:

a. To Provide Retirement Benefits Primarily To The Employee (And His Spouse).
b. To Prevent Indefinite Postponement Of Income Taxes.

2. When Are Minimum Distributions Required To Commence?

a. Required Beginning Date.

As a result of amendments made by the Small Business Job Protection Act of 1996, P.L. 104-188, for taxable years after 1996, the required beginning date ("RBD") for an employee who does not own 5% or more of the employer sponsoring the qualified plan is April 1 of the year following the later of (i) the year in which the employee reaches age 70 ½ or (ii) the year in which the employee retires. *IRC §401 (a)(9)(A) and (C).* Five percent (5%) or more owners of companies sponsoring the retirement plan and IRA owners continue to have an RBD of April 1 following the calendar year in which they attain age 70 ½. *IRC §401 (a)(9)(C)(ii).* NOTE: To simplify understanding of the concepts discussed in this outline, it will be assumed that the person participating in a qualified plan or listed as the owner of an IRA, including an IRA rollover (hereinafter referred to collectively as the "participant"), is male and gender references will be made accordingly.

(1) Significance Of RBD Under "Old" Rules.

Under the "old" minimum distribution rules (i.e., the proposed treasury regulations originally released in 1987 and modified in 1997), the period of time over which the participant had to take minimum required distributions from his qualified plans and IRAs was basically determined as of the participant's RBD. A key factor in determining the distribution period was whether, as of RBD, the participant had named a "designated beneficiary" (sometimes referred to as "DB") of his qualified plan or IRA. If so, the participant was entitled to use some form of joint life distribution upon reaching RBD. Special options were available to the participant if he named his spouse as his DB. Some of these options, such as the life expectancy recalculation election, had both advantages and disadvantages. In all, at least six different distribution periods were possible under the old rules for a participant who reached his RBD.

(2) Old Rules Required Prescience At RBD.

Unfortunately, once the participant reached his RBD and began taking MRDs from his retirement plan, no change in beneficiary after that date could lengthen his distribution period (although a change in beneficiary could shorten it). Thus, beneficiary designations and elections made at RBD were basically irrevocable. In many cases, the distribution method locked in at RBD later proved to be disadvantageous for the participant or his

beneficiaries. For a complete discussion of the "old" minimum distribution rules, *see* Gerstner, *Designating Trusts as Beneficiaries of Qualified Plans and IRAs*, State Bar of Texas 10th Annual Advanced Drafting: Estate Planning and Probate Course, November 1999.

(3) Intervening Rules: The January 2001 Proposed Regulations.

The Treasury Department released new proposed regulations under Code Sections 401(a)(9) and 408 on January 17, 2001. The January 2001 proposed regulations worked a major overhaul of the prior proposed regulations and served as a precursor to the final regulations released in April 2002. Treasury solicited comments from practitioners regarding the new proposed regulations. For the most part, the somewhat drastic changes proposed by Treasury were well received. The new proposed rules greatly simplified the calculation of MRDs and fixed some serious problems under the old rules.

b. Lifetime Distributions To Participant Must Commence By Required Beginning Date.

RBD has much less significance under the final regulations. Primarily, it is the date by which MRDs to the participant must commence. Whether the participant has a designated beneficiary as of RBD is irrelevant, except if the participant is trying to use the exception to the standard distribution period when his much younger spouse is his beneficiary (*see* I.B.3.b, *infra*).

3. Distribution Periods During Participant's Life Under The New Rules.

Upon reaching his RBD, the participant must begin taking minimum required distributions from his qualified plan or IRA based on one of only two possible distribution periods. In the vast majority of cases, the "Uniform Lifetime Table" will apply. Thus, it is much easier to determine MRDs during the participant's life under the new rules.

a. Participant's "Young Spouse" Is **Not** Sole Beneficiary.

If the participant's beneficiary at RBD is anyone other than his more than 10 years younger spouse (referred to as the "young spouse" in this outline), then minimum required distributions from his retirement plan are calculated using the "Uniform Lifetime Table" found at Section 1.401(a)(9)-9, A-2 of the finalized Treasury Regulations. *See* Exhibit 1 attached. The divisor for the participant's age as of his birthday in each distribution year is obtained from the table and multiplied by the plan account balance on December 31 of the prior year (with certain adjustments). *See Treas. Reg. §1.401(a)(9)-5, A-1(a) and A-3*. The uniform table assumes that the participant has named as his beneficiary a person who is 10 years younger than himself (whether he has, in fact, done so). It is basically the old minimum distribution incidental benefit ("MDIB") table utilized under the proposed regulations to artificially limit a joint life distribution period during the participant's life whenever the participant had in fact designated a non spouse beneficiary more than 10 years younger than himself at RBD. In addition, the life expectancy factors reflected in all of the applicable tables have now been updated to reflect current mortality assumptions. These changes made by the new rules lengthen the distribution period for most participants compared to the old rules. Thus, if the participant names his close-in-age spouse as his DB, the new uniform table provides a longer distribution period (and, therefore, lower minimum required distributions) than an actual joint life distribution would provide.

b. Participant's Young Spouse **Is** Sole Beneficiary.

The only other table used for determining MRDs *during the participant's life* is the actual joint life table, the Joint and Last Survivor Table, found at Section 1.401(a)(9)-9, A-3 of the finalized Treasury Regulations. *See* Exhibit 2 attached. This table can only be used if the participant's young spouse (or a trust for his young spouse that is treated the same as the young spouse, discussed *infra* at IV.C.3.) is his sole designated beneficiary.

(1) Death Of Young Spouse After MRDs To Participant Commence.

Under the proposed regulations released in January 2001, in order to use the actual Joint and Last Survivor Table for determining his MRD in a particular year, the participant had to be married to the young spouse on the last day of the year. Practitioners commented to Treasury that if the young spouse died during the participant's life while still married to the participant, the participant should not be "penalized" by that fact by having to switch to the Uniform Table for calculating his MRD for the year of the young spouse's death. Treasury responded favorably to this comment by providing in the final regulations that if the participant and his sole DB young spouse are legally married on January 1, then the participant may use the Joint and Last Survivor Table for calculating his MRD for that year, even if the marriage terminates later that year due to divorce or the death of the young spouse. *Treas. Reg. §1.401(a)(9)-5, A-4(b)(2)*. However, the change in the participant's beneficiary due

to the death or divorce of the young spouse will affect the determination of his MRD in the following calendar year.

c. IRS Tables.

The distribution tables per the new rules provide living participants with the benefit of recalculating life expectancies each year, thus minimizing required distributions during the participant's life (compared to using a "fixed" life expectancy method). Because of the new rules for distributions upon the participant's death, recalculation during the participant's life under the new rules does not have the disadvantage that it had under the old rules (namely, causing a drop to zero in the life expectancy of the person's life who was being recalculated upon that person's death and thereafter drastically shortening the distribution period).

4. Key To Distribution Periods After Participant's Death: Designated Beneficiary.

Having a "designated beneficiary" provides the best income tax results (longer deferral) for the beneficiary/ies named to receive distributions from the participant's retirement plan upon the participant's death. With the exception of the young spouse situation, having a DB as of RBD no longer affects the distributions to the participant during his lifetime.

a. Who Is A Designated Beneficiary?

The term "designated beneficiary" is a term of art under the rules. Not every named beneficiary of a participant's retirement plans will be treated as a designated beneficiary. Only individuals can be designated beneficiaries. *Treas. Reg. §1.401(a)(9)-4, A-1 and A-3.* Thus, estates, charities and trusts are never designated beneficiaries. However, the final treasury regulations retain the special "look through" rules for trusts that are named as beneficiaries of retirement plans. *See Treas. Reg §1.401(a)(9)-4, A-5*, discussed in detail in Section IV, *infra*. If a trust meets certain requirements, then the beneficiaries of the trust may be treated as designated beneficiaries for purposes of the minimum distribution rules.

b. New Applicable Date For Determining Designated Beneficiary.

The designated beneficiary is no longer determined at the earlier of the participant's death or RBD. (The only exception is for a participant having a young spouse who wants to use the actual joint life table for calculating MRDs during his lifetime -- in that case, he must have named his young spouse as his sole DB as of his RBD.) Under the new rules, the participant's beneficiary is determined on September 30 of the year following the year of the participant's death. *Treas. Reg. §1.401(a)(9)-4, A-4(a)*. For ease of reference, this date will be referred to as the "DB Determination Date" (not an officially defined term). The time period between the participant's death and the DB Determination Date has sometimes been referred to as the "shakeout period."

(1) Beneficiaries Remaining On DB Determination Date.

The resultant designated beneficiary must have been "named" or "designated" by the participant or the plan and must effectively have been in place as a beneficiary as of the participant's death. *Treas. Reg. §1.401(a)(9)-4, A-4(a).* That is, new beneficiaries cannot be added "out of whole cloth" after the participant's death, but beneficiaries can be eliminated after the participant's death, and those who are left standing on the DB Determination Date will be treated as the actual beneficiaries.

(a) Death Of Beneficiary Before DB Determination Date.

Note, however, that if an individual named as a beneficiary of the participant's plan survives the participant but then dies before the DB Determination Date, unless that beneficiary executed a qualified disclaimer or received full distribution of the amount to which he was entitled from the participant's plan prior to the DB Determination Date, he will still be considered a beneficiary of the participant's plan for purposes of determining whether the participant had a designated beneficiary. *Treas. Reg. §1.401(a)(9)-4, A-4(c).*

(b) Beneficiary Who Dies Before DB Determination Date Is Determined To Be Designated Beneficiary.

If the deceased beneficiary discussed in (a) immediately preceding turns out to be the participant's designated beneficiary, distributions from the participant's plan after the participant's death will be made based on the non recalculated life expectancy of the (deceased) designated beneficiary. *Treas. Reg. §1.401(a)(9)-5, A-7(c)(2).* Amounts that would have been distributed to the designated beneficiary, had he been living, are to be paid to his/her successor beneficiary instead. (Note: This rule in the final regulations is different from the rule that was proposed in the 2001 proposed regulations).

(c) Post Death Designated Beneficiary Planning.

Because there can be a period of up to one year and nine months between the participant's date of death and the DB Determination Date (e.g., participant dies on January 1, 2003, making the DB Determination Date September 30, 2004), post-death planning opportunities exist to "change" the designated beneficiary. For the most part, changing the designated beneficiary will be accomplished by means of disclaimers and "cashouts" of less desirable beneficiaries.

(d) Post Death Planning For Successor Beneficiaries.

As noted, if the individual who is determined to be the participant's designated beneficiary survives the participant and then dies, regardless of whether that DB's death occurs before or after the DB Determination Date, the DB's life expectancy will still be used for determining MRDs to the beneficiaries of the participant's plan. Thus, all DB planning must be done before the DB Determination Date. On the other hand, once the participant has died, the DB (and all other non-DB beneficiaries entitled to distributions from the participant's plan, for that matter) should name a "successor beneficiary" to take distributions in the event of the DB's death prior to complete distribution of all amounts in the participant's plan. These subsequent beneficiaries can be anyone (including entities, non-qualifying trusts, older persons, etc.) because their life expectancy (or lack thereof) will not change the DB determination. Further, the concern under the proposed regulations that the beneficiary's naming of a successor beneficiary will disqualify the plan has been eliminated. *Treas. Reg. §1.401(a)(9)-5, A-7(c).*

c. Which Designated Beneficiary "Problems" Can Be Fixed After The Participant's Death?

Under the new rules, the possibility exists for getting rid of "bad" beneficiaries and for directing plan/IRA benefits to more desirable beneficiaries (through disclaimers) before the DB Determination Date. Therefore, more attention needs to be paid to post-death planning during the shakeout period.

(1) Disclaimers.

The new rules clearly take into account the effect of disclaimers done after the participant's death, whether the participant dies before or after RBD (there were some uncertainties regarding the effect of disclaimers under the prior rules). *Treas. Reg. §1.401(a)(9)-4, A-4(a).* Disclaimers can be used to "skip over" certain beneficiaries so that more desirable beneficiaries will be in place by the DB Determination Date. No matter when the participant dies, there will always be sufficient time to do qualified disclaimers before the date on which the participant's designated beneficiary has to be determined. The disclaimer option, however, will have to be examined right away due to the absolute nine month deadline for making a qualified disclaimer.

(2) Other Post-Death DB Planning Techniques.

If "bad" beneficiaries (e.g., charities) have been named by the participant as part of a group of multiple beneficiaries of a single plan or IRA and if they are fully "cashed out" (i.e., paid the entire amount to which they are entitled) before the DB Determination Date, then only the (human) beneficiaries still remaining as of the DB Determination Date will be taken into account in determining the designated beneficiary. *Treas. Reg. §1.401(a)(9)-4, A-4(a).* Also, in situations where multiple beneficiaries are named jointly as beneficiaries of the participant's retirement plan, if separate accounts can be created for each of them by December 31 of the year following the year of the participant's death, then each beneficiary will be treated as the sole beneficiary of his/her separate account (and, therefore, will be able to use his/her own life expectancy in calculating MRDs). *Treas. Reg. §1.401(a)(9)-8, A-2.* (For a discussion of creating separate accounts after the participant's death, *see* I.B.6., *infra*.) Other possible post-death actions designed to clarify or improve the designated beneficiary determination may be tried and *may* work as long as completed prior to the DB Determination Date. In more recent rulings, however, post-death trust modifications have not been successful to "fix" a defective trust. *See*, e.g., PLR 201021038 (May 28, 2010). Also, note that, except in very limited cases (usually involving a surviving spouse or charities as residuary estate beneficiaries), it is not possible to fix the "Estate" as beneficiary after death. *See*, e.g., *infra* at I.B.5.a.(1)(a), for rulings involving surviving spouses.

(3) **WARNING:** Avoid Hasty Spousal IRA Rollovers.

Because of the increased availability of post-death DB planning techniques, the surviving spouse should *not* rush into a spousal IRA rollover of the participant's plans/IRAs prior to obtaining advice from qualified tax and estate planning professionals because that would foreclose many of the post-death planning options. A spouse designated beneficiary may roll over the participant's IRA into a spousal IRA rollover *at any time* (even years after the participant's death), so there is no need to rush.

5. Required Distributions On Or After Death Of Participant.

There are only six (6) post-death minimum distribution rules, three (3) applicable if the participant dies before RBD and three (3) applicable if the participant dies after RBD.

a. Participant's Death **Before** RBD.

There are three rules that apply regarding distributions from retirement plans if the participant dies *before* reaching his RBD. Note that these "death before RBD" rules apply to distributions from Roth IRAs after the Roth IRA owner's death. The so-called "5-year rule" is no longer the main rule, but still applies in cases where there is no "designated beneficiary" as of the DB Determination Date. Hopefully, most participants will be deemed to have a designated beneficiary by the DB Determination Date so that the 5-year rule will not apply. It should be noted, however, that some qualified plans mandate distribution pursuant to the 5 year rule where the participant dies before his RBD (whether or not the recipient of the plan benefits qualifies as a DB under federal tax law).

(1) No Designated Beneficiary: 5 Year Rule.

If there is no DB as of the DB Determination Date, then the entire amount in the retirement plan must be distributed by December 31 of the year that contains the fifth anniversary of the participant's death. *Treas. Reg. § 1-401(a)(9)-3, A-4(a)(2).* The retirement plan benefits may either be distributed entirely in the fifth year, ratably over the five (5) year period, or in any other manner just as long as no amount remains in the plan after December 31 of the fifth year. If a charity (not a DB) is the participant's beneficiary as of the DB Determination Date, there is no reason to delay distribution since a charity is not subject to income tax on the retirement plan benefits it receives.

(a) Query: If Participant's "Estate" Is Plan Beneficiary, Does Participant Have A Designated Beneficiary? Answer: No.

The final regulations expressly state that an estate can never be a designated beneficiary (*see Treas Reg. §1.401(a)(9)-4, A-3 and §1.401(a)(9)-8, A-11*). Thus, if a participant has named his "Estate" as the beneficiary of his retirement plan (or if his *estate* is the default beneficiary per the terms of the plan), even though the participant's Will or state law will determine the ultimate beneficiaries of his "Estate" and even though those beneficiaries will actually receive his plan benefits, those recipients cannot qualify as DBs. Thus, if the participant dies before his RBD and his "Estate" is the beneficiary, the 5 year rule applies.

(b) Query: Can "Estate" Be Bypassed As The Beneficiary (i.e., Is This Beneficiary Designation "Fixable" After Participant's Death)? Answer: No.

When the proposed regulations were released in January 2001, changing the date for determining the designated beneficiary, estate planning practitioners began discussing whether any post-death planning techniques could be utilized during the shakeout period to try to bypass the participant's estate altogether as the beneficiary of his retirement plan benefits and avoid the "No DB" rule. Practitioner's posited that if the executor/administrator of the participant's Estate were able to "assign" or "distribute" the plan/IRA to the beneficiaries of the Estate before the DB Determination Date, then perhaps the 5 year rule could be avoided. Does this technique work? The answer is "No" (except in certain cases with the right facts involving spouses and charities). After the final regulations were published, the answer to this question was confirmed by Marjorie Hoffman, Attorney, Senior Technical Reviewer, Tax Exempt/Government Entities, of the Internal Revenue Service ("IRS") and one of the principal authors of the final MRD regulations, in an ALI-ABA presentation on May 23, 2002. Thus, participants should be cautioned against listing their "Estate" or the "Executor" of their Estate or "per Will" as the beneficiary of their retirement plans. Also, a common default in qualified plan documents and IRA agreements in the case where the participant fails to name a beneficiary is that the participant's benefits will be paid to his "estate," so all plan participants should make sure they have named both a primary beneficiary and a contingent beneficiary of their retirement plan.

(c) Reason For Estate Beneficiaries Failing DB Qualification: Only Beneficiaries Named By Participant (Or Plan) Can Be DBs.

The reason why this approach fails is due to the rule that the designated beneficiary must be "named by" the participant (or named by the plan). *Treas. Reg. §1.401(a)(9)-4, A-1.* The final regulations provide: "The fact that an employee's interest under the plan passes to a certain individual under a will or otherwise under applicable state law does not make that individual a designated beneficiary". Pursuant to a similar provision in the January 2001 proposed regulations, intestate heirs of an estate seemed to be clearly precluded from qualifying as DBs, but

those proposed regulations left some doubt about the status of beneficiaries named in a Will. The final regulations clarify that neither intestate heirs nor Will beneficiaries can qualify as DBs where the participant (or the plan) has named the participant's "Estate" as the beneficiary of his retirement plan benefits.

(2) Participant's Spouse Is **Not** Sole Designated Beneficiary.

If the participant has named one or more designated beneficiaries but the participant's spouse is *not* his sole designated beneficiary, MRDs from his retirement plan after his death must be taken by the beneficiary/ies over the (oldest) beneficiary's life expectancy. *Treas. Reg §1.401(a)(9)-5, A-5(b) and (c)(1).* The divisor for the DB's age as of his/her birthday in the year following the year of the participant's death (i.e., in the first distribution year) is taken from the single life expectancy table (Single Life Table, Treas. Reg. § 1.401(a)(9)-9, A-1). *See* Exhibit 3 attached. This divisor is reduced by 1 in each subsequent year. Distributions based on the DB's life expectancy must begin by December 31 of the year following the year of the participant's death. *Treas. Reg. §1.401(a)(9)-3, A-3(a) and §1.401(a)(9)-5, A-5(b) and (c)(1).* If there are multiple beneficiaries of a single plan/IRA and separate shares/accounts are timely created, then each DB can use his own life expectancy to calculate post-death MRDs. (For a discussion of the creation of separate accounts, *see* I.B.6., *infra*.)

(a) "Inherited" IRA Rules.

The DB's life expectancy may *not* be recalculated each year in this situation and the DB may *not* "roll over" the benefits to his/her own participant IRA. *IRC §408(d)(3)(C).* What a beneficiary receives on the death of the participant is an "inherited IRA" and not a participant IRA The "inherited IRA" must reflect the deceased participant's name and/or otherwise indicate that it is an "inherited IRA." For example, the "inherited IRA" may be titled like this: "John Jones, Deceased, IRA fbo Mary Smith" (with "fbo" representing the words, "for the benefit of" and with Mary Smith being the beneficiary of what used to be John Jones' participant IRA before he died, but is now Mary Smith's "inherited IRA"). While the participant's beneficiary cannot "roll over" the participant's IRA into a new participant IRA for the beneficiary, the beneficiary may make a trustee to trustee (or custodian to custodian) transfer of an inherited plan or inherited IRA to another custodian (to facilitate achievement of investment objectives, for example). *See Rev. Rul. 78-406, 1978-2 C.B. 157; Rev. Proc. 89-52, 1989-2 C.B. 632; PLR 200228025 (July 12, 2992); and PLR 9250040 (December 11, 1992).*

(b) **IMPORTANT:** ***This Rule Applies To Accumulation Trusts***.

An accumulation trust that is named as the beneficiary of a retirement plan will fall under this rule, even if the surviving spouse is a beneficiary of the trust and even if the surviving spouse is treated as the participant's DB due to being the oldest of all of the trust beneficiaries. On the other hand, "conduit" trusts and "grantor" trusts, discussed *infra* at IV.C.3., are treated differently than accumulation trusts in this regard.

(3) Participant's Spouse **Is** Sole Designated Beneficiary.

If the participant has designated his spouse (or a trust for his spouse that is treated the same as the spouse – *see* IV.C.3., *infra*) as the sole beneficiary of his retirement plan and he dies *before* his RBD, the spouse has three options.

(a) Spouse's Option #1: Commencement Of Distributions When Participant Would Have Attained 70 ½.

In this situation (participant's death *before* RBD), a surviving spouse sole DB need not begin taking minimum required distributions from the participant's retirement plan until December 31 of the calendar year in which the participant would have attained age 70 ½. *Treas. Reg. §1.401(a)(9)-3, A-3(b)(2).* If this option is elected, the participant's retirement plans will remain in his name and the spouse will be taking distributions as a beneficiary. Thus, any distributions taken by the spouse prior to the required beginning date for minimum distributions will be discretionary and will *not* be subject to the early withdrawal penalty, regardless of the spouse's own age.

(i) Distribution Period For Sole DB Spouse.

When the spouse begins taking minimum required distributions from the *participant's* retirement plan, she will take them over her life expectancy, recalculated each year. *Treas. Reg §1.401(a)(9)-5, A-5(b) and (c)(2).* The divisor for distributions to the sole DB spouse in this case is taken from the single life table *each year* the spouse is living. *See* Exhibit 3. Under the new rules, she can name a beneficiary ("successor beneficiary") to take the amount remaining in the participant's retirement plan upon her death (and, unless the spouse takes more than the MRD each year, there will always be an amount remaining in the plan in this situation due to

recalculation of the spouse's life expectancy each year), and this will not disqualify the plan or alter the initial DB determination. *Treas. Reg. §1.401(a)(9)-5, A-7(c).*

(ii) Spouse's Death Before MRDs Commence.

If the sole DB spouse dies *before* distributions from the participant's retirement plan have commenced, the successor beneficiary must commence taking MRDs by December 31 of the year following the year of the spouse's death. MRDs to the successor beneficiary are taken over the beneficiary's non-recalculated life expectancy. The successor beneficiary is treated as the spouse's DB if living on September 30 of the year following the year of the spouse's death. *Treas. Reg. §1.401(a)(9)-4, A-4(b), §1.401(a)(9)-3, A-5, and §1.401(a)(9)-3, A-3(a).* If there is no successor DB, then the 5 year rule applies under these circumstances. *Treas. Reg. §1.401(a)(9)-4, A-4(b).*

(iii) Special Limitation Applicable To Beneficiary Spouse's New Spouse.

Even if the spouse's new spouse is her sole successor beneficiary, in this particular situation (participant dies before his RBD with spouse as sole DB and she dies before MRDs have commenced to her), in determining MRDs from the participant's plan, the participant's spouse's new spouse cannot recalculate his life expectancy each year. *Treas. Reg. §1.401(a)(9)-3, A-5 [last sentence].*

(iv) Spouse's Death After MRDs Commence.

If the participant's spouse dies *after* MRDs have commenced from the participant's retirement plan, the final MRD attributable to the participant's spouse for the year of her death must first be taken and then the successor beneficiary must commence MRDs by December 31 of the year following the spouse's year of death. In this situation, MRDs to the successor beneficiary (whether such beneficiary qualifies as a DB or not) are based on the spouse's remaining, non-recalculated life expectancy. *Treas. Reg. §1.401(a)(9)-5, A-5(c)(2) [last sentence].*

(b) Spouse's Option #2: Rollover Of Qualified Plan Benefits To IRA Rollover In Spouse's Name.

A surviving spouse who is the designated beneficiary of the participant's qualified plan may roll over all eligible amounts to an IRA rollover in her own name. *Treas. Reg. §1.408-8, A-7.* She will then be treated as the participant of her IRA rollover and, as a result, required distributions need not commence until *her* RBD. *IRC §§408(d)(3), 402(a)(7), 402(c)(9), 401(a)(9)(A).* [NOTE: Prior to January 1, 2002, however, the spouse could not roll over the deceased participant's qualified plan benefits to another qualified plan. *Treas. Reg. §1.402(c)(2), A-12(a).* The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), P.L. 107-16, generally effective for tax years beginning after December 31, 2001, expanded the spousal IRA rollover provisions to allow surviving spouses to roll over the deceased spouse's interest in a qualified plan to certain qualified plans in which the spouse participates. *See* EGTRRA, Section 641(d) of Subtitle D - *Increasing Portability for Participants*, amending IRC Section 402(c)(9).] If the spouse takes a distribution before reaching age 59 ½ in this situation (where she has rolled over the deceased participant's qualified plan into a new plan or IRA in which she is now the participant), the distribution ***will*** result in a penalty for early withdrawal (unless some other exception under IRC Section 72(t) applies) because the spouse is now the participant of the new IRA rollover/plan in her name.

(i) After Spousal IRA Rollover: Apply Rules With Spouse As Participant.

When the spouse begins taking MRDs from her IRA rollover at her RBD, she will use the Uniform Lifetime Table, unless her (new) young spouse is her *sole* beneficiary as of her RBD. In determining MRDs in this situation, the rules are applied with the spouse now being treated as the participant. *Treas. Reg. §1.408-8, A-5(a).*

(c) Spouse's Option #3: Spouse's Election To Treat Participant's IRA As Her Own.

A surviving spouse who is the designated beneficiary of the participant's IRA may elect to roll it over into a new spousal IRA rollover in her own name or treat the participant's IRA as her own. *Treas. Reg. §1.408-8, A-5(a) and A-8.* The effect of the latter is the same as a spousal IRA rollover. Distributions from the spousal IRA rollover need not commence until the surviving spouse's RBD. *IRC §408(d)(3)(C)(ii); Treas. Reg. §1.408-8, A-5(a).* If the surviving spouse fails to take distributions from the *participant's* IRA by the date that would have been the participant's RBD, it will be assumed that she has elected to treat the IRA as her own where she has not yet reached her own RBD. *Treas. Reg. §1.408-8, A-5(b)(1); Treas. Reg. § 1.408-2(b)(7)(ii).* Again, if the spouse takes a distribution after the date that would have been the participant's RBD and before she

reaches age 59 ½, the distribution ***will*** result in a penalty for early withdrawal (unless some other exception under IRC Section 72(t) applies) because the spouse is now the participant of the new IRA rollover in her name.

(d) Naming A Trust For Spouse's Benefit Versus Naming Spouse Directly As Beneficiary.

(i) Naming An Entity As Beneficiary Usually Precludes Spousal IRA Rollover Option.

The spousal IRA rollover option will usually only be available to a surviving spouse in situations where she is the "outright" designated beneficiary of the participant. The spousal IRA rollover option will ordinarily be foreclosed in cases where the participant's estate or a trust created by the participant is named as the beneficiary (even if the spouse is the sole current beneficiary of the estate or trust). *See Treas. Reg. §1.408-8, A-5(a).* Even if the retirement plan actually reaches the spouse due to action taken by the executor or trustee (such as a discretionary distribution), so that she obtains "possession" of the participant's retirement plan, the IRS takes the position in these cases that because the spouse is not receiving the plan benefits from the participant but from a third party, she cannot effect a spousal IRA rollover. There are some cases, however, based on certain important facts, where spousal IRA rollovers have been allowed even if an estate or trust was the participant's named beneficiary. The successful spousal IRA rollover cases involve situations where the spouse as fiduciary or beneficiary basically has an unlimited withdrawal right over the plan/IRA. *See* X., *infra*.

(ii) No "Spouse As *Sole* DB" Treatment For Accumulation Trusts, Even If Spouse Is Sole Current Trust Beneficiary.

Even if the spouse is the sole current beneficiary of a trust that has been named as the beneficiary of the participant's retirement plan (e.g., a QTIP Trust), she will not be treated as the sole DB of the participant under the rules unless the trust is either a "conduit" trust or a "grantor" trust. This is because the remainder beneficiaries of an accumulation trust *could* ultimately receive distributions from the participant's retirement plan made to the trust during the spouse's life and, therefore, the remainder beneficiaries have to be considered beneficiaries along with the spouse. *See* IV., *infra*.

(iii) Special Commencement Date Option Should Still Apply To Conduit/Grantor Trust For Participant's Spouse.

If a trust for the participant's spouse qualifies as a conduit or grantor trust (as to the spouse), although the IRA rollover option will usually be foreclosed (except in the case of a grantor trust over which the spouse possesses an unlimited withdrawal power over the participant's retirement plan and exercises it), the first spousal option discussed above (delay in commencing MRDs until the participant would have reached age 70 ½) should still be available.

b. Participant's Death **After** RBD.

If the participant dies *on or after* reaching his RBD, the commencement date for the participant's beneficiary/ies will be December 31 of the year following the year of the participant's death. *Treas. Reg. §1.401(a)(9)-3, A-3.* The distribution period depends on whether the participant has a DB by the DB Determination Date and, if so, who it is. A "regular" minimum distribution attributable to the participant will be required to be made by December 31 of the year of the participant's death (to the extent not already paid to the participant before his death). *Treas. Reg. §1.401(a)(9)-5, A-4(a)(1); Treas. Reg. §1.408-8, A-4 and A-5(a).* The post-death MRD attributable to the participant is paid to his beneficiary/ies. *Treas. Reg. §1.401(a)(9)-5, A-4(a) [last sentence]; Treas. Reg. §1.408-8,A-5(a) [last sentence - involving the case where the participant's spouse is his DB].*

(1) No Designated Beneficiary.

If there is no DB as of the DB Determination Date, then distributions from the participant's plan are made over the participant's remaining, non-recalculated life expectancy. *Treas. Reg. §1.401(a)(9)-5, A-5(a)(2).* The divisor for the participant's age as of his birthday in the year of his death is obtained from the Single Life Table and the number 1 is then subtracted in each subsequent year to calculate the MRD for the relevant year. *Treas. Reg. §1.401(a)(9)-5, A-5(c)(3).* MRDs to the resulting beneficiary must commence by December 31 of the year following the year of the participant's death. *Treas. Reg. §1.401(a)(9)-5, A-5(a)(2) and (c)(3) and §1.401(a)(9)-3, A-3(a).*

(2) Participant's Spouse Is **Not** Sole Designated Beneficiary.

If the participant has named one or more designated beneficiaries of a single plan or IRA, so that the participant's spouse is not his sole DB, then distributions are made from the participant's plan over the (oldest)

beneficiary's non-recalculated life expectancy or, if longer, over the participant's remaining life expectancy, not recalculated (this would be the logical choice if the DB were older than the participant was). *Treas. Reg. §1.401(a)(9)-5, A-5(a)(1) and A-5(c)(1).* Assuming the DB is younger than the participant was, in the first distribution year, the divisor for the DB's age as of his birthday in the year following the year of the participant's death (i.e., in the first distribution year) is obtained from the Single Life Table (*see* Exhibit 3 attached) and used to calculate the minimum required distribution. In subsequent years, the divisor is reduced by one. *Treas. Reg. §1.401(a)(9)-5, A-5(c)(1).* If the participant's non-recalculated life expectancy is being used instead, the divisor for the participant's age as of his birthday in the year of his death is obtained from the Single Life Table and is then reduced by 1 in each subsequent year. *Treas. Reg. §1.401(a)(9)-5, A-5(c)(3).* Distributions to the beneficiary must commence by December 31 of the year following the year of the participant's death. *Treas. Reg §1.401(a)(9)-3, A-3(a).* After the death of the participant's DB, MRDs continue to the DB's successor beneficiary following the same distribution schedule. *Treas. Reg. §1.401(a)(9)-5, A-7(c)(2).*

(3) Participant's Spouse **Is** Sole Designated Beneficiary.

As in the case of the participant's death before his RBD, if the participant dies on or after RBD and the participant's spouse is his sole designated beneficiary, she will have certain additional options not available to other beneficiaries.

(a) Spousal IRA Rollover Option.

One option available to a spouse who is the sole DB of the participant's qualified plan is the spousal IRA rollover, discussed *supra* at I.B.5.a.(3)(b). Another option available to the spouse who is the sole DB of the participant's IRA is the election to roll over the participant's IRA into her own IRA or to treat the participant's IRA as her own, also discussed *supra* at I.B.5.a.(3)(c). In either case, the spouse's RBD will then be used for commencing distributions since she will now be the participant of her new IRA rollover. REMINDER: The spousal IRA rollover option will usually not be available if the participant has named a trust for the spouse (versus the spouse directly) as the beneficiary of his retirement plan, unless the spouse has a complete withdrawal right over the plan benefits passing to the trust. *See* X., *infra*.

(b) Spouse As Participant's ***Sole*** Designated Beneficiary.

If the spouse is named as the participant's sole designated beneficiary and she does not utilize one of the options described in (a) immediately preceding, in the situation where the participant dies *after* reaching his RBD, the spouse must commence distributions from the participant's plan to herself on or before December 31 of the calendar year immediately following the calendar year of the participant's death, taking distributions from the participant's retirement plan over *her* life expectancy, recalculated each year. *Treas. Reg. §1.401(a)(9)-5, A-5(c)(2) and §1.401(a)(9)-3, A-3(b)(1).* During her life, the spouse utilizes the divisor from the Single Life Table in each distribution year to determine the minimum required distribution for that year. *See* Exhibit 3. The final regulations added another option for beneficiaries of participants who die after their RBD. If the deceased participant's remaining, non-recalculated life expectancy would be longer than the sole DB spouse's recalculated life expectancy (e.g., the surviving spouse is quite a bit older than the deceased participant was), then the sole DB spouse can opt to use the deceased participant's remaining, non-recalculated life expectancy to calculate MRDs, instead of using her own recalculated life expectancy. *See Treas. Reg. §1.401(a)(9)-5, A-5(a)(1).*

(c) Distributions On Death Of Sole DB Spouse.

After the spouse's death in this situation (where participant died on or after RBD and his spouse took MRDs as the participant's sole DB), the spouse's successor beneficiary will take MRDs over the spouse's remaining life expectancy, *not* recalculated (i.e., the divisor for the spouse's age as of her birthday in the year of her death is obtained from the Single Life Table and is then reduced by 1 in each subsequent year). *Treas. Reg. §1.401(a)(9)-5, A-5(a)(1) and A-5(c)(2).* A final MRD attributable to the spouse must be taken in the year of her death (to the extent not taken by her before her death). *Treas. Reg. §1.401(a)(9)-5, A-4(a)(1).* The spouse's successor beneficiary is determined on September 30 of the year following the year of her death. *Treas. Reg. §1.401(a)(9)-4, A-4(b).* The successor beneficiary must commence MRDs by December 31 of the year following the year of the spouse's death. *Treas. Reg. §1.401(a)(9)-3, A-3(a).*

6. Creation Of Separate Accounts After Participant's Death.

If a participant has named multiple beneficiaries of a single plan or account, assuming the participant's beneficiary designation is worded appropriately (or at least is not worded inappropriately), the individual beneficiaries of the participant's plan can separate their shares into separate accounts, even if the participant did not mandate separate accounts in his beneficiary designation. If the separation occurs by December 31 of the year following the year of the participant's death, and is done in accordance with the method required by the regulations (basically, pro rata and taking into account all distributions since date of death), then each beneficiary can use his/her own life expectancy for determining MRDs from his/her separate account. *Treas. Reg. §1.401(a)(9)-8, A-2(2) [third sentence]*. In fact, the participant's plan can be divided into separate accounts *at any time* after the participant's death (assuming the beneficiary designation is worded appropriately and the division is done in accordance with the regulations); however, if the separation occurs after the December 31 deadline noted above, it will not change the DB – in other words, each beneficiary of a separate account created after the applicable December 31 date must still calculate MRDs using the oldest DB's life expectancy. Even late created separate accounts may still be desirable for investment/management reasons, however.

a. Separate Accounts: Issues Relating To Beneficiary Designation Wording.

Due to the wording used in the final regulations, it appears that only "fractional" or "percentage" interests in a beneficiary designation can qualify for separate account treatment. *See Treas. Reg.* § 1.401(a)(9)-8, A-3(a). Thus, the type of wording in a beneficiary designation that will allow separate accounts to be created post-death will be something like "equally to my children" or "in equal shares to the following named beneficiaries" or a designation specifying factions or percentages of the plan to various beneficiaries. Another type of beneficiary designation that could lend itself to separate account treatment would be one that specifies a pecuniary amount to one or more beneficiaries, with the remaining balance to one or more other beneficiaries in equal or unequal shares. In this situation, however, the beneficiaries of the pecuniary amounts would have to be "cashed out" by the DB Determination Date (so that they can be ignored as beneficiaries), leaving only the beneficiaries who are entitled to the remaining portion or fractional shares of the plan to be considered with respect to the designated beneficiary determination.

(1) Problem: Division Of Retirement Plan Benefits Among Multiple Beneficiaries Is Not Provided For In Beneficiary Designation.

Wording such as "to the Trustee named in my Will" or "to the Trustee of Participant's Living Trust" is now clearly problematic in terms of allowing multiple beneficiaries under the Will or Living Trust to create the type of separate accounts that would enable each beneficiary to use his/her own life expectancy for calculating minimum required distributions. *See,* e.g., *PLR 200349009 (December 5, 2003); PLRs 200317041, 200317043 and 200317044 (April 25, 2003); PLR 200234074 (August 23, 2002); and PLR 200208031 (February 22, 2002).* This is true even if the Will (or Living Trust) distributes the participant's estate equally to his children and even if the children take their shares outright. This is because the IRS takes the position that the separation of benefits is not occurring in (or by reason of) the participant's beneficiary designation, but elsewhere and due to someone else's (i.e., the Trustee's) action. In PLR 200317041, the IRS stated it this way in the case of benefits passing to a Living Trust, and thereafter divided into subtrusts: "... the 'Final' Regulations do preclude 'seperate [sic] account' treatment for Code § 401(a)(9) purposes where amounts pass through a trust." The same would be true for amounts passing "through" an estate (and, of course, in that case there would be the additional problem of an estate not qualifying as a designated beneficiary).

(2) Problem: Remainder Beneficiaries Of Accumulation Trusts Are Considered In Determining Designated Beneficiary.

In cases where the Participant's retirement plan benefits will pass into trusts that could accumulate plan benefit distributions during the lifetime of the primary beneficiary ("accumulation trusts"), the final regulations, as interpreted by a number of private letter rulings, indicate that the remainder beneficiaries of the trust must be taken into account in determining whether there is a designated beneficiary. *See,* e.g., *PLRs 200235038-200235041 (August 30, 2002); PLRs 200317041, 200317043 and 200317004 (April 25, 2003); and PLR 200228025 (July 12, 2002).* Thus, true separate account treatment may not be available in the accumulation trust context, even if the division of benefits among the trusts is spelled out in the beneficiary designation itself (versus in the Will or Living Trust Agreement).

(3) Does Failing To Obtain Separate Account Treatment Matter?

Whether separate account treatment is necessary or desirable in a particular case depends on the participant's estate plan. For example, if the participant's retirement plan benefits pass to the Trustee in his Will, to be allocated between the Bypass Trust and the Marital Trust in such amounts as the Trustee determines, it should not matter whether separate account treatment is available if the participant's surviving spouse is the oldest beneficiary of both trusts (and is treated as the DB). For another example, if the Trustee in the Will (in general) is named as the beneficiary of the participant's IRA in the beneficiary designation form, and if the Trustee is directed by a Will provision to divide the IRA equally among the participant's three children, who are 37, 36 and 34 years old, even if the IRA is divided in a timely, correct manner after the participant's death, all three children will have to use the 37 year old child's life expectancy in calculating the MRDs from their separate inherited IRAs because the separation of benefits did not occur in the beneficiary designation itself. The difference in life expectancy between age 37 and age 34 is really not that significant, however (*see* Single Life Table at Exhibit 3). Even if all three children must use the oldest child's life expectancy to calculate MRDs, they may still find it desirable to create separate inherited IRAs for management/investment reasons. *See,* e.g., *PLRs 200235038-200235041 (August 30, 2002)*. If separate account treatment is desired in this case, the *beneficiary designation* itself should specify the shares or percentages passing to each child. Examples of wording that could be used and that should allow for the creation of separate accounts after the participant's death can be found, for example, in Exhibits 8, 9, 13, 14 and 16 (*see* comments and footnotes to exhibits). Suppose, however, in the situation discussed above, the beneficiary designation itself provides for separate shares for each child, but the share passing to the youngest child is subject to an age 35 contingent trust created in the participant's Will. If the separate trust for that child is a conduit trust, then true separate account treatment should be available. On the other hand, suppose (i) the 34 year old has no children, (ii) per the terms of the trust, the two older siblings of the 34 year old are the remainder beneficiaries of his contingent trust if he dies before age 35 (without children), and (iii) the trust is in the form of an accumulation trust. In that case, the 37 year old remainder beneficiary would be treated as the DB of the share held in the 34 year old child's trust and the 37 year old's life expectancy would be used to calculate MRDs payable to the 34 year old child's trust. *See PLR 200228025 (July 12, 2002)* and IV.D.2. Therefore, true separate account treatment would not be available in that case for the youngest child regardless of where and how the separation of benefits occurs.

b. Method For Division Into Separate Accounts After Participant's Death.

The final regulations provide that separate accounts are separate portions of the participant's benefit reflecting the separate interests of the participant's beneficiaries under the plan as of the date of the participant's death. *Treas. Reg. §1.401(a)(9)-8, A-3.* All post-death investment gains and losses, contributions and forfeitures that occur between the participant's date of death and creation of the separate accounts must be allocated on a pro rata basis. Plus, any distribution(s) made during that time period must be allocated to the separate account of the beneficiary/ies receiving the distribution(s). *Treas. Reg. §1.401(a)(9)-8, A-3.*

c. Ambiguities In Final Regulations Regarding Separate Accounts.

The final regulations contain many ambiguities regarding separate accounts. Hopefully, some of these ambiguities will be clarified in the near future (some have already been clarified).

(1) Effective Date Of Separate Account Treatment.

The effective date for calculating MRDs when separate accounts are established after death was not entirely clear in the final regulations. The wording used, that the minimum distribution rules are applied separately to each separate account "for years *subsequent to* the calendar year containing the date on which the separate accounts were established...", made it appear that MRDs will be calculated separately for each separate account beginning in the year *after* the account is established. *See Treas. Reg. §1.401(a)(9)-8, A-2(a)*, original version (emphasis added). For example, if the participant dies in Year 1 having named multiple beneficiaries of his plan in his beneficiary designation form, and, after the designated beneficiary has been determined on September 30 in Year 2, separate accounts are established by December 31 of Year 2 (making each beneficiary of a new separate account the designated beneficiary of his/her own separate account), are MRDs for all of the beneficiaries for Year 2 determined based on the life expectancy of the DB determined on September 30 of Year 2, with separate account treatment only becoming available to each beneficiary in Year 3, or can each beneficiary of each new separate account use his/her own life expectancy for calculating MRDs in Year 2? The answer was clarified in Treasury Decision 9130, dated June 14, 2004, effective for calendar years beginning on or after January 1, 2003. T.D. 9130 removes Treasury Regulation Section 1.401(a)(9)-6T and modifies the first sentence of Paragraph (a)(2) of Treasury Regulation Section 1.401(a)(9)-8, A-2, to provide that if the participant's retirement plan/IRA is

actually divided into separate accounts by the end of the calendar year following the year of the participant's death, then the beneficiaries may avail themselves of separate account treatment for determining MRDs beginning in the year following the year of the participant's death. *See Treas. Reg. §1.401(a)(9)-8, A-2 (a)(2), as modified by T.D. 9130*. Thus, in the example above, each beneficiary can use his/her own life expectancy for calculating MRDs beginning in Year 2.

(2) How Are Separate Accounts "Established"?

The final regulations introduced the concept that establishing separate accounts means doing something more than recognizing that multiple beneficiaries of a participant's retirement account have separate interests in the account. This is because, prior to the final regulations, the definition of "separate account" in both the 1987 proposed regulations and the 2001 proposed regulations used the term "portion" to describe a separate account, indicating that the separate account concept was primarily an accounting rule, while the final regulations added the action verb, "establish", to the separate account requirements. *See Treas. Reg. §1.401(a)(9)-8, A-3.* So, how is a separate account actually established under the final regulations? The safest approach would be for the IRA custodian/trustee to create new accounts for the beneficiaries (i.e., a separate "inherited IRA" account for each beneficiary) and then transfer from the deceased participant's original IRA the proportionate amount (taking into account the post-death adjustments delineated in the final regulations) belonging to each beneficiary to that beneficiary's new separate account by December 31 of the year following the year of the participant's death. All of the new separate accounts will be "inherited IRAs" and, as such, will retain the deceased participant's name, but wording such as "for the benefit of", followed by the name of the beneficiary. Subsequent to establishment of the separate accounts, any beneficiary who wants to move his separate account to another financial institution can accomplish that by a "trustee to trustee" transfer. *See* previous discussion at I.B.5.a.(2)(a).

7. Effective Dates.

The final regulations state that for purposes of calculating MRDs from account balances or benefits in existence on or after January 1, 1985, the new rules are effective beginning on or after January 1, 2003. *Treas. Reg. §1.401(a)(9)-1, A-2(a).* For determining MRDs for calendar year 2002, taxpayers may rely on the final regulations, the January 2001 proposed regulations or the 1987 proposed regulations. *Vol. 67, No. 74, Federal Register (April 17, 2002), Rules and Regulations, Required Distributions from Retirement Plans, Summary: Effective Date.*

a. Transitional Rules.

Allegedly, the new rules apply for calendar years beginning on or after January 1, 2003, even if the participant died prior to January 1, 2003. The rules further state that, in such a case, the designated beneficiary and the applicable distribution period must be redetermined under the new rules. *Treas. Reg. §1.401(a)(9)-1, A-2(b)(1).*

b. Relief From 5 Year Rule.

A beneficiary stuck with the 5 year rule under the prior proposed regulations who can qualify for a life expectancy distribution under the new rules may switch to the life expectancy method as long as all amounts that should have been taken pursuant to the life expectancy method are actually distributed by the earlier of December 31, 2003, or the end of the originally applicable 5 year period. *Treas. Reg. §1.401(a)(9)-1, A-2(b)(2).*

c. Relief For Failure To Provide Trust Documentation.

If a trust failed the trust regulatory requirements solely due to not providing a copy of the trust document to the plan administrator by October 31 of the year following the year of the participant's death, that default can be cured by providing the required trust documentation to the plan administrator by October 31, 2003. *Treas. Reg. §1.401(a)(9)-1, A-2(c).*

8. Reporting Requirements.

The January 2001 proposed regulations attempted to impose on IRA trustees and custodians the same reporting responsibility applicable to administrators of qualified plans. That is, IRA trustees and custodians were directed to report the amount of an IRA owner's MRD from his IRA. A significant number of financial institutions sponsoring IRA accounts strenuously objected to this requirement. As a compromise, the final regulations left this matter somewhat incomplete. The Service has authority to determine the extent to which IRA trustees and custodians must report IRA information. In conjunction with this provision, Notice 2002-27, 2002-18 IRB 814 (April 16, 2002) has been issued, which specifies that, beginning in 2004, IRA trustees and

custodians must identify to the IRS each IRA from which a MRD is required to be made. Although the IRA trustee/custodian does not need to report the amount of the MRD to the IRS, beginning in 2003, it must either provide such information to the IRA owner or offer to calculate the amount for the IRA owner upon request (and if requested to do so, must calculate the MRD). The Service still has concerns regarding compliance with the MRD rules by taxpayers and is likely going to continue to impose reporting requirements on trustees and custodians of IRAs similar to those imposed on administrators of qualified plans.

C. Taxation Overview.

1. Income Taxation.

For the most part, distributions from retirement plans are taxed as ordinary income upon receipt. *See IRC §72 and §408(d)*. Only items such as nondeductible participant contributions, amounts the participant included in income due to life insurance coverage, and loan repayments treated as taxable distributions, etc., are considered a return of basis (and, therefore, non-taxable). *IRC §72*. The participant's basis in the plan must be reduced by any amounts distributed before his annuity starting date that were treated as a return of his investment. *IRC §72(b)(4)(B)*.

a. Special Income Tax Rules.

(1) Ten Year Averaging.

Ten year averaging will not be discussed in this outline because such treatment is only available to those who qualify under the transitional rule. *See Tax Reform Act of 1986, P.L. 99-514, Section 1122(a)(2)(A)*. The transitional rule is generally available only to participants (or beneficiaries of deceased participants) who had attained age 50 before January 1, 1986 (i.e., for participants born before 1936).

(2) Capital Gain Treatment.

Capital gain treatment for certain plan distributions will not be discussed in this outline because such treatment is only available to those who qualify under the transitional rule. *See Tax Reform Act of 1986, P.L. 99-514, Section 1122(b)(2)(D)*. The transitional rule is generally available only to participants (or beneficiaries of deceased participants) who had attained age 50 before January 1, 1986 (i.e., for participants born before 1936).

(3) Five Year Averaging.

Under 5-year averaging, a lump sum distribution from a qualified plan (not an IRA) is taxed separately from other income of the recipient. The amount of tax is determined by multiplying by 5 the amount of tax, using the single taxpayer rate, on 1/5 of the excess of the total taxable amount of the lump sum distribution over the minimum distribution allowance. The minimum distribution allowance is equal to the lesser of $10,000 or ½ of the total taxable amount of the lump sum distribution for the taxable year, reduced (but not below zero) by 20% of the amount (if any) by which such total taxable amount exceeds $20,000. *See IRC §402(d)(1)*. Once the total taxable amount reaches $70,000, the minimum distribution allowance is eliminated. If there are multiple beneficiaries, each beneficiary may elect whether to take special averaging treatment or, with respect to a participant or spouse beneficiary only, roll the distribution into an IRA rollover. If 2 or more trusts or individuals are beneficiaries, a tentative tax is determined on the aggregate amount, regardless of whether each recipient elects special averaging, and is then apportioned according to the relative amount that each recipient receives. *IRC §402(d)(2)(D)*. Five (5) year averaging was available through December 31, 1999, and is no longer available (beginning January 1, 2000) as a result of repeal by the Small Business Job Protection Act of 1996. *P.L. 104-188, Section 1401, amending Code Section 402(d)*.

b. Rollovers.

(1) Rollover By Participant.

The taxable portion of a qualified plan distribution received by a participant upon separation from service may be rolled over by the participant to another qualified plan or an IRA rollover, thereby continuing tax deferral until the participant's RBD (or as allowed under the minimum distribution rules). *IRC §402(c)*. [NOTE: As a result of EGTRRA, P.L. 107-16, beginning in 2002, participants in qualified plans have been able to roll over to certain other qualified plans or to an IRA rollover not just the taxable portion of their benefits, but the after-tax portion as well. *See* EGTRAA, Section 643 of Subtitle D -- *Increasing Portability for Participants*, amending IRC Section 402(c)(2).] The participant has sixty (60) days from receipt of the lump sum distribution to make the rollover. *IRC §402(3)*. The entire distribution need not be rolled over (and non-taxable amounts, such as nondeductible employee contributions, may not be rolled over before 2002); however, any taxable amount not rolled over will be subject to ordinary income tax in the year of receipt. *IRC §402(a)*. Withholding in the

amount of 20% will automatically occur unless the participant directs a trustee to trustee transfer (i.e., a "direct" rollover). *See IRC §§402, 403, and 3405(c).* If 20% is withheld, the participant must replace it within the sixty (60) day time period or it will be treated as a taxable distribution, subject to income tax.

(2) Rollover By Spouse Designated Beneficiary.

A surviving spouse is the ***only*** beneficiary of a deceased participant who may roll over the taxable amount of the participant's qualified plans to an IRA rollover or to another qualified plan and be treated as the participant (the latter option being available on or after January 1, 2002). *IRC §402(c)(9).* [EGTRRA, P.L. 107-16, generally effective for tax years beginning after December 31, 2001, expanded the spousal IRA rollover provisions to allow surviving spouses to roll over the deceased spouse's interest in a qualified plan to certain qualified plans in which the spouse participates. *See* EGTRRA, Section 641(d) of Subtitle D - *Increasing Portability for Participants*, amending IRC Section 402(c)(9).] She may also elect to treat the participant's IRA as her own or roll over any of the participant's IRAs into a new IRA rollover in her name. *See* I.B.5.a.(3) and I.B.5.b.(3), *supra*.

c. Inherited Retirement Plans.

(1) "Inherited" Qualified Plans Before the Pension Protection Act.

Unfortunately, many qualified plans require non-spouse beneficiaries of a deceased participant's interest in the plan to take either a lump sum distribution or distribution over a very short number of years of the participant's entire interest in the plan. This plan requirement is not based on federal tax law, but is included for the administrative convenience of the company sponsoring the plan. If such a full distribution had occurred before the end of 1999, 5-year averaging would have been available to the beneficiary to help alleviate the income tax burden. Once 5-year averaging went away, the beneficiary who had to take a large distribution of the amount inherited from the deceased participant's qualified plan in a single year had to pay income tax on the entire taxable amount received in that one year. (Remember that, because qualified plans and IRAs are "income in respect of a decedent" or "IRD", they do not get a step up in basis at death. *IRC §1014(c).*) Some qualified plans *do* permit non-spouse beneficiaries to take distribution of the participant's interest in the plan pursuant to the minimum distribution rules, allowing a designated beneficiary to use his/her life expectancy for calculating MRDs from the inherited plan/IRA after the participant's death. Some plans that don't require an immediate lump sum distribution of the entire inherited plan amount may require distribution to the participant's beneficiary pursuant to the 5-year rule, even if another method would be permitted under the federal rules. The reason for these policies is that administrators of qualified plans do not want to maintain distribution responsibility for anyone other than the participant and his spouse.

(a) Inherited Qualified Plans After The Pension Protection Act.

The Pension Protection Act of 2006 ("PPA") fixed the problem for beneficiaries who inherited qualified retirement plans that required a more rapid distribution than the federal tax laws allowed. Thus, for the first time, non-spouse beneficiaries of qualified plans became able to make a direct rollover (i.e., a trustee to trustee transfer) of the inherited plan benefits to an "inherited IRA". The purpose of this portion of the PPA was to enable designated beneficiaries of qualified plans to use a life expectancy payout for their inherited plan benefits. This essentially put designated beneficiaries of qualified plans on the same footing as designated beneficiaries of IRAs. Unfortunately, it was unclear from the PPA, when first passed, whether qualified plan documents had to be amended to allow this type of rollover. The answer turned out to be "Yes". Thus, many persons who inherited an interest in a qualified plan shortly after PPA became law were not able to do a tax-free rollover to an inherited IRA because the qualified plan did not permit it. So, in response to this problem, Congress passed the Worker, Retiree and Employee Recovery Act of 2008, providing that, beginning in 2010, *all* employer plans must be amended to allow non-spouse beneficiaries to make a direct rollover of inherited plan benefits to an inherited IRA. Between 2006 and 2010, qualified plans could be amended to allow the direct rollover (and many–but not all–plans did so during that time). Today, all qualified plans must allow the direct rollover of an inherited plan to an inherited IRA.

(2) "Inherited" IRAs.

IRAs passing to non-spouse beneficiaries upon the participant's death must remain in the deceased participant's name since non-spouse beneficiaries are not permitted to roll over the deceased participant's IRA to a new participant IRA in their own name. *IRC §408(d)(3)(C).* (It is permissible to state that the deceased participant's IRA is "held for the benefit of" the named beneficiary.) If the beneficiary wants to move the inherited IRA to another institution (to achieve his/her investment objectives, for example), he/she can do so by

effecting a "trustee to trustee" or "custodian to custodian" transfer, which is not a rollover (again, the inherited IRA remains in the deceased participant's name for the benefit of the beneficiary). *See Rev. Rul. 78-406, 1978-2 C.B. 157; Rev. Proc. 89-52, 1989-2 C.B. 632; PLR 200228025 (July 12, 2002); PLR 9250040, supra*. These days, distributions from inherited IRAs can almost always be made according to the minimum distribution rules in the Code (ten year ago, some IRA custodians and trustees limited distributions to the 5-year rule, even if a longer deferral would have been permitted under the federal rules). Also, ten years ago, some IRA sponsors disallowed continued distribution per the minimum distribution rules when the participant's designated beneficiary died and the inherited IRA passed on to his/her beneficiary. Currently, however, because the "new" rules clearly allow the designated beneficiary to name a successor beneficiary to receive the amounts remaining in the inherited IRA upon his/her death, IRA custodians and trustees permit continued MRDs to the successor beneficiary (based on the same distribution period that applied to the DB).

d. $5,000 Death Benefit Exclusion.

Prior to repeal by the Small Business Job Protection Act, a $5,000 death benefit exclusion from income tax was available to recipients of death benefits from a participant's *qualified plan* (but not IRAs) under Section 101(b) of the Code. Repeal of this exclusion became effective for decedents dying after August 20, 1996.

2. Estate Taxation.

a. General Rule.

Under current law, a deceased participant's interest in retirement plans as of his date of death is included in his gross estate under either Code Section 2033 or Section 2039. Prior to 1983, however, the value of a participant's interest in a *qualified plan* was completely excludible from his gross estate if 10-year averaging was not elected and the plan benefits were *not* payable to his "Estate". The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced this unlimited exclusion for qualified plan benefits to $100,000 for decedents dying after December 31, 1982. *P.L. 97-248, Section 245(a)(b)*. After December 31, 1982 and through December 31, 1984, $100,000 of the value of the decedent's interest in qualified plans was excluded from his gross estate. As a result of the Deficit Reduction Act, the $100,000 exclusion was repealed for participants dying after December 31, 1984. *P.L. 98-369*. Thereafter, no amount was excluded unless a transitional ruled applied.

b. Two Transitional Rules May Still Provide Exclusion From Participant's Estate For Qualified Plans Benefits.

While estates that can take advantage of these rules are few now, this should still be checked.

(1) Unlimited Exclusion.

If a participant separated from service before January 1, 1983, as long as the form of his benefit was not changed after that date or at any time prior to his death, his interest in that qualified plan would not have to be included in his estate upon his death.

(2) $100,000 Exclusion.

If a participant separated from service after December 31, 1982 and before January 1, 1985, and did not (or does not) change the form of his benefit prior to his death, then $100,000 of his qualified plan may be excluded from his estate upon his death.

c. Estate Tax Transitional Rules Not Applicable To IRAs.

The IRS has ruled that the estate tax transitional rules do not apply to IRAs, including IRA rollovers from qualified plans. *Rev Rul. 92-22, 1922-1 C.B. 313; TAM 9144046*.

d. Caution Advised.

If a participant could qualify for one of these estate tax transitional rules, he should exercise caution before making changes to the form of his benefits and/or before making an IRA rollover (which will cause loss of the exclusion).

D. Penalty Taxes.

Be aware that the Code provides penalties for violating the minimum distribution rules.

1. Premature Distributions.

If a participant takes distributions from his retirement plan/account before reaching age 59 ½ and one of the exceptions is not available, in addition to income taxes on the distribution, a 10% penalty will have to be paid. *See IRC §72.*

2. Late Or Insufficient Distributions.

If the participant or his beneficiary fails to take at least the minimum required distribution amount by the due date, a 50% penalty will apply (in addition to income taxes due on the required distribution in the year actually taken). *See IRC §4974(a).*

3. Elimination Of Penalty Taxes On Excess Accumulations And Distributions.

The Small Business Job Protection Act of 1996 suspended the 15% penalty on excess retirement distributions for amounts received in 1997, 1998 and 1999. *P.L. 104-188.* The Taxpayer Relief Act of 1997 repealed both the excess distributions tax and the excess accumulations tax for distributions made and for estates of decedents dying after December 31, 1996. *P.L. 105-34, Section 1073(a).*

E. Spousal Rights.

Effective for plan years after 1984, a retirement plan will not be qualified under Section 401(a) of the Code unless it provides certain benefits to the participant's spouse. These benefits were generally added by the Retirement Equity Act of 1984 (REA), P.L. 98-397, and amended (retroactively) by the Tax Reform Act of 1986, P.L. 99-514.

1. Two Required Spousal Benefits For Certain Plans.

All defined benefit plans and certain defined contribution plans (those that are subject to the minimum funding standards under Code Section 412, such as money purchase pension plans), must provide the following survivor annuity benefits:

a. QJSA. If a married participant is living on his annuity starting date, the plan must pay his accrued benefit in the form of a qualified joint and survivor annuity ("QJSA"). *IRC §401(a)(11)(A)(i).*
b. QPSA. If a married participant dies before his annuity starting date and is vested in any portion of his accrued benefit, the plan must provide his surviving spouse with a qualified preretirement survivor annuity ("QPSA"). *IRC §401(a)(11)(A)(ii).*

2. Spousal Benefit Requirements For Other Plans.

Even those plans that are not subject to the QJSA and QPSA requirements, such as profit sharing plans and stock bonus plans, must satisfy certain rules to avoid the QJSA and QPSA requirements. The following conditions must be met:

a. Spouse Must Be Beneficiary. The plan must provide that if the participant is married at the time of his death, his vested accrued benefit will be paid in full to his surviving spouse unless she consents to the naming of another beneficiary. *IRC §411(a)(11)(B)(iii)(I).*
b. No Annuity Rule. The participant must not elect to receive benefits from the plan in the form of a life annuity. *IRC §411(a)(11)(B)(iii)(II).* If he does, the plan must provide that the QPSA and QJSA rules will then apply to all of his plan benefits (except in cases where separate elections are made for segregated benefits or shares in the plan and there is a separate accounting for the account balance subject to the election). *Treas. Reg. §1.401(a)-20, A-4.*
c. Not A Transferee Plan. To omit offering survivor annuities, the profit sharing or stock bonus plan must not be a transferee from a defined benefit plan (that would have been required to pay a survivor annuity). *IRC §411(a)(11)(B)(iii)(III).*

3. Additional Technical Rules.

There are numerous additional technical rules relating to these spousal benefits, most of which are beyond the scope of this outline.

4. Waivers And Consents.

For purposes of this outline, however, the rules regarding how the participant and his spouse can elect out of the required spousal benefits is relevant.

a. Participant's Waiver.

A plan that must provide QPSA and QJSA benefits must also permit the participant to waive that form of benefit. The waiver must be in writing in order to be effective. *IRC §417(a)(2)(A)(i).* A plan must also give the participant the opportunity to revoke his waiver of the spousal annuity form of benefits within the relevant election period. *IRC §§417(a)(1) and 417(a)(2).*

b. Spousal Consent To Waiver.

The participant's waiver of the spousal annuity benefits provided by defined benefit plans, or the spouse's right to receive benefits from defined contribution plans, will only be effective if the participant's spouse consents to the waiver. The spouse's consent must be in writing and must be acknowledged before a representative of the plan administrator or a notary public. *IRC §417(a)(2)(A)(i) and (iii).*

(1) General Consent.

A spouse may execute a general consent, consenting both to the waiver of the annuity form of benefits, if applicable, and to the designation by the participant of another beneficiary. If the spouse gives a full, general consent, no further consent will be required as to any subsequent change in beneficiary. *Treas. Reg. §1.401(a)-20, A-31(a).*

(2) Specific Consent.

A spouse may specifically consent to waiver of just one particular form of benefit, or to waiver of all spousal benefits. Further, the spouse may consent to the naming of one particular beneficiary (only). In the case of a specific consent by the spouse, subsequent changes by the participant, other than the participant's subsequent waiver of his revocation of the spousal annuity form of benefits, will be ineffective without spousal consent. *Treas. Reg. §1.401(a)-20, A-31(a).*

(3) Optional Form Of Benefit Identified.

Even in the case of a general consent by a spouse, for plan years beginning after 1986, the waiver and/or consent regarding the QJSA must specify the alternative form of benefit that is selected by the participant. *Treas. Reg. §1.401(a)-20, A-31(b).*

c. Sample Language.

The IRS has published sample language that can be used to waive the spousal annuity form of benefits and to consent to receiving benefits in a form other than the QJSA and QPSA for plans required to pay them. Also included is sample language that can be used to waive the spouse's right to receive benefits from defined contribution plans. *See Notice 97-10, 1997-1, C.B. 370.*

d. Consideration To Spousal Rights.

Because of the spousal rights in retirement plans, these rules must be taken into account whenever a participant desires to name someone other than his spouse (such as a trust) as the beneficiary of his retirement plans.

F. Community Property Laws.

In 1997, the U.S. Supreme Court decided Boggs v. Boggs, 177 S.Ct. 1759 (1997). Boggs is an important case that all estate planning practitioners need to understand. Note that the Court in Boggs did *not* say that the spouse of a qualified plan participant, known as the non-participant spouse ("NPS"), does not own a community property interest in the participant's qualified retirement plans that accrued during the marriage while the couple was living in a community property state. Further, the Boggs case does not override the Texas Constitution or the Texas Family Code or Texas case law, including such cases as Allard v. Frech, 754 S.W.2d 111 (Tex. 1988), cert. denied, 109 S.C. 788 (January 8, 1989). In fact, federal law (still) recognizes community property law in most cases and under most circumstances. Only rarely can federal law ignore state property law. In order to "preempt" (or, override) state property law, including state marital property law, a federal court must specifically find, under the facts in a particular case, that a particular state law conflicts with federal law in a way that hinders the effectiveness of the federal law. In the case of qualified plans, the inclusion of statutory provisions relating to qualified domestic relations order is just one example of federal law's recognition of spousal rights, including state community property ownership rights. Further, the additional provisions found throughout the Code relating to community property indicate Congress' recognition of the community property regime. Unfortunately, since the majority of states are not community property states, most lawmakers' and judges'

understanding of community property law is not well developed and, therefore, erratic treatment often results. However, Boggs clearly does *not* stand for the proposition that qualified plans owned by a couple living in a community property state are not community property. It stands for something else.

1. Devisability Issue.

Whether the NPS has *the right to dispose of* her community property interest in the participant's qualified plans upon her death if she is the first spouse to die is a separate issue from underlying ownership. The Boggs case does provide a clear answer to this issue.

a. Qualified Plans - No Right Of Disposition.

Although the Boggs case arose in Louisiana, the decision in that case applies to Texas participants and their spouses. In a somewhat awkwardly worded decision, a plurality of the U.S. Supreme Court held in Boggs that the NPS does not have a right to dispose of her community property interest in the participant's *qualified plans* upon her death prior to the participant's death. The decision was based on ERISA preemption of state law, in this case, state community property law as it applies in the context of the death of the NPS. Since the primary purpose of ERISA qualified plans is to provide retirement income to employees (and their spouses), and not to provide inheritance-type benefits to (able bodied, employment age) children or other beneficiaries, the ERISA purpose would be defeated if the NPS's children in Boggs could take away retirement benefits from Mr. Boggs.

b. IRAs - *Boggs* Not Applicable.

Although the Boggs case recites the fact that, subsequent to the NPS's death, the participant rolled over some of his qualified plan benefits to an IRA rollover, that fact is extraneous to the decision. In this author's opinion, the Boggs decision does not apply to IRAs for two (2) reasons. First, the decision is based on federal law (ERISA) preemption of state (community property) law. IRAs are not qualified plans under ERISA. They are merely tax favored accounts that are subject to most of the same minimum distribution rules applicable to qualified plans. Second, no IRA (or IRA rollover) was in existence at the time of the death of the NPS in the Boggs case. Thus, the IRA issue was not ripe (and was not decided) in that case.

c. Status Of IRA Rollovers From Qualified Plans.

If a participant rolls over his qualified plan benefits to an IRA rollover, is the Boggs result avoided? The answer is clearly "Yes". As noted, the Boggs case stands only for the proposition that the NPS cannot devise her community property interest in the participant's qualified plans upon her death if she dies before the participant (because of ERISA preemption). If a living participant rolls over his qualified plan benefits to an IRA rollover and if the qualified plan benefits were community property prior to the rollover, those benefits should continue to be community property after the rollover. Another theory would be that an IRA rollover, which is not a qualified plan subject to ERISA, is a new asset, so that under the inception of title rule, a rollover that occurs during the marriage must create a community property asset. A recent private letter ruling is very helpful on this issue. In PLR 199937055 (Sept. 17, 1999), the Service ruled that IRC § 408(g), which provides that § 408 must be applied without regard to community property rules, relates primarily to the deduction rules under Code Sections 219 and 220 and does not abrogate substantive property rights under state law. Therefore, the classification of an IRA/IRA rollover as community property (or not) is a matter to be determined under applicable state law. Thus, until there is a federal case involving an IRA rollover in this fact situation that holds that some other federal law (besides ERISA) preempts state community property law with respect to devisability of the NPS's interest in the IRA rollover, the NPS who predeceases the participant should be able to dispose of her community property interest in the IRA rollover upon her death, even if the rollover was derived from the participant's qualified plan.

2. Drafting Issues.

Even if the NPS has the right to devise her community property interest in the participant's IRA upon her death, how does she do it?

a. How Does The Interest Pass?

It would appear, based on Texas case law, that the NPS's interest in the participant's IRAs passes by Will or intestacy upon her death. In a Living Trust plan, a pour over Will would probably be necessary unless the NPS's community property interest in the IRA could somehow be conveyed to the Living Trust prior to her death. It is very doubtful that a qualified plan could be transferred or assigned to a Living Trust during the participant's life due to ERISA's anti-alienation rule. One recent private letter ruling states the "fact" that a Living Trust "owned"

an IRA. *See PLR 199925033 (June 25, 1999).* It is not clear how ownership of an IRA can be conveyed to a Living Trust (if it can). This author has found no discussion regarding the documentation necessary to accomplish this. Therefore, it would appear safer to include the desired disposition in the NPS's Will (or, if the disposition is contained in the Living Trust document, then the pour over Will should be probated).

b. To Whom Should The Interest Pass?

(1) To Participant.

Because federal law, for the most part, and IRA custodians and trustees (sponsors) consider the participant to be the owner of all IRAs titled in his name, it would be simpler in most cases for the NPS to make a specific bequest of her community property interest in the participant's IRAs, including IRA rollovers, directly to the participant spouse in her Will (this bequest is sometimes referred to as an "anti-*Allard*" clause). As a result of such a bequest, the surviving spouse would then actually own the IRA titled in his/her name. This gift should qualify for the federal estate tax marital deduction, regardless of the form of benefits (a specific statutory provision applies to survivor annuities under IRC § 2056(b)(7)(c)).

(2) To Participant, With Disclaimer Option.

To accomplish additional estate tax and other objectives, the NPS may wish to pass her interest in IRAs to the participant spouse but provide, additionally, that if the participant disclaims all or any portion of that gift, the disclaimed amount will pass into trust. This author recommends using a specially drafted "Disclaimer Trust" in the Will or Living Trust Agreement as the recipient of disclaimed assets (versus the "regular" Bypass Trust or QTIP Trust created in the instrument). The Disclaimer Trust in the NPS's Will or Living Trust Agreement could either be a "stripped down" Bypass Trust (a Bypass Trust with no powers of appointment in it) or a multiple purpose trust set up to function as either a Bypass Trust or a QTIP Trust (providing mandatory income distributions to the spouse and disallowing distributions to others during the spouse's lifetime), therefore, maximizing the possibilities (including the possibility of obtaining the credit for tax on prior transfers if the spouses die within 9 months (disclaimer) or 15 months (partial QTIP election) of each other). Using a specially designed Disclaimer Trust as the recipient of disclaimed assets and, in particular, as the recipient of IRA benefits, is usually preferable to having disclaimed assets pass directly to a regular Bypass Trust or QTIP Trust, which often contain powers of appointment, thereby necessitating a disclaimer of those powers in order to effect a qualified disclaimer. To some extent, the technical issues that apply when a trust is named as the beneficiary of retirement plans may apply in this context (although, unlike the death of the participant, the death of the NPS does not trigger any required distributions under the federal income tax laws [i.e., minimum distribution rules]). Therefore, if designated beneficiary treatment, or other favorable income tax treatment, is desired, special drafting of the Disclaimer Trust is warranted.

c. Documentation Of Disclaimer By Participant.

If the NPS devises her community interest in the participant's IRAs to the participant and the participant makes a qualified disclaimer of all or part of the gift so that the disclaimed portion is now "owned" by the Disclaimer Trust, what type of documentation is used?

(1) Qualified Disclaimer.

Obviously, a written disclaimer meeting all of the requirements of Section 37A of the Texas Probate Code and Section 2518 of the Internal Revenue Code is the first document required. In the disclaimer, the participant should recite that a gift was made to him in the NPS's Will of the NPS's community property interest in the participant's IRA and that the participant is disclaiming all of that gift, or X% of that gift.

(2) IRA Documentation - Implementation Of Disclaimer.

It would appear that at least three (3) possibilities exist for implementing the result of the disclaimer.

(a) Withdrawal By Participant.

The participant could withdraw from his IRA the percentage passing to the Disclaimer Trust as a result of his disclaimer. That amount would then be transferred to the Disclaimer Trust (bank or brokerage) account. Income taxes would be due on the withdrawn amount, which should be borne by the Disclaimer Trust (technically, the income taxes would be payable by the participant, who would then seek reimbursement from the Disclaimer Trust). If the participant is under age 59 ½ at the time of the withdrawal, a penalty tax would also apply. (The penalty tax exception for death under IRC Section 72 is not available in the case of the death of the NPS.) While the withdrawal approach is one possible method for implementing the disclaimer, it is not very

popular due to the immediate tax consequences. It does have the advantage of simplicity, however, and may be worth doing in the case of very small amounts. (The Disclaimer Trust should be drafted so that if this method is chosen, the Trustee must reimburse the participant for any income taxes he has paid on the trust's behalf).

(b) Co-ownership Of IRA: Agreement Between Participant And Trustee.

The participant's IRA could remain exactly as it was before the NPS's death. As a result of the participant's disclaimer of the testamentary gift of the NPS's interest in the IRA, however, the IRA would now be co-owned by the participant and (the trustee of) the Disclaimer Trust in percentages based on the amount disclaimed. The participant and the Trustee of the Disclaimer Trust (frequently the same person) could enter into an agreement memorializing the ownership of the IRA from that point forward. The Trustee of the Disclaimer Trust and the participant would also agree that the participant should designate the Disclaimer Trust (or its remainder beneficiaries) as the beneficiary of its percentage of the IRA. Distributions from the IRA would then be taken by the participant based on the applicable minimum distribution rules, utilizing the new lifetime distribution table. If the participant will be naming different beneficiaries for his percentage interest in the IRA, he should consider using separate accounts or segregated shares (because of problems that can arise under the multiple beneficiary rules). As the participant takes distributions from the IRA, the portion of the distribution allocable to the Disclaimer Trust would be paid to it by the participant and, depending on the terms of the Disclaimer Trust, could then distributed from the Trust (in whole or in part) to the participant as the income beneficiary of the Trust. The Agreement between the participant and the Trustee of the Disclaimer Trust should address the income tax liability issues. Because the IRA is not necessarily divided under this approach, the distributions taken from the IRA by the participant are being taken proportionately from the participant's portion and the Disclaimer Trust's portion of the IRA.

(c) Separate IRA Approach.

A third approach for implementing the disclaimer by the participant is to separate the IRA into two (2) separate accounts, on a fractional or percentage basis, corresponding to the respective fractional/percentage interests owned by the participant and the Disclaimer Trust. *Both IRAs would remain in the Participant's name.* For ease of identification, the severed IRA now belonging to the Disclaimer Trust could have "for the benefit of the Disclaimer Trust" (or similar wording) included in the title following the participant's name, for example: "John T. Jones IRA for the benefit of the Mary Jones Disclaimer Trust." In any event, the Disclaimer Trust, or its remainder beneficiaries, should be designated as the beneficiary of that separate inherited IRA. The advantages of this approach are (i) it allows for separate account treatment under the multiple beneficiary rules, and (ii) it should allow the participant to take minimum required distributions in a non-pro rata manner from his two IRAs, as specifically authorized per Treasury Regulation Section 1.408-8, A-9 (the successor to now superseded IRS Notice 88-38, I.R.B. 1988-15).

3. Planning Ideas To Assist NPS In Her Estate Planning.

With the increasing estate tax exclusion amounts passed into law by EGTRRA, fully utilizing the NPS's estate tax exclusion amount if she dies first may be less of a concern than it was before. Nevertheless, here are some ideas to be considered.

a. Roll over qualified plan benefits to IRAs.
b. Increase NPS's assets through partition (even non-pro rata partition).
c. Increase NPS's assets through gifts.
d. Decrease amounts held in qualified plans and IRAs by taking discretionary distributions (after age 59 ½) before age 70 ½ and by taking additional distributions in excess of the minimum required amounts after age 70 ½. With additional amount taken, do one or more of the following:

    (1) Spend it.
    (2) Make tax free or charitable gifts with it.
    (3) Invest it in (after tax) assets that will be suitable for funding a Bypass Trust.

e. Buy life insurance for liquidity to pay taxes and/or fund trusts.
f. Plan for disclaimer by participant spouse.

II. OPTIMAL BENEFICIARY DESIGNATIONS

A. Married Participant: Designate Spouse As Primary Beneficiary.

Designating the spouse as the primary beneficiary of retirement benefits has numerous advantages. NOTE: In this section, it will be assumed that the designated spouse is a U.S. citizen.

1. Qualifies for Estate Tax Marital Deduction.

The participant's interest in retirement plans passing directly to his spouse will qualify for the federal estate tax marital deduction. *See IRC §2056*. This is true even if the distribution is required to be made in annuity form.

a. Automatic QTIP Treatment For Survivor Annuities.

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA), P.L. 100-647, amended the QTIP rules to require automatic QTIP treatment for a survivor annuity unless the decedent's executor elects otherwise. *IRC §2056(b)(7)(C)*. Interestingly, while annuities are generally "terminable" interests, the qualified joint and survivor annuity (QJSA) and the qualified preretirement survivor annuity (QPSA) mandated by the Retirement Equity Act of 1984 (REA) are generally not *non*deductible terminable interests, since no amount will pass to anyone upon the spouse's death (actually, no amount should remain to be included and taxed in the surviving spouse's estate). Thus, strictly speaking, the TAMRA amendment to the QTIP rules should not have been necessary to make those types of annuities qualify for the marital deduction (although the amendments also apply to the community property interest in such annuities owned by the non-participant spouse in the event of her death prior to the participant, a more troublesome situation due to the possibility of the participant's subsequent remarriage). Does this mean that the amendment was meant to apply to other "annuity" types of distribution (such as a "life expectancy" payout)?

b. Periodic Payment Issues.

On the other hand, if the deceased participant's spouse is his sole DB and she will be taking merely the MRD each year over her recalculated life expectancy, an amount *will* remain in the plan upon the surviving spouse's death for distribution to others. Does automatic QTIP treatment in the participant's estate per the TAMRA amendment apply in this case? One private letter ruling involving periodic payments over the joint and last survivor life expectancies of the participant and his spouse under the old rules indicated that it does. *See,* e.g., *PLR 9204017 (January 24, 1992).* Of course, the new rules have different distribution periods and the sole DB spouse would usually have the right to withdraw the entire balance in the deceased participant's plan at any time, which should make the gift to her qualify for the marital deduction as an *outright* gift.

2. No Gift Tax Issue.

No transfer of the non-participant spouse's interest in the retirement plans is being made by her upon the participant's death because she is keeping her half (as well as receiving the participant's half).

3. Spouse Qualifies As Sole Designated Beneficiary.

For purposes of determining lifetime distributions to the participant, it no longer matters (except in one case) who his designated beneficiary is as of his RBD. Distributions beginning at RBD will be based on the Uniform Lifetime Table unless the participant's young spouse is his sole DB. *See* I.B.3., *supra*. However, by naming his spouse as the primary beneficiary of his retirement plans, the participant will have set up several favorable income tax options for his spouse upon his death and not jeopardized the federal estate tax marital deduction for his estate.

4. Spouse's Options Upon Death Of Participant.

a. Spouse's IRA Rollover Option.

If the participant designates his spouse as the sole beneficiary of his qualified plan, she can roll over all or any portion of the participant's benefits (excluding the required minimum distribution for that year, if any, and, before January 1, 2002, ineligible rollover amounts, such as after-tax employee contributions) to a spousal IRA rollover (and after December 31, 2001, to certain qualified plans in which the spouse participates – *see* I.B.5.a.(3)(b), *supra*). If the participant's retirement benefits are held in an IRA/IRA rollover in his name and his spouse is the designated beneficiary, she can roll over his IRA/IRA rollover into a new IRA rollover in her name. A spouse is the ***only beneficiary*** who has a true rollover option (i.e., who can become the participant of the plan/IRA she inherits). The spousal rollover option will not usually be available if someone else, including a trust for the benefit of the spouse, is the designated beneficiary (unless the trust happens to have certain provisions

that result in the spouse having complete access to the IRA, such as an unlimited withdrawal right over it -- *see* X., *infra*). A spouse may make an IRA rollover regardless of whether the participant dies before or after his RBD and regardless of the age of the spouse at the time of the participant's death. The spouse will then be treated as the participant of her spousal IRA rollover. As such, she is entitled to designate new beneficiaries of her rollover IRA. Because the spouse becomes the participant of her spousal IRA rollover, minimum required distributions must commence by *her* RBD (or, if she is already past her RBD, then by December 31 of the year following the year of the participant's death).

b. Spouse's Assumption Of Participant's IRA.

As an alternative to a spousal IRA rollover, when the deceased participant's benefits are already in an IRA, a spouse who is the designated beneficiary may simply elect to treat the participant's IRA as her own instead of rolling it over into a new IRA. The effect is basically the same as a spousal rollover.

c. Disadvantages Of Spousal IRA Rollover.

(1) Penalty On Distributions If Spouse Is Under Age 59 ½.

One disadvantage of exercising the spousal IRA rollover option is that a spouse designated beneficiary who is under age 59 ½ may *not* take distributions from her IRA rollover before reaching that age without triggering the early distribution penalty (unless one of the exceptions in IRC Section 72(t) applies). In contrast, the penalty for withdrawal by a person under age 59 ½ does *not* apply if the spouse remains in the position of being the beneficiary of the deceased participant's IRA.

(2) Rollover Could Accelerate Distributions To Spouse In Some Cases.

Another disadvantage of the spousal IRA rollover is that it *could* accelerate distributions during the surviving spouse's lifetime if the surviving spouse is substantially older (i.e., more than 10 years older) than the participant was. This is because, after the spousal IRA rollover, MRDs to the surviving spouse will be based on her life expectancy, recalculated, plus ten years, under the Uniform Lifetime Table, while distributions to the surviving spouse from an inherited IRA (an IRA still in the deceased participant's name) may be taken based on the deceased spouse's remaining life expectancy, not recalculated (thus providing lower required distributions if the deceased spouse was significantly younger than the surviving spouse). One other factor to consider, however, is the non-recalculation vs. recalculation of life expectancy effect of the two different methods. Another factor to consider is the effect of this choice on the beneficiaries who will receive what remains on the death of the surviving spouse (no "stretch IRA" will be available to those beneficiaries if the second option is taken).

d. Taking Distributions As Participant's Beneficiary.

As an alternative to the rollover option discussed above, the spouse may decide not to do a spousal IRA rollover and not to treat the decedent's IRA as her own but to take distributions as the deceased participant's designated beneficiary. This might be the best choice, for example, where the designated beneficiary spouse is much older than the participant spouse was and the participant has died before reaching his RBD. Tax deferral can be achieved because distributions will not have to begin until the later of (a) December 31 of the calendar year immediately following the calendar year in which the participant died and (b) December 31 of the calendar year in which the *participant* would have attained age 70 ½. *Treas. Reg. §1.401(a)(9)-3, A-3*. This might also be the best choice (for at least part of the retirement plan) in cases where the surviving spouse is substantially under age 59 ½ and where she anticipates needing to take distributions before reaching that age. The death of the participant provides an exception to the penalty for early distribution in this situation.

e. Disclaimer Option.

Naming the spouse as the primary beneficiary and then naming as the contingent beneficiary either the Trustee of a particular trust, such as the Bypass Trust or a Disclaimer Trust drafted specifically to hold disclaimed assets, or the Trustee, in general, under the Participant's Will or Living Trust Agreement, is, perhaps, the best strategy in the vast majority of cases. This beneficiary designation provides maximum flexibility because it allows for optimal estate and income tax planning by preserving options and delaying decisions until more factors are known. This beneficiary designation sets up the disclaimer option for the surviving spouse, so that she can disclaim the amount of retirement benefits necessary or desirable to fully fund or at least minimally fund the Bypass Trust created by the participant in his Will or Living Trust Agreement. Further, by naming the spouse first, the spousal IRA rollover option is preserved. At the time of the participant's death, calculations can be done comparing the income tax benefits of exercising the spousal IRA rollover option to the estate tax benefits of disclaiming to fund the Bypass Trust. The actual value of the retirement benefits, as well as the value of the

other assets in the deceased participant's estate and the value of the assets owned by the surviving spouse, will be known at that time, thus eliminating part of the speculation that may skew pre-death planning calculations. The age and health of the surviving spouse at the time of the participant's death can also be taken into account, along with the estate and income tax rates in effect at that time, leading to a more informed decision. In the case of participants who die in 2011 or later, the portability election is another option that can be used. Making the portability election (i) allows the surviving spouse to accept 100% of the plan/IRA and do the spousal IRA rollover, setting up the "stretch IRA" for the couple's children on the death of the surviving spouse, and (ii) transports the deceased spouse's unused estate tax exemption amount to the surviving spouse so that it is not "wasted" by the spouse receiving the deceased spouse's plan/IRA outright.

B. Single Participant With Children: Designate Adult Children As Outright Beneficiaries.

If the participant's children are adults and capable of managing money, in many cases an unmarried participant should just designate his children as the outright beneficiaries of his retirement plan benefits. While estate planning attorneys frequently recommend the use of trusts for assets passing to clients' children at death to protect them from creditors' claims, the assets held within both qualified plans and IRAs enjoy creditor protection due to ERISA's anti-alienation provisions and Texas Property Code Section 42.0021, respectively. In many other states, however, IRAs do not enjoy creditor protection. Also, some bankruptcy courts have held that exemption statutes only protect participant IRAs and not inherited IRAs. The Fifth Circuit Court of Appeals recently reversed the Eastern District of Texas Bankruptcy Court's holding that inherited IRAs are not exempt. *See In re Chilton*, 426 B.R. 621 (Bankr E.D. Tex. 2010), rev'd 444 B.R. 548 (E.D. Tex. 2011). Thus, in Texas, at least right now, inherited IRAs are exempt assets in bankruptcy.

1. Multiple Beneficiary Rule.

Under the "new" rules, even if a participant with more than one child did not create separate accounts or segregated shares prior to his death, as long as his beneficiary designation form is worded in a way that allows separate account treatment, separate accounts can be created for each child after his death. *See* I.B.6., *supra*. As long as separate accounts are established by December 31 of the year following the year of the participant's death, then each child may use his/her own nonrecalculated life expectancy for determining MRDs from his/her own (separate) inherited IRA. If multiple beneficiaries are named in a Will or Living Trust, but the beneficiary designation form names the Trustee of the Will or of the Living Trust as the beneficiary, then separate account treatment will not be available. In that case, the oldest child's life expectancy will be used in determining the MRDs to all of the children (even if the IRA is later divided into separate inherited IRAs for investment or other reasons).

a. Separate Accounts/Segregated Shares.

It is wise to use separate accounts or segregated shares whenever there are multiple beneficiaries (unless their ages are virtually the same). However, because under the new rules (i) the actual designated beneficiary is not determined until September 30 of the year following the participant's year of death, (ii) the identity of the beneficiaries at RBD no longer affects the lifetime distributions to the participant (except in the case of the young spouse sole DB), and (iii) several post-death techniques are available to eliminate "bad" beneficiaries and to create separate accounts, it is not as crucial for the participant himself to create separate accounts (or separate IRAs) before his death. However, the participant should be careful not to word his beneficiary designation in a manner that might *preclude* the creation of separate accounts after his death if separate accounts are desired. *See* I.B.6., supra.

2. Caveat: Restrictive Qualified Plan Provisions.

As already noted, many qualified plans have more restrictive rules than otherwise allowed by federal law and require immediate distribution of the entire balance in the participant's retirement plan to children and other non-spouse beneficiaries. If the participant's qualified plan requires a full distribution to children on the participant's death and the participant has the option of rolling over his qualified plan benefits to an IRA that is not so restrictive, the participant should consider doing so during his life (although, with the passage of the Pension Protection Act, this is no longer that crucial). Note also, however, the different Roth conversion rule for beneficiaries who inherit a qualified plan versus beneficiaries who inherit a traditional IRA. *See* Roth IRAs at Exhibit 18. This difference may weigh in favor of the participant remaining in the qualified plan.

C. Single Participant, No Children, Charitable Intent: Designate Charity As Direct Beneficiary Upon Death.

If the participant has a charitable intent, he should designate one or more charities as the beneficiary of his retirement plan. The most efficient and tax effective way to do this is to designate the charity directly in the beneficiary designation form (and not to make a pecuniary gift in the Will or Living Trust Agreement to charity that might be satisfied with other assets or with retirement plan proceeds that are paid to the estate or trust first).

1. Charity Is Not A Designated Beneficiary But No Longer Adversely Affects Participant.

A charity is not a designated beneficiary for purposes of the minimum distribution rules. However, this does not make a difference in the lifetime distributions to the participant under the new rules, so it is no longer disadvantageous for a living participant to name a charity as the beneficiary of his retirement plan.

2. Charity As One Of Multiple Beneficiaries: Use Separate Accounts.

If the participant also wants to designate human beings as beneficiaries of his qualified plan or IRA, he should consider utilizing separate accounts (i.e., separate IRAs) or segregated shares to make things easier for his individual beneficiaries after his death. However, if he fails to create separate accounts before death, under the new rules, the charitable beneficiary can be "cashed out" before the DB Determination Date, so that only human beings remain as beneficiaries on that date. Then, the individual beneficiaries can use the oldest designated beneficiary's non-recalculated life expectancy for determining minimum required distributions post-death, or, if separate accounts for the individual beneficiaries are established in time, then each DB of each separate account can use his/her own life expectancy to calculate post-death MRDs with respect to his/her account. The beneficiary designation should be set up in a way that allows the charitable beneficiary to be cashed out early. *See,* e.g., Exhibit 14 attached. Or, if separate accounts are created before the DB Determination Date, then the charity will no longer be a beneficiary of the separate accounts established for the individual beneficiaries.

3. Estate Tax Result: Charitable Deduction.

The value of the participant's retirement plan benefits passing to charity upon the participant's death should qualify for the estate tax charitable deduction, thus eliminating estate tax on that transfer.

4. Income Tax Result For Charity.

A charity is exempt from income tax (except for unrelated business income). Although retirement benefits are IRD, the charity does not pay any income tax on receipt of the IRD. Thus, the charity receives 100% of the retirement plan benefits, whereas other beneficiaries would net much less due to the income taxes payable on those benefits (and estate taxes may be payable from those benefits as well, reducing the net amount to individual beneficiaries even more). Thus, naming a charity as the beneficiary of IRD items is a tax efficient way for a participant with a charitable intent to accomplish his goals.

5. Qualified Charitable Distributions From IRA During Participant's Life.

The American Taxpayer Relief Act of 2012 put back into the law the provisions allowing an IRA owner who is at least 70 ½ to make a direct distribution from his IRA to charity in an amount not exceeding $100,000. This is discussed at V.III.D, infra.

III. REASONS FOR DESIGNATING A TRUST AS THE BENEFICIARY OF RETIREMENT PLANS

A. Non-Tax Reasons.

1. Control ultimate disposition of retirement plan benefits after death of initial beneficiary (e.g., a second marriage situation).
2. Provide capable management of retirement plan benefits for the beneficiary (i.e., use a prudent Trustee
3. In some states, achieve creditor protection for IRAs and, in Texas, achieve creditor protection for distributions from qualified plans and IRAs.
4. Preserve separate property character of inherited retirement plan benefits.
5. Provide for multiple beneficiaries' interests in retirement plan benefits.

B. Tax Reasons.

1. Fund a Bypass Trust (to reduce or avoid estate taxes on death of surviving spouse).
2. Fund a QDOT Trust (to avoid immediate estate taxes where spouse is not a U.S. citizen).
3. Generation-skipping tax planning (achieve potential long term estate tax savings and income tax deferral).

4. Make a testamentary gift to charity (and obtain estate tax charitable deduction), but provide benefits to human beings as well (i.e., use a split interest charitable trust).

IV. OBTAINING DESIGNATED BENEFICIARY TREATMENT IF A TRUST IS NAMED AS BENEFICIARY OF RETIREMENT PLANS

A. History Of The Trust Regulatory Requirements.

The regulations as originally proposed in 1987 contained four (4) specific requirements that a trust had to meet in order for the participant who named the trust as the beneficiary of his retirement plans (or for the beneficiaries of the trust after the participant's death) to obtain designated beneficiary treatment. If the trust met the four (4) regulatory requirements as of the relevant date, then the beneficiaries of the trust could qualify as designated beneficiaries under the rules. The original proposed regulations for trusts were amended in 1997 and again (somewhat) by the proposed regulations released in January 2001. The final regulations provide some additional changes.

B. Trust Itself Is Not A Designated Beneficiary.

A trust can never be a designated beneficiary itself because only human beings can be designated beneficiaries. *Treas. Reg. §1.401(a)(9)-4, A-3*. Unlike an estate or a charity, however (which are also not designated beneficiaries), if a trust that is named as the beneficiary of a participant's retirement plans meets all of the regulatory requirements, then the beneficiaries of the trust can qualify as designated beneficiaries. *See Treas. Reg. §1.401(a)(9)-4, A-5(a)*. When a trust meets the regulatory requirements, it is referred to as a "qualified see-through trust" because, to determine the DB for MRD purposes, one must look through the trust to the actual beneficiaries of the trust. Certain trust beneficiaries are taken into account (i.e., are "countable") in determining whether all beneficiaries of the trust are DBs and, if so, which DB is the oldest. If a trust that is named as the beneficiary of the participant's plan or IRA has *any* "countable" beneficiaries that are not human beings or qualified trusts (e.g., a charity), then the trust cannot obtain designated beneficiary treatment. *Treas. Reg. §1.401(a)(9)-5, A-7(b)*. *See <u>also</u> PLR 9820021 (February 21, 1998)*. There are basically two types of qualified see-through trusts: accumulation trusts and conduit trusts. There will always be more than one "countable" beneficiary of an accumulation trust. In that case, assuming there are "no bad countable beneficiaries" and that the other trust qualification requirements are met, the individual with the shortest life expectancy (i.e., the oldest) will be treated as the designated beneficiary for purposes of the minimum distribution rules. *Treas. Reg. §1.401(a)(9)-5, A-7(a)(1)*. With a conduit trust, only the current beneficiary (i.e., the trust beneficiary to whom the Trustee *must* distribute the MRD [or other amount] received from the retirement plan upon receipt, per the specific terms of trust) is "countable" and, thus, all other trust beneficiaries can be ignored. Therefore, it's OK for the remainder interest in a conduit trust to pass to charity.

C. Trust Regulatory Requirements Under The Final Regulations.

If the regulatory requirements are met by a trust named as the beneficiary of the participant's plan, then the beneficiaries of the trust (and not the trust itself) will be treated as the beneficiaries of the participant. *Treas. Reg. §1.401(a)(9)-4, A-5(a)*. The requirements are

(1) The trust is a valid trust under state law, or would be but for the fact that there is no corpus.
(2) The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee.
(3) The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable within the meaning of A-1 of this section from the trust instrument.
(4) The documentation described in A-6 of this section has been provided to the plan administrator.

1. <u>Overview Of The Four Trust Requirements.</u>

a. First Requirement.

The first requirement is basically the same as it has been since the original 1987 proposed regulations. This requirement is easy to satisfy – it basically just requires that a valid, written trust be created (even if currently unfunded) to receive the plan benefits.

b. Second Requirement.

The second requirement is basically worded the same as it has been since the 1997 amendments to the original proposed regulations; however, it has been clarified and modified so that it is now clear that the trust that is named as the participant's beneficiary need not be irrevocable at the time when it is named as beneficiary or even at the participant's RBD, as long as it will become irrevocable as of the participant's death. Further, there is

no longer any issue regarding whether revocable management trusts (i.e., "Living Trusts") or testamentary trusts created in a participant's Will meet this requirement.

c. Third Requirement.

The third requirement is also worded basically the same as it has been from the beginning. However, identification of all of the beneficiaries of the trust who have an interest in the participant's plan benefits is the most difficult part of determining whether the trust qualifies for designated beneficiary treatment when an accumulation trust is used. This issue is discussed separately at IV.C.4, *infra.* It is easy to identify the beneficiary who has an interest in the plan benefits in the case of a conduit trust.

d. Fourth Requirement.

The fourth requirement, that certain trust documentation be provided to the plan administrator, has been modified by the final regulations and will be discussed separately at IV.C.2, immediately following.

2. Trust Documentation No Longer Required At RBD.

Since it no longer matters (except in the case of a young spouse sole DB) who a living participant has named as his beneficiary for purposes of determining MRDs to him beginning at his RBD, the relevant trust documentation no longer has to be provided to the plan administrator at RBD (unless the young spouse exception is sought for a trust created for the young spouse). The general rule is that if the participant has named a trust as the beneficiary of his retirement plan, the plan administrator must be provided with the relevant trust documentation by October 31 of the year following the year of the participant's death. *Treas. Reg. §1.401(a)(9)-4, A-6(b).*

a. Exception: Trust For Young Spouse.

If the participant has named a trust created for his young spouse as the beneficiary of his retirement plan, and if the trust qualifies as the type of trust that is essentially ignored as an entity, so that the participant's young spouse is deemed to be the *sole* beneficiary of his plan at RBD (therefore allowing the participant to use the Joint and Last Survivor Table to calculate his MRDs during his lifetime – instead of the Uniform Lifetime Table), then the required trust documentation must be provided to the plan administrator by the participant's RBD. *Treas. Reg. §1.401(a)(9)-4, A-6.*

(1) Who Is The Plan Administrator?

The plan administrator is the administrator of the qualified plan in which the participant participates or the custodian or trustee of the participant's IRA. *Treas. Reg. §1.408-8, A-1(b).*

(2) What Type Of Documentation Must Be Provided?

The participant must provide either (a) a copy of the trust instrument itself, and agree to provide copies of any amendments to the trust instrument as they are made, or (b) a list of *all* beneficiaries of the trust (including contingent and remainder beneficiaries, with a description of the conditions of their entitlement sufficient to establish that the spouse is the sole beneficiary), certify that the list is correct and complete, agree to provide copies of any amendments to the trust instrument as they are made, and agree to provide a copy of the trust instrument to the plan administrator upon demand. *Treas. Reg. §1.401(a)(9)-4, A-6(a)(1) and (2).*

b. Post-Death Trust Documentation.

After the participant's death, if a trust was named as the beneficiary of all or a portion of the participant's retirement plan benefits, the required trust documentation must be provided to the plan administrator by October 31 of the year following the year of the participant's death. *Treas. Reg. §1.401(a)(9)-4, A-6(b).* The plan administrator must evaluate whether the trust meets all four of the regulatory requirements, so that it can be ascertained whether designated beneficiary treatment is available for post-death MRDs. Once all trust beneficiaries who have an interest in the deceased participant's plan benefits are identified, then the beneficiary with the shortest life expectancy (i.e., the oldest) can be determined and the appropriate initial divisor obtained from the Single Life Table to calculate MRDs to the trust. COMMENT: It is interesting to note that the final regulations do not specifically require that the birthdates of all trust beneficiaries be provided to the plan administrator, but, obviously, that is one of the most crucial pieces of information needed and most trust instruments would not reveal this information.

3. What Types Of Trusts Created For The Spouse Will Qualify For Sole DB Treatment?

If the participant wants to use the Joint and Last Survivor Table for calculating his MRDs, his young spouse must be considered the *sole* beneficiary of his plan. *Treas Reg. §1.401(a)(9)-5, A-4(b)(1)*. While the participant can name as his beneficiary a trust that has been created for his young spouse instead of naming his young spouse directly, accumulation trusts will not qualify for "spouse as sole DB" treatment. The only two types of trusts that will work for this purpose are the "conduit" trust and the "grantor" trust.

a. Conduit Trust.

The conduit trust is a trust whose terms expressly require that all amounts distributed from the participant's retirement plan to the trust be paid out to the "current" beneficiary of the trust by the trustee, basically upon receipt. Thus, plan distributions merely flow through the trust directly to the current trust beneficiary and that trust beneficiary is the DB. *See Treas. Reg. §1.401(a)(9)-5, A-7(c)(3), Example 2*.

b. Grantor Trust.

For purposes of the minimum distribution rules, references to a "grantor trust" are to that type of trust over which the current beneficiary possesses an unlimited withdrawal right. Therefore, if this type of trust is named as the beneficiary of the participant's plan and if the plan itself does not preclude complete withdrawal by the beneficiary of the participant's entire interest in the plan, then the sole, current beneficiary of the trust, who possesses an unlimited withdrawal right over the trust assets, should be treated as the sole beneficiary of the participant's plan benefits. This trust is not specifically referred to in the final regulations, but has been recognized in several private letter rulings and is recognized by implication in the regulations. *See*, e.g., PLR 199903050 (January 22, 1999) and discussion therein of the "survivor's trust", over which the surviving spouse had a complete withdrawal right. Thus, if the participant has named a grantor trust for the benefit of his young spouse as his beneficiary as of his RBD and the appropriate trust documentation is provided to the plan administrator, he should be able to use the Joint and Last Survivor Table for calculating his MRDs during his lifetime.

4. Identification Of All Trust Beneficiaries Having An Interest In Participant's Plan.

The third trust requirement appears relatively straightforward on its face, but it can be extremely complicated in the case of an accumulation trust.

a. Contingent Beneficiaries.

All trust beneficiaries, except for those who qualify as "mere successor beneficiaries" (discussed below), ***must*** be taken into account in determining whether a person other than an individual is designated as a beneficiary (thereby disqualifying the trust for DB treatment) and in determining which DB out of multiple DBs has the shortest life expectancy. *Treas. Reg. §1.401(a)(9)-5, A-7(b).* A person who has any right (including a contingent right) to any part of the participant's plan benefits, beyond being a mere successor to the interest of another beneficiary upon that person's death, ***must*** be considered a beneficiary for MRD testing purposes. *Treas. Reg. §1.401(a)(9)-5, A-7(c)(1).*

(1) Explanation.

The final regulations state: "[I]f the first beneficiary has a right to all income with respect to an employee's individual account during that beneficiary's life and a second beneficiary has a right to the principal but only after the death of the first income beneficiary (any portion of the principal distributed during the life of the first income beneficiary to be held in trust until that first beneficiary's death), both beneficiaries must be taken into account in determining the beneficiary with the shortest life expectancy and whether only individuals are beneficiaries." *Treas. Reg §1.401(a)(9)-5, A-7(c)(1) [last sentence]* (emphasis added).

(2) The Death Contingency Rule Under The Former Proposed Regulations.

Recall the controversy and ambiguity relating to the so-called "death contingency" rule in the earliest version of the proposed regulations. Under the former rules, contingent beneficiaries had to be taken into account in determining the designated beneficiary; however, if the death contingency "exception" applied, then beneficiaries receiving benefits due to the death of a prior beneficiary could be ignored. The only way this author could reconcile the death contingency rule with the "normal" contingent beneficiary rule under the earlier set of proposed regulations was to read the word "solely" into the rule. The January 2001 proposed regulations actually added the word "only" to clarify that if a contingent beneficiary's entitlement to any of the participant's plan benefits was due only (solely) to the death of the prior beneficiary (without more), then he/she could be

ignored. If any other factor was involved (such as the trustee's determination to accumulate distributed plan benefits in the trust), then that contingent beneficiary could not be ignored. The final regulations also make this distinction.

b. Successor Beneficiary.

A person will ***not*** be considered a beneficiary for purposes of determining whether only individuals have been named and, if so, which individual has the shortest life expectancy, if "the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death." *Treas. Reg. §1.401(a)(9)-5, A-7(c)(1)*. If the individual beneficiary who is treated as the participant's DB dies after the DB Determination Date, distributions to the subsequent beneficiary will continue to be calculated based on the original DB's remaining (non-recalculated) life expectancy. *Treas. Reg. §1.401(a)(9)-5, A-7(c)(2).*

c. Specific Examples In The Regulations.

(1) Accumulation QTIP Trust.

Participant (referred to as "A") names a traditional QTIP Trust (referred to as "Trust P") as the beneficiary of his plan. Of course, A's spouse (referred to as "B") is the sole, current beneficiary of the QTIP Trust (remember, however, that that fact, alone, *does not* make her the sole beneficiary of the participant's plan under the MRD rules). A's children (who are all younger than A's spouse, B) are the remainder beneficiaries (apparently outright) of the traditional QTIP Trust.

(a) Terms Of QTIP Trust.

Pursuant to the terms of the trust, all income of the QTIP Trust is payable at least annually to A's spouse, B, and no one has the power to appoint the principal of the trust to anyone other than B during her lifetime. B has the power to compel the Trustee to withdraw from the plan the greater of (i) the MRD (calculated pursuant to the life expectancy rule for situations where the spouse is *not* the sole DB, but assuming the trust qualifies for DB treatment and the spouse is treated as the DB because she is the oldest of all of the DBs), or (ii) the amount of income earned on A's interest in the plan (or in A's account) that year. Only the "income portion" of the amount withdrawn from the plan by the Trustee of the QTIP Trust must be paid out to B pursuant to the specific terms of the QTIP Trust and applicable federal estate tax marital deduction rules. The "principal portion" of the distribution from the plan may be retained in the QTIP Trust and accumulated for possible later distribution to B (if authorized by the instrument and warranted under the circumstances) or for final distribution to the remainder beneficiaries upon termination of the trust when B dies. This makes this particular QTIP Trust an accumulation trust under the MRD rules.

(b) DB Analysis.

The regulations provide: "Because some amounts distributed from A's account in Plan X to Trust P may be accumulated in Trust P during B's lifetime for the benefit of A's children, as remaindermen beneficiaries of Trust P, even though access to those amounts are (sic) delayed until after B's death, A's children are beneficiaries of A's account in Plan X in addition to B and B is not the sole designated beneficiary of A's account. Thus the designated beneficiary used to determine the distribution period from A's account in Plan X is the beneficiary with the shortest life expectancy. B's life expectancy is the shortest of all the potential beneficiaries of the testamentary trust's interest in A's account in Plan X (including remainder beneficiaries). Thus, the distribution period for purposes of section 401(a)(9)(B)(iii) is B's life expectancy." *Treas. Reg §1.401(a)(9)-5, A-7(c)(3), Example 1(iii)*. The example also notes that because A's spouse cannot be treated as A's *sole* DB, the options available to a spouse named as sole DB (such as the delay in commencement of MRDs until A would have reached age 70 ½, where A dies before RBD) are not available.

(2) Conduit QTIP Trust.

The second example in the final regulations explaining the difference between contingent trust beneficiaries (who must be taken into account) and mere successor beneficiaries (who can be ignored) involves a conduit QTIP Trust. Since all amounts distributed from the participant's plan to the trust *must* be distributed out of the trust by the Trustee to the current beneficiary (i.e., this is mandated by the instrument and the Trustee has no discretion), then the remainder beneficiaries of the trust are mere successor beneficiaries who can be ignored, and the current trust beneficiary, who must receive each distribution from the plan as it is made (even though it goes through the trust) is deemed to be the *sole* DB under the rules. *See Treas. Reg. §1.401(a)(9)-5, A-7(c)(3), Example 2.*

D. Unanswered Questions Regarding Trusts Named As Beneficiaries.

The final regulations do not specifically address potential beneficiaries who can receive trust benefits due to the exercise of a power of appointment by another trust beneficiary, but, clearly, these potential beneficiaries must be considered in the case of an accumulation trust, at least.

1. Beneficiaries Of Powers Of Appointment.

Beneficiaries who could receive a portion of the trust assets due to the exercise of a power of appointment would be contingent beneficiaries (who *must* be taken into account) and not "mere successor beneficiaries" (who can be ignored under the new rules).

a. General Powers And Broad Special Powers.

If any beneficiary of a trust that is named as the beneficiary of a participant's retirement plan possesses a *general* power of appointment over the trust, that trust would **not** qualify for designated beneficiary treatment (because it is impossible to identify all of the possible beneficiaries of a general power of appointment, therefore failing the third regulatory requirement). [NOTE: For purposes of the MRD rules, possessing a general power of appointment over a trust is far different from possessing an unlimited withdrawal power over a trust]. With respect to non-general powers of appointment, a trust over which a beneficiary is given the broadest possible special power of appointment (i.e., one that merely excludes the power holder, the power holder's estate, creditors of the power holder and creditors of the power holder's estate) will also not pass the "identification of all beneficiaries" test.

b. Limited Powers.

Certain other limited powers of appointment might be all right if carefully drafted. If it is desired that the particular trust named as beneficiary of the participant's plan qualify for DB treatment, then the beneficiaries of the non general power of appointment must be defined in such a way so that it is clear that (i) all potential beneficiaries are individuals (human beings) or qualifying trusts for individuals, and (ii) none of those beneficiaries are older than the beneficiary of the trust who is the intended DB. Obviously, then, if a power of appointment contained in a trust that is named as the beneficiary of a retirement plan includes "charities" as permissible beneficiaries, that trust cannot qualify for DB treatment (because charities are entities, not human beings). If it is desired to allow the exercise of a power of appointment among members of a class, the class should be defined in a way to preserve designated beneficiary treatment. For example, if a special or limited power of appointment can be exercised in favor of "spouses of descendants", then wording to the effect that any spouse of a descendant who is older than the trust beneficiary who is the intended DB will be excluded from the class. Additional complications arise under the MRD rules when the special or limited power of appointment can be exercised "in further trust." To be a qualified see-through trust for MRD purposes, the required trust documentation must be provided to the plan administrator by October 31 of the year following the year of the participant's death. If the beneficiary of a trust that is the beneficiary of the participant's retirement plan can appoint the trust assets in further trust, how is that future trust's documentation going to be supplied to the plan administrator of the participant's plan in a timely manner? If the trust beneficiary's exercise of his/her limited power of appointment is limited to appointing only to trusts that are created in the same instrument that creates the initial beneficiary trust (i.e., the participant's Will or Living Trust Agreement), then the trust documentation requirement perhaps will have been met for that future trust because of the documentation supplied for the current beneficiary trust. There is another problem, however: Can it truly be said that that future trust became irrevocable on the participant's date of death? One would have to argue that the "relation back" doctrine applies–that that future trust is an extension of the original trust that was created as of the participant's death. Thus, there are some problems with a power of appointment that gives the beneficiary of the trust named as the participant's beneficiary the power to appoint in further trust.

2. Remainder Beneficiaries.

Example 1 in the final regulations is instructive with respect to all trusts that can accumulate any part of a distribution made from a retirement plan during the life of the intended DB of the trust. Per Example 1, the immediate remainder beneficiaries must be taken into account in determining the DB issue. If the assets remaining in the trust (including already distributed, accumulated plan benefits) pass *outright* to the remainder beneficiaries upon termination of the trust (and at least one member of that class is living), it appears that any potential successor beneficiaries (such as the surviving descendants of a remainder beneficiary who predeceases termination of the trust) can be ignored. Example 1 in the final regulations does not discuss what level of remainder beneficiary must be considered if the assets in the original trust pass into further trust for the remainder

beneficiaries. If the remainder interest in a trust that is named as the beneficiary of the participant's retirement plan is passing into further trusts, the same BD analysis must continue through those remainder beneficiary trusts as well, until the assets are distributed outright and free of trust.

a. Is The Life Expectancy Theory Still Viable?

In a private letter ruling issued under the January 2001 proposed regulations, the Internal Revenue Service ruled that secondary, contingent remainder beneficiaries of an age 30 contingent trust had to be taken into account in determining the designated beneficiary issue. *See PLR 200228025 (July 12, 2002).*

(1) Facts.

A participant named a contingent trust for his two minor grandsons as the beneficiary of his retirement plan. The trust provided that each grandson had the right to withdraw his entire share upon reaching age 30. If either grandson were to die prior to attaining age 30, the other grandson would then become the sole beneficiary and receive all distributions from the trust. In the event both grandsons failed to reach age 30, then certain other beneficiaries (the oldest of whom was age 67 at the time of the participant's death) would receive the remaining trust assets.

(2) Ruling.

In ruling that the 67 year old (secondary) contingent remainder beneficiary had to be taken into account and, therefore, had to be considered the DB (requiring the 67 year old's life expectancy to be used to calculate MRDs to the grandsons' trust), the Service stated: "In this case, the discretion the trustee of Trust X has with respect to the payment of trust amounts to the Grandchildren, who are the primary beneficiaries, is a contingency over and above the death of a prior beneficiary. The Trust X language does not require that the payments from the IRA Accounts be paid to the Grandchildren on an annual basis and therefore Trust X language does not preclude there being an accumulation of distributions from the IRA Accounts [in the trust]." Some commentators have stated that this ruling appears to conflict with several prior rulings (e.g., PLRs 9846034 and 199903050, *supra*) and seems to negate a life expectancy theory. However, in this author's opinion, it does seem consistent with the "flavor" of certain prior rulings [cited in this author's previous outlines] and this author has never embraced the life expectancy theory. With an accumulation trust, the remainder beneficiaries are always counted in the DB analysis, and you must continue analyzing the DB issue at each level until you reach an outright beneficiary who is already living on the DB Determination Date.

V. SPECIAL CONCERNS IN NAMING A QTIP TRUST AS BENEFICIARY

A. Complete Distribution To QTIP Trust.

Most retirement plans allow the beneficiaries of a deceased participant to take a complete distribution of the participant's entire interest in the plan at one time. Many qualified plans *require* all non-spouse beneficiaries (including trusts of any type) to take such a full distribution shortly after the participant's death.

1. Estate Tax Marital Deduction.

A lump sum payment of the participant's entire interest in the plan to a QTIP trust will qualify for the federal estate tax marital deduction. *See*, e.g., *PLR 9729015 (July 18, 1997) and PLR 8351097 (September 22, 1983).* Of course, a full distribution directly to the participant's spouse will also qualify for the estate tax marital deduction. Thus, naming a QTIP Trust as the beneficiary of a retirement plan is done for non-tax reasons.

2. Income Tax Issues.

If a QTIP Trust received a complete distribution of the participant's interest in the retirement plan on or before December 31, 1999, 5-year averaging would have been available to reduce the income tax impact of receiving such a large among in one taxable year. After that date, 5-year averaging is no longer available (due to its repeal). (In the case of certain participants in qualified plans born before 1936, special 10 year averaging and capital gains treatment may be available pursuant to the transitional rule). *See* I.C.1., *supra*.

3. IRD.

The lump sum payment from the retirement plan to the QTIP Trust is IRD to the Trust and subject to ordinary income tax in the year received (non-taxable amounts, such as nondeductible participant contributions, are not subject to income tax).

a. No IRD Deduction.

Because the lump sum amount is paid directly to a QTIP trust, assuming all QTIP qualification requirements are met and the QTIP election is made, no estate tax will be payable on it due to the marital deduction. Therefore, there will not be an IRD deduction under Section 691(c) (for estate taxes paid) for income tax purposes.

4. Allocation Between Principal And Income.

Although the lump sum payment is taxable as ordinary income for income tax purposes, normally, the entire distribution would be allocated to principal for fiduciary accounting purposes. There were some issues and potential problems with the allocation of receipts from retirement plans under Texas law before 2004. For a discussion of principal and income allocation issues involving retirement plan benefits paid to a trust under pre-2004 Texas law, *see* Gerstner, *You Have Named a Trust as the Beneficiary of Qualified Plans/IRAs - Now What? (Fiduciary Accounting, Tax and Other Administrative Issues to Consider When Plan/IRA Benefits Pass to a Trust),* State Bar of Texas 25th Annual Advanced Estate Planning and Probate Course, June 2001 (hereinafter cited as "*You have Named a Trust - Now What?*").

a. Texas Uniform Principal And Income Act Allocation Rules.

In 2004, Texas law was changed to provide a new rule for allocating receipts from retirement plans. *See Texas Trust Code §116.172,* which came into the law as part of Texas' adoption of the Uniform Principal and Income Act ("UPIA"). Of course, a different principal and income allocation rule can be provided in a Will or Trust instrument. For those instruments subject to UPIA, receipts from retirement plans passing to trusts are allocated as follows:

(1) Income Characterization By Payer. To the extent that the payer characterizes a payment as interest or a dividend, the trustee must allocate the receipt to income. TTC § 116.172(b).

(2) The 4% Rule. If no part of a payment "required to be made" is characterized as interest or a dividend, then the trustee must allocate to income "the part of the payment that does not exceed an amount equal to: (1) four percent of the fair market value of the future payment asset as determined under Subsection (d); less (2) the total amount that the trustee has allocated to income for a previous payment received... during the accounting period." TTC § 116.172(c). Amounts received are allocated to income until they aggregate during the accounting period 4% of the value of the asset. The remaining amounts received are allocated to principal.

(3) Determination Date. The determination of the 4% valuation is made on the later of "(1) the date on which the future payment right first becomes subject to the trust; or (2) the first day of the trust's accounting period during which the future payment asset is received." TTC § 116.172(d).

(4) Receipt of Entire Amount = Principal. If no part of a payment is required to be made, or the payment received is the entire amount to which the trustee is entitled, the trustee must allocate the entire payment to principal. TTC § 116.172(e).

(5) Discretionary Withdrawal Rule. A payment is not "required to be made" to the extent that it is made only because the trustee exercises a right of withdrawal. TTC § 116.172(g).

(6) No Real Allocation Rule For Marital Trusts. If the marital deduction is at stake with respect to a trust to which payments are made, the trustee must allocate sufficient amounts to income to protect the marital deduction. TTC § 116.172(h).

b. Comparison to "National" UPIA.

The new UPIA retirement plan distribution allocation rule is not based on the "national" version of UPIA, but is unique to Texas. It follows a "unitrust" approach, which is fairer than the "national" UPIA approach (wherein 90% *of each distribution* is principal and 10% is income). The new Texas UPIA allocation rule is also an improvement over prior Texas law. *See* Gerstner, *You Have Named a Trust - Now What?*, cited at V.A.4.

5. Observation Regarding Reduction In Value Of Retirement Plan Due To IRD.

It is interesting to note that the gross value of the full distribution to the QTIP Trust qualifies for the federal estate tax marital deduction; yet, because it is IRD, the net amount remaining in the QTIP Trust after payment of income taxes is substantially lower. While no one has put forth an argument (to this author's knowledge) that the *marital deduction* ought to be reduced to the net after tax amount of the distribution from a retirement plan, in some respects the issue is analogous to the concerns raised by the Hubert case (and now addressed in the regulations to Section 2056). NOTE: An argument to this effect (that the estate tax value of the retirement

plan should be reduced due to the income tax liability) involving valuation of retirement plan benefits passing to beneficiaries in a taxable estate situation failed. *See Estate of Smith v. U.S., 93 AFTR 2d 2004-556 (300 F. Supp.2d 474, D.C. Tex. 2004) and TAM 200247001 (November 22, 2002).*

B. Periodic Payments To QTIP Trust.

Most participants would prefer not to have a lump sum distribution of their entire plan benefits made all at once to the QTIP Trust on their death but, instead, to have the QTIP Trust receive periodic payments pursuant to the minimum distribution rules. During the planning phase, the participant should ascertain whether his qualified plan or IRA permits this. If not, the participant can do an IRA rollover during life or counsel his beneficiary to use the Pension Protection Act's rollover provisions to create an inherited IRA to receive the plan benefits on his death. Participants not only desire to obtain a federal estate tax marital deduction for the retirement plan benefits passing to the QTIP Trust, they also desire to obtain "designated beneficiary" treatment because it provides a better income tax result. The following considerations relate to these desires.

1. Estate Tax Marital Deduction Issues.

A primary area that deserves significant drafting attention involves the requirements for obtaining the federal estate tax marital deduction when qualified plan or IRA benefits are passing to a marital trust.

a. Satisfying The "Qualifying Income Interest For Life" Requirement.

In order to obtain the federal estate tax marital deduction for "terminable interests" passing to the decedent's spouse, the spouse must have a qualifying income interest for life. *IRC § 2056(b)(7)(B)(i)(II).* The spouse will have a qualifying income interest for life if (a) she is entitled to all of the income from the property, payable at least annually, and (b) no person has a power to appoint any part of the property to anyone other than the spouse. *IRC §2056(b)(7)(B)(ii).*

(1) Form Of Benefit.

Lump sum distributions to the participant's spouse will qualify for the marital deduction. If the spouse has the option to take a lump sum distribution, the marital deduction is available even if she elects a different option. If the plan mandates the form of benefit or the participant elects a form of benefit that does not automatically qualify for the marital deduction, such as an annuity or other periodic payment that would be considered a terminable interest and that does not come within Section 2056(b)(7)(C) of the Code, then QTIP treatment may be necessary to obtain the marital deduction.

(2) Periodic Distributions From Retirement Plans.

Periodic distributions from retirement plans are "terminable interests". In order for those distributions to qualify for the marital deduction, all of the QTIP requirements must be satisfied. As a result of amendments made by TAMRA, certain survivor annuities are deemed to satisfy the qualifying income interest for life requirement under the QTIP rules and a QTIP election is automatic for such annuities. *IRC §2056(b)(7)(C).* In such cases, the Executor must elect out of the automatic QTIP treatment, otherwise the annuities are deemed to be QTIPped.

b. Two Alternatives For Meeting The Qualifying Income Interest Requirement.

(1) The Conduit Approach.

If the plan distributions themselves qualify as QTIP under the special survivor annuity rule (and the Executor does not elect *out* of QTIP treatment), and the plan distributions flow through the QTIP Trust to the spouse, so that the trust is a mere "conduit," then the qualifying income interest requirement will be met. Another variation of the conduit approach where a survivor annuity is not involved is to have 100% of the periodic distribution from the plan (i.e., both the required "all income" distribution amount and the additional "principal" amount, if any, that must be distributed from the plan pursuant to the minimum distribution rules) flow out of the plan to the trust and out of the trust to the spouse (i.e., the full distribution amount flows from the plan, through the trust, to the spouse.) If this method is desired, the trust should be affirmatively drafted as a "Conduit Trust" -- at least with respect to qualified plan and IRA benefits passing to it. Under the conduit approach, there would be no accumulations of plan benefit distributions in the QTIP Trust itself. Therefore, the plan benefits are, in essence, passing directly to the spouse with the trust being a mere "flow through" entity. Thus, all of the remainder beneficiaries and potential beneficiaries under a testamentary special power of appointment can be ignored in making the DB determination.

(a) Comment On Conduit Approach.

Some clients may find the conduit approach acceptable for a QTIP Trust in certain cases. While it is true that, over time, the amount remaining in the retirement plan will be virtually depleted due to minimum required distributions being forced out, and since distributions from the plan to the QTIP Trust flow right out of the trust to the spouse (so that no distributed amounts will remain in the trust either), perhaps the QTIP Trust is desired more for management reasons or perhaps the client does not mind using the plan benefits to support his spouse during her lifetime and merely wants to protect other assets (e.g., those assets held in the Bypass Trust) or to preserve what is left in the plan itself (if anything) at the spouse's death for the participant's ultimate beneficiaries.

(2) Flow Through Of "Income" Portion Of MRD (Only).

If the conduit approach is not used, then the surviving spouse must at least have the right to compel the trustee of the QTIP Trust to withdraw from the plan each year the greater of (a) the minimum distribution amount under Section 401(a), or (b) all income produced by the trust's interest in the plan that year. *See Rev. Rul. 2000-2, I.R.B. 2000-3, January 18, 2000, rendering obsolete Rev. Rul. 89-89, 1989-2, C.B. 231 and also Treas. Reg. §1.401(a)(9)-5, A-7(c)(3), Example 1.* The trust instrument should provide that the Trustee has the power to demand, and the spouse has the power to compel the Trustee to demand, distribution of such additional amount above the minimum required distribution, if any, so that all income earned by the trust's interest in the plan will be distributed to the trust each year. In the latter case, all of the income produced by the trust's interest in the plan for the current year that is actually withdrawn from or distributed by the plan (plus all income earned by the QTIP Trust itself on all of its other assets) will then be distributed out of the trust to the spouse.

c. Conflict Between Minimum Distribution Rules And "All Income" Requirement Under The Estate Tax Marital Deduction Rules.

(1) Problem: Delay In Commencement Of Distributions.

If the participant dies before his RBD, depending on whether there is a "designated beneficiary" and, if so, who it is, distributions may not have to commence (or be made) until (a) December 31 of the year that contains the fifth anniversary of the participant's death (5 year rule), (b) December 31 of the year following the year in which the participant died (rule where spouse is not sole DB -- the rule that applies to accumulation trusts), or (c) the year in which the participant would have reached age 70 ½ (exception for sole designated beneficiary spouse, available with the conduit trust approach). This delay in commencement of distributions under the minimum distribution rules is not compatible with the estate tax marital deduction "all income" requirement for a QTIP Trust.

(a) One (Rejected) Theory: Plan Or IRA Is An Asset Of QTIP Trust.

Theoretically, it could be argued (and was argued by certain taxpayers early on) that the qualified plan or IRA is merely an asset of the QTIP Trust that happens to be unproductive of income during this time period, and since the surviving spouse is given the right in the instrument to compel the Trustee to make unproductive QTIP assets productive of income, no problem should arise. This is not the IRS's view, however. In PLR 9220007 (May 15, 1992), the IRS stated, "Initially, we question whether the IRA is properly characterized as an asset. The nature of the IRA account (a significant amount of liquid assets held by a fiduciary) is such that the account is itself a trust that may qualify for QTIP treatment based on its own terms, as in Rev. Rul. 89-89. The QTIP rules should not be avoidable by classifying what is inherently a separate trust corpus as an 'asset' of a QTIP Trust, thus vitiating the requirement that the spouse receive all the income from the separate trust property."

(2) Problem: Minimum Distribution Is Less Than Income Produced.

In other cases, even when a minimum distribution is currently required under the rules, the amount required to be distributed to the QTIP Trust as the beneficiary can be less than the income actually produced by the trust's interest in the plan assets.

d. Solution: Two Choices Now For Meeting "All Income" Requirement.

Formerly, the QTIP Trust had to be drafted to provide that all income earned by the trust's interest in the plan *had* to be demanded or withdrawn by the Trustee of the QTIP Trust each year (including during the time period predating the commencement of required distributions) in order to obtain QTIP treatment. *See Rev. Rul. 89-89, 1989-2, C.B. 231.* Now, Rev. Rul. 2000-2 provides an important "new" method to use in this situation. Rev. Rul. 2000-2 allows distributions to be delayed until otherwise required under the minimum distribution rules, even if a QTIP Trust is the named beneficiary, and allows the trust to qualify for the marital deduction as long as

the spouse has the ***right*** to compel the Trustee to withdraw the income earned on the trust's interest in the plan each year.

(1) Preferred Method: Rev. Rul. 2000-2.

As a result of Rev. Rul. 2000-2, most practitioners will now probably draft the QTIP Trust to provide the spouse with the power to compel the trustee to withdraw the income earned by the trust's interest in the retirement plan or IRA, rather than mandating that the Trustee actually withdraw such income from the plan or IRA each year. If the spouse does not need the income, it can remain in the plan, accumulating tax deferred, until minimum distributions are required to commence under the applicable rules. Thus, Rev. Rul. 2000-2 provides a way to meet the "all income" requirement and still observe (and, for the most part, obtain the benefit of) the minimum distribution rules. There are some other potential problems caused by the Rev. Rul. 2000-2 approach, however. *See* Gerstner, *You Have Named a Trust - Now What?*, cited earlier at V.A.4.

e. Principal And Income Allocation Issues.

Pursuant to the instrument or state law (or the Trustee's proposed allocation, *see* PLR 9232036 (May 13, 1992), or the participant's allocation in the beneficiary designation, *see* PLR 9830004 (July 24, 1998)), either (i) the entire distribution from the plan is treated as trust accounting income (follows the conduit theory) or (ii) the portion of the distribution from the plan representing income earned in the plan that year on the trust's interest in the plan is allocated to income for trust accounting purposes (and, therefore, is distributable to the spouse from the QTIP Trust once received, at least annually), and the balance of the distribution, if any, is allocated to principal. WARNING: The latter approach can result in accumulation of plan benefit distributions in the trust, therefore making remainder beneficiaries of the trust "countable" beneficiaries in determining whether the trust qualifies for designated beneficiary treatment. Because the remainder beneficiaries of the QTIP Trust are also "counted" as beneficiaries in this situation, the spouse cannot use the special spousal commencement date for required distributions and designated beneficiary treatment will be precluded if a charity or other entity is a remainder beneficiary. *See* IV.C.4., *supra*.

(1) Why Is Principal And Income Allocation Of Plan Benefit Receipts Necessary?

In cases in which the participant has named a qualified see-through trust in accumulation form as his beneficiary and is deemed to have a designated beneficiary (because the trust regulatory requirements have all been met), payment of the required distribution amount to the trust after the participant's death satisfies the minimum distribution rules. Thus, the trust is not required to redistribute the payment it has received from the plan to the trust beneficiary merely to satisfy the minimum distribution rules (because it is not a conduit trust). As noted above, however, distribution of trust accounting income to the spouse from a QTIP Trust is required for estate tax marital deduction qualification purposes.

(2) State And Uniform Principal And Income Allocation Rules Applicable To Retirement Plans.

Following the allocation rules provided in some states' principal and income allocation statutes may or may not produce an acceptable result. Under some state statutes and under various uniform acts, only a small percentage (e.g., 5% or 10%) of the periodic distribution received by the trust from the retirement plan is treated as "income" for fiduciary accounting purposes. The Texas Uniform Principal and Income Act (effective on and after January 1, 2004) basically "punts" on this issue. *See Texas Trust Code §116.172(h)*. Therefore, specific drafting of principal and income allocation rules in the relevant instrument is recommended. A provision requiring that just that portion of the distribution equal to the income earned by the trust's interest in the plan for that year must be allocated to income has been deemed acceptable under the IRS rulings to date. This allocation would allow retention of the "principal" portion of the plan distribution in the QTIP Trust, if desired. It may not be desirable to do this, however, since the "principal" portion of the distribution is still taxable as ordinary income for income tax purposes. Thus, retention of such taxable amounts in the trust will cause income taxation at the high income tax rates applicable to trusts. Of course, another issue if the QTIP Trust is drafted this way (i.e., as an accumulation trust), is whether all "countable" beneficiaries qualify as designated beneficiaries and, if so, who the oldest "countable" beneficiary is. It may not be the spouse, depending on who the remainder beneficiaries of the QTIP Trust are. In fact, if the remainder beneficiary is a charity, a QTIP Trust in the form of an accumulation trust will not be a qualified see-through trust and, therefore, designated beneficiary treatment will not be allowed. Most QTIP Trusts allow distributions of principal to the spouse also, so that all of the distribution from the plan *can* be passed through the trust to the spouse (and taxable to her), if desired. Thus, a QTIP Trust in the form of a conduit trust would not be that unusual. Remember that, merely because the Trustee exercises his discretion to distribute both income and principal to the spouse in the form of the entire distribution from the plan/IRA,

however, does not make the QTIP Trust a conduit trust for purposes of the minimum distribution rules. If a conduit QTIP Trust is desired, the trust should be specifically drafted that way.

f. Post-death Administrative Requirement: Two QTIP Elections.

The executor or trustee must make two (2) QTIP elections in this situation, one for the QTIP Trust itself and one for the qualified plan or IRA. *Rev. Rul. 2000-2, I.R.B. 2000-3, January 18, 2000.* In the case of a qualified survivor annuity, the Executor or Trustee must make the QTIP election for the QTIP Trust and must not elect out of the automatic QTIP treatment for such annuity.

g. Plan Distribution Options Must Be Satisfactory.

The qualified plan or IRA must allow distribution options that will qualify for QTIP treatment. *See PLR 9220007 (January 30, 1991).* (As explained by the IRS in the cited ruling, this problem cannot be cured by post-death redrafting of options by the Trustee.)

2. Designated Beneficiary Issues.

a. The Trust Regulatory Requirements.

The QTIP Trust must meet the four (4) trust requirements under the proposed regulations as of the applicable date in order to "look through" the trust to determine the designated beneficiary. *See* IV.C., *supra*.

(1) The Multiple Beneficiary Rule: Trusts That Accumulate Distributions.

If any remainder beneficiary of the QTIP Trust is not an individual (e.g., a charity), there should be no accumulations in the trust of any amount of plan benefits distributed to the trust from the plan during the spouse's life (regardless of whether such distributions are treated as income or principal and regardless of the fact that QTIP treatment can be obtained merely by distributing all income). In other words, the trust should be drafted as a conduit QTIP Trust in that case.

(a) Designated Beneficiary Treatment Unavailable for Accumulation Trusts If Charity Is Remainder Beneficiary.

In PLR 9820021 (May 15, 1998), involving accumulations of plan benefits in a QTIP Trust, the surviving spouse could not be treated as the designated beneficiary because the remainder beneficiaries, whose interests were deemed not to be *solely* contingent on her death, were charities. Thus, the trust could not obtain designated beneficiary treatment. Therefore, it is possible to have a conduit QTIP Trust with remainder to charity, but not an accumulation QTIP Trust with remainder to charity.

(b) Special Spousal Commencement Date Option Unavailable.

In PLR 199908060 (March 1, 1999), because of the accumulation of plan benefit distributions in the trust, the remainder beneficiaries were also counted as beneficiaries under the multiple beneficiary rules, and since the spouse was not the sole beneficiary of the plan benefits under these rules, the special distribution commencement date option allowed where the spouse is the sole DB was not available. The same decision was reached by the IRS in PLR 9847022 (November 20, 1998), although the death contingency issue was not explicitly addressed in that ruling. This "spouse as sole beneficiary" requirement for utilizing the special option of beginning minimum required distributions when the participant would have reached age 70 ½ was reconfirmed in Rev. Rul. 2000-2 and has now been codified in the final regulations. *Treas. Reg. §1.401(a)(9)-5, A-7(c)(3), Example 1 (iii) [last sentence]*.

(c) Drafting For Trust Accumulation Of Plan Distributions: Obtaining DB Treatment.

If a complete flow through of the entire distribution made from the plan to the QTIP Trust each year (i.e., the "conduit" approach) is not desired (so that the "principal" portion of the distribution is retained in the QTIP Trust), the accumulated distributions could be specially earmarked for distribution only to the surviving spouse, preferably during her lifetime, if the trust has any potentially problematic beneficiaries. Accumulated distributions could also be required to be distributed outright only to "qualified" remainder beneficiaries (e.g., children) on the spouse's death. Another idea would be to specify in the trust instrument that all accumulated plan benefit distributions must be kept in a separate account from other trust assets and must be utilized first to make discretionary principal distributions to the spouse. A further idea would be to give the spouse a withdrawal power (but not a general power of appointment, which precludes designated beneficiary treatment) over accumulated plan distributions held in the QTIP Trust. A "savings clause" to the effect that accumulated plan distributions can never be distributed to "bad" beneficiaries could also be included.

(2) Example.

For example, in cases in which a participant dies before reaching his RBD having named the QTIP Trust as his beneficiary, with proper planning (e.g., the participant's children, who are all younger than the participant's spouse, are outright remainder beneficiaries of the trust and the plan or IRA allows all of the distribution options under the minimum distribution rules), the QTIP Trust Trustee should be able to take distributions over the surviving spouse's life expectancy (as the DB), even if plan distributions are accumulated. Whether the surviving spouse's life expectancy is recalculated each year depends on whether the conduit approach (yes) or accumulation trust approach (no) is used. *See* Examples 1 and 2 in the final regulations, discussed earlier in this outline at IV.C.4.c.

(3) Form Of Marital Trust Used Affects DB Qualification.

A life estate with general power of appointment ("LEPA") marital trust under IRC § 2056(b)(5), which is named as the beneficiary of qualified plan or IRA benefits will not qualify for designated beneficiary treatment because of the spouse's possession of a general power of appointment. *See* IV.D.1., *supra*.

3. IRD Issues.

Because retirement plan benefits are IRD, they should not be used in a *discretionary* manner to satisfy a pecuniary bequest, including a pecuniary marital deduction formula bequest. This could happen where the plan benefits are made payable to the Trustee under the participant's Will or Living Trust Agreement, and then are distributed by the Trustee, in the exercise of the Trustee's complete discretion, to satisfy a pecuniary marital bequest to the QTIP Trust. This will accelerate the IRD (i.e., cause immediate income taxes on the entire amount). *IRC § 691(a)(2).*

a. Specific Bequest Approach.

If the relevant instrument makes a specific bequest of the retirement plan benefits to the QTIP Trust, IRD is not accelerated. For example, the beneficiary designation could direct that the participant's interest in the retirement plan is to pass directly to the QTIP Trust. As an alternative, if the participant's interest in the plan passes to the Trustee under his Will and the Trustee is specifically directed by a provision in the Will to allocate all of that IRD to the QTIP Trust, no acceleration of IRD should occur.

b. Fractional Share Approach.

Another way to avoid triggering current income taxes on the entire present value of the retirement plan benefits when it is desired that such IRD pass into trust, especially to more than one trust, is to use a fractional share formula. Admittedly, this is not the simplest method for dealing with this problem.

c. Residuary Trust.

If the IRD items pass to a residuary trust under the Will, then IRD should not be accelerated.

4. Tax Payment Issues.

a. Estate Taxes.

If estate taxes are due on the participant's death, it would be better if assets other than the decedent's interest in retirement plans were used to pay them (because withdrawal from the plan to pay estate taxes will trigger income taxes). Further, if plan benefits are being paid to a QTIP Trust and no QTIP election is made or only a partial QTIP election is made, resulting in estate tax becoming due, a standard tax apportionment clause is not advisable (again, it would be better if other assets were used to pay the estate taxes in this situation). Another reason to be cautious in this regard is due to the IRS's theory that if the instrument requires or even authorizes the use of plan benefits to pay estate taxes, the participant's "Estate" is deemed to be one of the beneficiaries of the plan benefits (and an estate is not a designated beneficiary).

b. Income Taxes And Expenses.

Some of the favorable rulings allowing DB treatment to a QTIP Trust named as a plan beneficiary recited the fact that no trust expenses or income taxes payable on the plan distribution received by the QTIP Trust were charged to the income of the trust. While it is not clear whether this fact was important, some consideration should be given to having the income portion of the plan distribution flow through the QTIP Trust to the spouse without diminution by such charges.

5. Instructive Rulings.

A review of various private letter rulings in which the marital deduction was allowed for retirement plans (usually IRAs) passing to a QTIP Trust should be helpful in determining what provisions, among others, ought to be included in the relevant instrument. The most important recent ruling in this area is more than just instructive on some of these issues. *See Rev. Rul. 2000-2, supra.* Many important document provisions have already been discussed in this section of the outline. It is important to note, however, that in many of the rulings, the designated beneficiary issue was not addressed. The following are some favorable rulings issued before release of the final regulations on April 17, 2002, that the practitioner may want to study, in addition to Rev. Rul. 2000-2: PLR 8351097; PLR 8843033 (actually involving a LEPA and not a QTIP Trust); Rev. Rul 89-89, *supra*; PLR 9204017; PLR 9229017; PLR 9232036; PLR 9245033; PLR 9320015; PLR 9416016; PLR 9442032; PLR 9537005; PLR 9551015 and PLR 9830004.

6. Will Contests And Other Litigation.

What if the Will which creates the QTIP Trust is contested and prolonged litigation is likely? If it is not clear who the beneficiary of the participant's retirement plan is by the DB Determination Date, then designated beneficiary treatment will be jeopardized. Could the QTIP Trust provisions and related designated beneficiary provisions in the Will be incorporated by reference into the beneficiary designation so that minimum distribution amounts can be determined and timely distributed (even if a Will contest is still unresolved by the DB Determination Date)? What if the decedent's waiver or the spouse's consent to waiver of REA rights is being challenged? Does state law or ERISA control the decision? How do community property laws impact this issue (if they do)? Some interesting complex litigation issues can arise involving trusts that are named as the beneficiary of retirement plan benefits and the impact of the litigation on both the estate tax marital deduction (if applicable) and the designated beneficiary issue should be determined.

VI. SPECIAL CONCERNS IN NAMING A QDOT TRUST AS BENEFICIARY

A. Spouse Not U.S. Citizen.

If the participant's spouse is not a U.S. citizen, amounts passing directly to her will not qualify for the federal estate tax marital deduction. IRC § 2056(d). A qualified domestic trust ("QDOT") must be used to obtain the marital deduction in this situation. *IRC § 2056A.*

B. Creation of QDOT.

Either the participant or the surviving spouse may create the QDOT. The considerations discussed above relating to the QTIP Trust will usually apply, especially if the participant is the one creating the QDOT. In addition, all of the usual QDOT requirements must be included in the governing instrument.

C. Rollover to QDOT by Non-Citizen Spouse.

1. Three Illustrative Rulings.

a. PLR 9623063.

(1) Facts.

The participant of three (3) IRAs died, having designated his spouse, S, who was not a U.S. citizen, as his beneficiary. S timely created a QDOT that met all of the QDOT requirements. S proposed to roll over to one or more IRAs in her name the participant's community property interest in his IRAs. The IRA rollovers would then be allocated to corpus of the QDOT. S, who was age 68 when the participant died, had a complete withdrawal right over the IRAs. S proposed to treat the portion of the distributions from the IRA rollovers to the QDOT representing the trust's income available for distribution (i.e., income earned by the trust during the calendar year) as income, and to treat the income earned in the IRA rollovers but not distributed during the calendar year as principal.

(2) QDOT Qualification For Marital Deduction.

The IRS ruled that because the IRAs passed directly (outright) to S, the QDOT to which the IRA rollovers were transferred did not have to meet the QTIP requirements of Code Section 2056(b)(7), or the LEPA requirements of Code Section 2056(b)(5), or constitute an estate trust under Treasury Regulation Sections 20.2056(c)-2(b)(1)(i) through (iii). The IRS concluded that S's IRA rollovers were eligible for the marital deduction under Section 2056(d)(2)(B) of the Code.

(3) Income Issue.

The IRS did not quite use the same terminology S used in S's ruling request, but ruled that amounts distributed from her IRA rollovers during any calendar year will be deemed income, to the extent of the IRA rollover's current income for the calendar year, within the meaning of Section 2056(c)(2) of the Code.

b. PLR 9109021.

In this ruling, the non-citizen spouse rolled over 403(b) and IRA benefits to a QDOT that she created after the participant's death. Although the ruling contains very little discussion of the income issue, the IRS held that the QDOT created with the plan benefits qualified for the marital deduction. *PLR 9109021 (November 30, 1990).*

c. PLR 9321032.

For a ruling that contains an excellent discussion of both the marital deduction issue in the case of a non-citizen spouse and the minimum distribution issues, *see* PLR 9321032 (May 28, 1993). *See also PLR 9322005 (June 4, 1993).*

D. Annuity As QDOT.

Congress allowed Treasury to issue regulations stating that annuities, including those emanating from qualified plans and IRAs, may be treated as QDOTs. *IRC §2056A(e).* The problem with this approach is that the annuity distributions under the minimum distribution rules eventually carry out "principal" and the non-citizen surviving spouse must pay estate tax on principal distributions from a QDOT (except for emergency distributions of principal).

E. Final QDOT Regulations.

Under the final QDOT regulations, a non-citizen spouse can obtain QDOT treatment for annuities if she either agrees to pay the deferred estate tax on the principal portion of each annuity distribution or rolls the principal portion of the annuity distribution into a QDOT. *Treas. Reg. §20.205A-4(c); see also PLR 9729040 (July 18, 1997).*

VII. SPECIAL CONCERNS IN NAMING A BYPASS TRUST AS BENEFICIARY

A. Complete Distribution To Bypass Trust.

Many qualified plan documents require a lump sum distribution of a deceased participant's entire interest in the plan in the case of all non-spouse beneficiaries. Thus, if a Bypass Trust has been named as the beneficiary, many qualified plans will require a lump sum distribution to the trust. Ignoring the Pension Protection Act for a moment, in a case like this, the Bypass Trust would be underfunded because the date of death value of the participant's interest in the plan (the "gross" amount) is included in his estate under either Section 2033 or Section 2039 and, yet, when the Bypass Trust receives the lump sum distribution of the plan benefits, it is fully taxable as IRD in the year of receipt. Thus, the Bypass Trust "immediately" shrinks by the amount of the income taxes it must pay on the distribution. This illustrates why "pre-tax" assets are not the best choice for funding a Bypass Trust. Before the Pension Protection Act, participants in a plan like this usually rolled over their qualified plan benefits to an IRA rollover to avoid their beneficiaries having to take a lump sum distribution on death. Now, because of the Pension Protection Act, the inherited qualified plan benefits can be moved to an inherited IRA for the benefit of the Bypass Trust, without accelerating the income taxes, as long as the Bypass Trust is properly drafted–i.e., is in the form of a "qualified see-through trust." Another option that may be superior in some cases, especially where long term income tax deferral is actually likely, would be for the participant to convert his traditional IRA to a Roth IRA during life and then name the Bypass Trust as the beneficiary of the Roth IRA. Discussion of Roth IRAs is included in Exhibit 18.

1. IRD Deduction.

If estate taxes are paid by the participant's estate as a result of the IRD passing to the Bypass Trust, then the Bypass Trust should be entitled to the IRC § 691(c) deduction for income tax purposes (for estate tax attributable to the IRD item). Usually, however, the estate plan would be designed so that no estate taxes are caused by the amount passing to the Bypass Trust.

2. Principal And Income Allocation Issues.

If a complete distribution of the participant's interest in the plan (i.e., a lump sum) is received by the Bypass Trust, it would be beneficial to allocate such receipt to principal for trust accounting purposes. The Texas UPIA

rules would require this. *See Texas Trust Code §116.172(g).* Even though allocated to principal, income taxes would still be due on the lump sum distribution since it is IRD (i.e., taxable income).

B. Minimum Distribution Payments To Bypass Trust.

If the Bypass Trust is going to be a beneficiary of retirement plan benefits, it would be preferable for the Bypass Trust to qualify for designated beneficiary treatment so that payments to the trust could be made over the life expectancy of the oldest trust beneficiary pursuant to the minimum distribution rules. Periodic distributions from the plan to the Bypass Trust will allow for further tax-deferred growth in the plan assets (versus a complete distribution up front).

1. Principal and Income Allocation Issues.

If the Bypass Trust is structured as a qualified see-through trust, so that only minimum required distributions have to be paid to it each year from the retirement plan, assuming the plan administrator or IRA custodian/trustee does not characterize the distribution as interest or dividend income, then the "4% rule" applies. *See Texas Trust Code §116.172(c).*

2. IRD Reduces Estate Tax Effectiveness.

It is still better to have non-IRD assets (i.e., "after tax" assets) pass into a Bypass Trust for federal estate tax purposes because IRD assets are not true "growth" assets (due to the inherent income tax liability). While some possibility for growth exists as long as the opportunity for deferral is preserved, IRD assets do not "grow" in the same way as after-tax assets. Thus, allocating IRD assets to the Bypass Trust is usually not the best use of the participant's federal estate tax exemption amount. Planning efforts should be directed toward allocating all other assets that could be used to fund the Bypass Trust, including real estate and life insurance, to the Bypass Trust first. Better Bypass Trust funding might be possible through a non pro rata distribution. And, for decedents who die in 2011 or later, another option for this situation is portability. Both are discussed, *infra,* at VII.C.

3. Strategies For The Participant During Life.

If the participant is concerned with fully funding or, at least, optimally funding the Bypass Trust, he should consider the following strategies:

a. Not Waiting Until Age 70 ½ To Take Distributions From His Retirement Plans.

Many retired people under age 70 ½ spend all of their after tax assets, while continuing to let their retirement plans grow larger (thus, worsening the problem). If a participant's estate is taxable and consists primarily of retirement plans, he should consider taking distributions earlier (as long as he is at least age 59 ½). He will pay income taxes on the distributions, but then he can either invest the net after tax amount in other assets that will be more suitable for funding a Bypass Trust, spend it, or make gifts with it -- all effective estate tax reduction strategies.

b. Not Taking Merely The Minimum Required Distributions Upon Reaching RBD.

While many people complain about having to pay income taxes on retirement plan distributions, these monies have not paid any income taxes previously and they have benefitted tremendously by this tax deferral. On the other hand, when the surviving spouse dies and estate taxes are payable, the children may have to withdraw amounts from the retirement plan to pay the estate taxes, incurring income taxes at the same time, and possibly resulting in a combined tax rate of 80% or more on these assets. The participant and his spouse will likely never have to pay taxes at that high a rate on distributions from these plans during life. Thus, taking extra distributions during lifetime to save taxes later is not a bad idea. Some people take just enough extra from their plans to stay within the income tax bracket they would have been in anyway as a result of their required distribution and other taxable income. Also, every time income taxes are paid on these assets, the participant's estate is being reduced by that tax payment.

c. Rolling Over Qualified Plan Benefits To An IRA.

For a variety of estate planning reasons, the participant should consider taking a lump sum distribution from his qualified plan and rolling it over to an IRA rollover when he separates from service. Participants can also do in-service rollovers of qualified plan benefits to an IRA rollover. Besides the fact that IRAs are generally easier to deal with, post-death, than qualified plans, moving from a qualified plan to an IRA rollover allows the non-participant spouse to do estate planning with her community half of the IRA (IRAs are not qualified plans under ERISA and, therefore, the Boggs decision does not apply to them).

d. Converting to a Roth IRA.

There is no longer an Adjusted Gross Income limit for converting a traditional IRA to a Roth IRA. Thus, in the year 2012, when 35% was the top income tax rate, many taxpayers were urged to make a Roth IRA conversion.

4. Complicating Factors.

a. Multiple Beneficiaries.

A Bypass Trust often has multiple current beneficiaries, but even if it is drafted so that the surviving spouse is the sole current beneficiary, unless it is drafted in the form of a "conduit" trust, the remainder beneficiaries of the trust *must* be taken into account in determining its qualification for DB treatment after the participant's death. *See* IV.C.4., *supra*. If all "countable" beneficiaries of such an accumulation Bypass Trust are human beings, then the individual with the shortest life expectancy (usually the spouse) will be treated as the designated beneficiary whose life expectancy will be used as the measuring life for calculating MRDs to the trust after the participant's death.

(1) Power Of Appointment To Charity.

If the Bypass Trust is not a conduit trust and the spouse has a testamentary power of appointment over the Bypass Trust in favor of charity, then designated beneficiary treatment is jeopardized. The surviving spouse should timely disclaim the offending power if DB treatment is desired. With a conduit Bypass Trust, the spouse's testamentary power of appointment can include charities. With a conduit trust, a charity can even be the remainder beneficiary (or one of the remainder beneficiaries) of the trust and it will not affect the trust's qualification for DB treatment. Usually, however, a charity is not a remainder beneficiary of a Bypass Trust because there is no estate tax on the remaining trust assets when the surviving spouse dies and, therefore, no need for a charitable deduction.

(2) Charity Is Potential Remainder Beneficiary Of Accumulation Bypass Trust.

If charity is a "countable" remainder beneficiary of a Bypass Trust in accumulation form, designated beneficiary treatment is not available. *See,* e.g., *PLR 9820021, supra.* If there are intervening outright remainder beneficiaries of the trust before an ultimate charitable beneficiary is reached, then charity may be deemed a "mere potential successor beneficiary" as long as there is at least one outright remainder beneficiary in the class alive on the DB Determination Date. For example, if the Bypass Trust passes *outright* to the deceased participant's children upon termination at the spouse's death, and if at least one child is alive, and if charity only takes if all of the children predecease the surviving spouse, charity should be treated as a mere potential successor beneficiary in that case and, therefore should be ignored in evaluating the DB issue. Example 1 in the final regulations would appear to support this result (although it does not go that far). *See* IV.D.2, *supra*.

(3) Accumulation Bypass Trust: Special Commencement Date Option Not Available.

Even if all of the beneficiaries of the Bypass Trust are human beings and the trust meets all of the requirements for designated beneficiary treatment, if the trust is not specifically designed as a conduit trust (meaning that the full amount distributed from the plan to the trust must be distributed from the trust to the spouse per the trust instrument), then the trust cannot avail itself of the special commencement date for distributions available to a sole designated beneficiary spouse under Section 401(a)(9)(B)(iv)(I) of the Code. This interpretation was originally found in PLRs 9847022 and 199903050, *supra*, confirmed by implication in Rev. Rul. 2000-2, *supra*, and now expressly stated in the final regulations. *See Treas. Reg. §1.401(a)(9)-5, A-7(c)(3), Example 1 (iii) [last sentence]*. Thus, distributions to a Bypass Trust in the form of an accumulation trust must commence by December 31 of the year following the year of the participant's death (just like any other non-spouse designated beneficiary).

5. Drafting Strategies.

a. Beneficiary Designations.

In many estate planning situations, the beneficiary designation should be designed so that the surviving spouse will have the option, at least, of using the retirement plan benefits to fund the Bypass Trust. There is no universal rule regarding the wording of beneficiary designations. A lot depends on the wording in the particular Will or trust instrument. Sometimes the beneficiaries are listed on the beneficiary designation form itself. Other times, a "Schedule A" attachment, indicating the primary and contingent beneficiaries and their shares, is attached to the beneficiary designation form. In other cases, a Trustee is named as the beneficiary on the beneficiary

designation form and the actual allocation is made by the Trustee, in a fiduciary capacity, pursuant to applicable provisions in the Will or Trust under which the Trustee serves. Various sample beneficiary designations are attached to this outline as Exhibits 4-16. Here are some possibilities:

(1) Simplest Method.

Spouse is primary beneficiary, Trustee in participant's Will (or Living Trust Agreement) is contingent beneficiary. *See*, e.g., Exhibit 4. Benefit: Spouse will clearly qualify as a designated beneficiary if spouse survives participant. Spouse has the option to do the spousal IRA rollover (or treat the participant's IRA/IRA rollover as her own) and also has the option to disclaim all or a portion of the participant's interest in the retirement plan benefits passing to her in order to fund the Bypass Trust (this assumes the Will or Living Trust has a provision specifically allocating disclaimed plan benefits to the Bypass Trust). If the spouse fails to survive the participant, this contingent beneficiary designation will result in the plan benefits being distributed according to the participant's estate plan in his Will or Living Trust Agreement. Usually, the plan benefits will be distributed to the same beneficiaries receiving the residuary estate or remaining property (i.e., allocation provisions in the instrument will funnel plan benefits to the correct contingent beneficiaries). Thus, the beneficiary designation form itself need not be "cluttered up" with various contingencies that are more easily addressed in the Will or Trust Agreement. Many qualified plan administrators and IRA custodians allow the naming of the Trustee of a revocable Living Trust as the participant's beneficiary, but not the Trustee under the participant's Will. This appears to be because a Living Trust is a trust while a Will is not a trust. Also, many plan administrators and IRA custodians want the name of "the trust" and not the name of the Trustee, even though a trust has no legal significance without the Trustee. Getting beneficiary designation forms accepted is more of an art than a science. *See* Exhibit 17 for further discussion.

(2) Method Affirmatively Discussing Disclaimer.

The participant's spouse is named as the primary beneficiary; however, in the beneficiary designation form itself, it provides that if the spouse survives the participant but executes a disclaimer, the disclaimed amount passes to the Trustee of the Bypass Trust (or the Disclaimer Bypass Trust) created in the participant's Will (or Living Trust Agreement). *See*, e.g., Exhibit 6. Descendants, per stirpes, could be listed as contingent beneficiaries (perhaps subject to Contingent Trust or TUTMA provisions). *See*, e.g., Exhibit 5.

(3) Possibly Risky Method.

The Trustee in the participant's Will (or Living Trust Agreement) is named as the primary beneficiary (there may be no contingent beneficiary named, or the spouse, if any, may be named as the contingent beneficiary). This may be the best choice if the plan is to set up the non pro rata distribution technique with a funded revocable trust (this plan is described below in VII.B.2). There are some issues with this approach, however.

(a) Issues.

What is happening to the participant's spouse's community interest in the plan or IRA with a beneficiary designation like this? Is the spouse being forced to an "election" by this type of designation? If the Will or Trust Agreement doesn't clearly allocate the spouse's community interest in the IRA directly to her, she could have serious rollover problems (even though she "owns" half of the plan already under community property law). Many rulings, however, have allowed the surviving spouse to do an IRA rollover with this type of beneficiary wording under the right facts. *See* X., *infra*. Note that separate account/segregated share treatment is not available with this type of designation. *See* I.B.6., *supra*.

(b) Non Pro Rata Distributions.

Naming (the Trustee of) a revocable trust as the primary beneficiary appears to work well in the case of non pro rata distributions, at least based on some recent private letter rulings. *See* VII.B.2, *infra*.

(4) Another Option.

Primary Beneficiary Designation: Spouse is the beneficiary of ½ of the benefits and the Trustee of the Bypass Trust is the beneficiary of the other ½ of the benefits; the contingent beneficiary is the Trustee in the Will (or descendants, per stirpes). *See*, e.g., Exhibit 7 for similar wording, splitting plan benefits between spouse and QTIP Trust. Assuming all of the benefits are community property, the surviving spouse is receiving her community share outright and can clearly do a spousal IRA rollover as to that half. The participant's half will pass directly to the Trustee of the Bypass Trust, so no acceleration of IRD should occur (which happens when the fiduciary has discretion to use IRD assets to fund a pecuniary amount). The amount may be too large, however,

and needs to be monitored. The Bypass Trust must meet all of the trust regulatory requirements to obtain designated beneficiary treatment. A formula could be used in the beneficiary designation form to divide the Trustee's share between a Bypass Trust and a Marital Trust created in the Will or Living Trust Agreement. Or, a "one-lung" trust (meeting QTIP trust requirements) could be named as the beneficiary of the decedent's half of the IRA. In that case, the trust could serve as either a Bypass Trust or a Marital Trust, and the trust could be severed into two separate trusts based on the decedent's remaining estate tax exemption amount, if desired.

b. Bypass Trust Provisions.

All of the usual Bypass Trust drafting considerations apply (e.g., if spouse will be the Trustee, limit distributions to the ascertainable standard; don't give spouse a general power of appointment over Bypass Trust, etc.). Consider, in addition, the following:

(1) No Power Of Appointment Or Specially Designed Limited Power Of Appointment.

If the plan benefits will reach the Bypass Trust via a disclaimer by the participant's spouse, then the participant's spouse should not be given a power of appointment over the trust (or, at least, over the disclaimed assets) because of the rules for qualified disclaimers. Of course, the spouse could disclaim the problematic power after death. Further, in the case of a Bypass Trust in the form of an accumulation trust, it would be safer in cases involving the distribution of plan benefits to forego giving the spouse any type of power of appointment because all potential donees of the power have an interest in plan benefits accumulated in the trust. If the plan benefits will pass to the Bypass Trust directly, either because the Trustee of the Bypass Trust is specifically named as the beneficiary in the beneficiary designation form or because the Trustee in the Will (or Living Trust Agreement) must allocate or chooses to allocate plan benefits as to which the Trustee is named the beneficiary to the Bypass Trust, then, theoretically, the spouse can have a limited power of appointment, but it must be designed so as not to cause problems under the trust regulatory requirements (including the multiple beneficiary rules). *See*, IV.D.1., *supra*. All appointees of the power of appointment must be clearly identifiable (pursuant to the trust regulatory requirements). The power of appointment should not be exercisable in favor of a charity or other entity (not a designated beneficiary). If it is desired that the participant's spouse be treated as the designated beneficiary for purposes of calculating MRDs and if the Bypass Trust is in the form of an accumulation trust, then appointees pursuant to a power of appointment should be limited to persons who are younger than the spouse. Even a power to appoint to the "spouses of descendants" might fail because a descendant might be married to someone who is older than the participant's spouse. Also, as noted above in IV.D.1.b, if the power of appointment can be exercised in further trust, it will be hard to satisfy the trust regulatory requirements with respect to that future trust. Thus, special drafting is needed for powers of appointment if the Bypass Trust is in the form of an accumulation trust. The surviving spouse's power of appointment over a conduit Bypass Trust should be testamentary only.

(2) Sole Beneficiary Spouse Treatment Desired.

If it is desired that the spouse be treated as the sole beneficiary for purposes of the minimum distribution rules, and especially the more favorable commencement date option, then no one else can be a current beneficiary of the trust and no plan distribution amounts can be accumulated in the trust for the benefit of the remainder beneficiaries. Either the "conduit" approach must be used (not necessarily bad from an income tax standpoint) or the spouse must be given some sort of withdrawal power over the plan distribution amounts not distributed to her by the Trustee of the Bypass Trust (making her a grantor of the trust to that extent). *See* IV.C.3., *supra*. The spouse will not be treated as the "sole" beneficiary merely because the Trustee, in fact, chooses to distribute to the spouse 100% of the plan distributions received by the trust. Special drafting in the instrument will be required to achieve the correct result. But giving the spouse a withdrawal power over the plan benefits will cause the amount over which the spouse has a withdrawal power to be included in her estate at death, defeating one of the purposes of the Bypass Trust. Thus, the safest course is to use a conduit Bypass Trust if the special commencement date for sole beneficiary spouses is desired. Again, special drafting of the Bypass Trust is required to achieve this treatment.

(a) Commencement Date For Distributions.

If the spouse is treated as the sole beneficiary for purposes of the minimum distribution rules (i.e., the Bypass Trust is a conduit trust) and if the participant dies before reaching his RBD, distributions to the Bypass Trust will not need to commence until December 31 of the year in which the participant would have reached age 70 ½. This continued deferral is very valuable. Of course, an accumulation Bypass Trust will not be able to meet the requirements for obtaining this special MRD commencement date. It may be simpler to use a more "normal"

Bypass Trust (i.e., an accumulation Bypass Trust) and begin taking distributions by December 31 of the year following the year of the participant's death (assuming the trust meets the regulatory requirements and has no beneficiaries who do not qualify as designated beneficiaries). NOTE: It is the IRS' continuing position that if the Trustee named in the Will, in general (versus the Trustee of the Bypass Trust), is named as the beneficiary *in the participant's beneficiary designation form* and the Trustee makes the allocation of plan benefits to the Bypass Trust as a result of exercise of the Trustee's *discretion*, all potential beneficiaries who *could* have received plan benefits as a result of the Trustee's discretionary allocation (including all other beneficiaries in the Will or Trust, including all other trusts created in the Will or Trust and their beneficiaries) have to be taken into account to determine whether the participant has a designated beneficiary and, if so, who it is (i.e., which DB's measuring life is used for purposes of the minimum distribution calculations). *See PLR 199903050, supra, PLR 9305025 (November 12, 1992), and PLR 9641031 (October 11, 1996)*. This same theory is being used by the IRS to preclude post-death separation of benefits into separate accounts when the Trustee is named as the beneficiary on the beneficiary designation form. *See* I.B.6., *supra*. Therefore, if the Trustee in the Will, in general, is designated as the beneficiary, at the very least the Will or trust instrument should mandate or direct the allocation of the plan benefits, so that it is not a matter left to the Trustee's discretion. This will reduce the number of potential beneficiaries who must be taken into account for MRD purposes.

C. New Approaches.

At the present time, there are two other (and perhaps better) options.

1. Elect Portability.

For decedents who die in 2011 or later, instead of trying to fund a Bypass Trust with pre-tax retirement benefits, the surviving spouse, as Executor (or the non-spouse Executor, perhaps with the consent of the surviving spouse and children), can file a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, for the decedent's estate, even if the value of the estate is under the 706 filing requirement, for the purpose of making the portability election. The portability election results in "transporting" the deceased spouse's unused estate tax exemption amount to the surviving spouse. This option was first added to the law by the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" passed in December 2010, and was made "permanent" by the American Taxpayer Relief Act of 2012 passed by Congress on January 2, 2013 and signed into law by President Obama on January 3, 2013. The portability election is particularly useful when couples have a taxable estate and one or both spouses have significant pre-tax retirement plans.

a. Better Income Tax Situation For Surviving Spouse.

If portability is elected, the surviving spouse can accept the deceased spouse's gift to her of his (interest in the) plan or IRA and do the spousal IRA rollover for the entire plan/IRA. At that point, the spouse will become the participant of the IRA rollover, allowing her to use the Uniform Lifetime Table for calculating distributions from the IRA rollover once she reaches *her* RBD. For one and, perhaps, two reasons, this reduces the amount that must be distributed after the decedent's death compared to having the plan/IRA (or any part of it) belong to a Bypass Trust. One reason is that the Uniform Lifetime Table, which the spouse can utilize with respect to her IRA rollover, results in smaller required distributions compared to the Single Life Table, which is what the Bypass Trust would have to use (whether in conduit form or accumulation form). The other is that, in the case of the, perhaps, more common accumulation Bypass Trust, minimum required distributions (MRDs) must begin by December 31 of the year following the deceased IRA owner's death, while, with the spousal IRA rollover, MRDs do not have to begin until the spouse reaches *her* RBD.

b. Better Income Tax Situation For Children After Death Of Surviving Spouse.

In addition, by doing the IRA rollover, the spouse can name the children as beneficiaries of her IRA upon her death, thereby preserving the "stretch IRA" option for the children. In contrast, the children would not have the "stretch IRA" option for any part of the decedent's IRA allocated to a Bypass Trust, regardless of whether the Bypass Trust is in conduit form or accumulation form because once the surviving spouse dies, MRDs from the plan/IRA that "belongs to" the Bypass Trust have to continue to be made based on the spouse's single life expectancy, not recalculated.

c. Disadvantages Of Portability Election.

The only "disadvantages" of the portability approach are: (i) preparing a Form 706 adds a significant amount to the post-death estate settlement costs and (ii) if the surviving spouse remarries and her new spouse also predeceases her before she actually uses her prior spouse's unused estate tax exemption amount to make taxable

gifts, her original spouse's unused estate tax exemption amount will expire, despite the filing of the Form 706, because her estate can only use her most recently deceased spouse's unused estate tax exemption amount when she dies.

2. Non Pro Rata Distributions.

Although portability is a nice current option to have, many couples would still prefer to fund a Bypass Trust on the first spouse's death, if possible, to secure the non-tax advantages that trusts provide (such as creditor protection and ultimate control). From a tax effectiveness standpoint, however, IRD assets, such as qualified plans and IRAs, are not the best choice for funding a Bypass Trust. Qualified plan benefits and IRAs are overstated in value due to the built-in income tax liability that applies to the pre-tax portion of the plan/IRA (which, in most cases, is virtually the entire amount). In addition, when a plan or an IRA is allocated to a Bypass Trust, this eliminates the "stretch IRA" for the couple's children when the second spouse dies. Further, IRAs already have creditor protection, while "regular" (after-tax) investment assets do not. Thus, in a perfect world, a Bypass Trust would be funded with "after-tax growth assets" and the surviving spouse would own the entire IRA. In view of the fact that all assets are likely to be community property, is there a way to put *all* of the after-tax growth assets owned by the couple (i.e., 100% and not just 50%) into a Bypass Trust? We don't want the surviving spouse to contribute any of her own assets to the Bypass Trust because of estate tax concerns caused by Section 2036 of the Code. We also don't want to cause an adverse income tax result, such as acceleration of income taxes on the entire IRA by making a transfer that is taxable per Code Section 691(a)(2). The technique of utilizing a non pro rata distribution on the first spouse's death seems to provide the solution.

a. What Is The Plan?

The best (safest) method involves creating a joint revocable trust while both spouses are living and funding the trust with as many of the couple's "after-tax" probate assets as possible before the first spouse dies. If the joint revocable trust is not funded with probate assets prior to the first spouse's death, probating the deceased spouse's pour-over Will will cause his community interest in the probate assets to be distributed to the trust upon his death and the surviving spouse can also place her community interest in the probate assets into the trust at that time. (Some practitioners also use this technique with Wills, relying on the Executor's power to administer both halves of the joint community property and the decedent's sole management community property, but there are some technical problems in the Will situation in the case of the death of the *participant* spouse because we are not going to name the "estate" or the "Executor" as the beneficiary of the plan or IRA. Thus, how, exactly, does an Executor actually obtain possession of the plan/IRA to make the non pro rata distribution if it doesn't pass to the estate?) The conservative approach would be for the revocable trust instrument to specifically give the Trustee the power to make non pro rata distributions (even though Texas statutory law arguably gives trustees this power). The beneficiary designations for the couple's IRAs and qualified plans should either name the joint revocable trust as the primary beneficiary or name the spouse as the primary beneficiary and name the revocable trust as the contingent beneficiary. (In the latter case, the surviving spouse could disclaim the deceased spouse's community one-half (½) interest in the plan or IRA on his death, resulting in that interest being distributable to the Trustee of the joint revocable trust.) When the first spouse dies, the Trustee can allocate the deceased spouse's community interest in the IRA to the surviving spouse and can allocate the surviving spouse's community interest in other trust assets having an equivalent value to the Bypass Trust. The result is that 100% of the IRA will be owned by the surviving spouse and 100% of the after-tax growth assets will be owned by the Bypass Trust. There are a couple PLRs with these precise facts, discussed below.

b. What Are The Risks Of This Plan?

There are a few potential risks of this approach. The first concern is whether the non pro rata distribution is a "taxable sale or exchange" under the federal income tax rules (i.e., Code Sections 61, 1001 and/or other sections). The second concern is whether the transaction comes within Section 691(a)(2), which causes acceleration of income taxes when an IRD asset (such as an IRA) is transferred. Another issue is the actual control of the assets involved in the non pro rata distribution by the fiduciary. Some commentators have also raised an issue relating to the type of community property system in Texas, compared to the type in other states, but this issue appears to have gone away. And, finally, there is also the Section 2036 risk for the surviving spouse (because her half of the non-IRA assets is passing into the Bypass Trust). Based on the following rulings and cases, however, this technique should work.

c. Federal Income Tax Support.

There are many cases and rulings that provide comfort for the proposition that, if a fiduciary is making a non pro rata distribution to beneficiaries pursuant to his/her/its duty to distribute assets pursuant to the instrument under which the fiduciary is serving, as long as the non pro rata distribution is either *specifically authorized by the instrument or applicable state law*, then the non pro rata distribution should not be treated as a taxable sale or exchange for federal income tax purposes. Also, in some of the same rulings addressing the sale or exchange issue, the issue of the acceleration of income taxes per Section 691 was addressed and resolved in the taxpayer's favor. The following are *some* of those authorities (note that some of the following predate the addition of Section 1041 to the Code [added in 1984], which makes non-taxable the division of assets between spouses):

Frances R. Walz, Administratrix v. Commissioner, 32 B.T.A. 718 (1935). Holding: Where community assets are divided in kind between the spouses so that, thereafter, some whole assets belong to the husband and other whole assets belong to the wife, if the value of what each receives is approximately equal, such a division is non taxable.

Commissioner v. Mills, 183 F.2d 32 (9th Cir. 1950), *aff'g* 12 T.C. 468 (1949). Holding: Conversion of community property into separate property via a partition is non taxable if the value of the assets allocated to each spouse is approximately equal.

Osceola Heard Davenport v. Commissioner, 12 T.C.M. 856 (1953). A non pro rata partition of community property incident to a divorce does not give rise to taxable sale or exchange treatment. The Court added that a pro rata division might not have been in the best interests of the parties. It also added that dividing the cost basis on a pro rata basis might have produced an inequitable result.

Clifford H. Wren, 24 T.C.M. 290 (1965). Holding: A non pro rata partition of community property is not a taxable event as long as the value of the interests received by each spouse is approximately equal.

Rev. Rul. 76-83, 1976-1, C.B. 213, distinguishing Rev. Rul. 69-486 (which characterized a non pro rata distribution as a pro rata distribution followed by an exchange [i.e., a sale] due to lack of authority in the trust instrument or under state law to make a non pro rata distribution). Ruling: A non pro rata division of marital property between husband and wife (without more) is not a taxable event.

GCM 37716 (October 5, 1978). An approximately equal division of jointly owned marital property incident to a divorce is not a taxable event and no gain or loss is realized upon such a division.

PLR 8016050 (January 23, 1980). Community property of husband and wife divided into non pro rata shares, of equal value, *after* death of wife. (While other states' community property laws were mentioned on the issue of whether death works an immediate partition of the community property into two separate shares, so that the surviving spouse and the Executor of the deceased spouse's estate each hold, separately, ½ of each asset, that part of the ruling was not important because, under Texas law, the Executor administers both halves of the joint community property and all of the decedent's sole management community property and separate property [*see* Section 177 of Texas Probate Code]) and, per the trust instrument, the Trustee of a joint revocable trust manages all of the trust assets on the death of the first spouse). Issue in the situation presented was the holding period of the assets allocated to the husband in the non pro rata division made after the wife's death. It was noted that the non pro rata division and distribution in this situation was not a taxable sale or exchange (citing Rev Rul 76-83). Ruling: husband's assets maintained holding period relating back to holding period of husband and wife in those assets before wife's death.

PLR 8037124 (June 23, 1980). Community property of A and B divided into non pro rata shares, of equal value, during life. Ruling: not a taxable sale or exchange under Section 1001.

GGM 38640 (February 20, 1981). Ruling: A division of marital property between spouses pursuant to a property settlement agreement is treated as the division of an entity for tax purposes (regardless of differences in state law as to the type of marital property system) and is not a taxable event. GCM 38640 re-affirmed GCM 37716 and clarified the rule that marital property divisions are non taxable, whether entered into by couples in community property states or common law states. This ruling is important because the author, acting for the Director, says:

"We do not believe the Service can distinguish the tax treatment of divisions of community property and joint property incident to divorce by arguing that, unlike the interests of spouses in joint property, the 'community' itself is a separate entity and that the husband and wife have interests in the community and not in specific assets. We believe that the courts have established that the rationale for the conclusion that equal divisions of community property or joint property incident to divorce are nontaxable is that taxpayers are dividing an entity, i.e. the marital property." Thus, regardless of whether a couple lives in a common law state or a community property state, and regardless of the type of community property law applicable in a particular state for marital property law purposes, *for federal tax purposes*, at least as far as more or less equal divisions by spouses (even prior to the addition of Section 1041 to the Code), the IRS views the division of marital property as the division of an entity and, therefore, a non-taxable event.

Rev Rul 83-61, 1983-1, C.B. 78. Facts: corporate liquidation case; 2 shareholders ("S/Hs"), one a charity; charity S/H received low basis assets on liquidation through non pro rata division and distribution of assets pursuant to liquidation. Ruling: Gain on liquidation determined by assets actually received by S/Hs upon liquidation (thus, non pro rata distribution recognized for tax purposes and no re-characterization of distribution on liquidation as pro rata followed by an exchange).

PLR 9422052 (March 9, 1994). Facts: Decedent was married and living in a community property state at the time of his death; decedent's assets were placed in a Revocable Trust prior to his death; trust instrument authorized Trustees to make non pro rata distributions. Ruling: Trustees' exercise of non pro rata distribution power to fund Credit Shelter Trust, Marital Trust and Survivor's Trust did not constitute a taxable sale or exchange.

PLR 199912040 (March 29, 1999). Facts: Husband and wife, living in a community property state, created a joint revocable trust estate plan. After husband's death, Trustees allocated 100% of IRA (that had been community property prior to husband's death) payable to revocable trust to widow and allocated 100% of other community property assets of equivalent value to Bypass Trust. Ruling: The non pro rata distribution was not a taxable sale or exchange because it was authorized by state law. Further, the widow may roll over her deceased husband's IRA to her own IRA rollover, tax-free.

PLR 199925033 (June 28, 1999). Facts: Couple placed all of their community property in a trust that authorized the Trustee to make non pro rata distributions; on death of first spouse, IRA payable to Trust was allocated 100% to survivor's trust, withdrawn by surviving spouse and rolled over into spousal IRA rollover (other trust assets were allocated to Bypass Trust). Ruling: The non pro rata distribution did not result in a taxable sale or exchange and no acceleration of income taxes on IRA per Section 691.

d. Texas Statutory Provisions.

Texas now has one fairly clear statute that authorizes the making of non pro rata distributions by the trustee of a trust. Section 113.027 of the Texas Trust Code provides, in pertinent part:

"When distributing trust property or dividing or terminating a trust, a trustee may

(1) make distributions in divided or undivided interests; [and]
(2) allocate particular assets in proportionate or disproportionate shares..."

In addition, Section 112.057(b) of the Texas Trust Code, which addresses the division of one trust into two or more separate trusts, seems to allow a non pro rata distribution upon division of the trust when it says that the Trustee "shall allocate trust property among the separate trusts on a fractional basis.... *or in any other reasonable manner* (emphasis added)".

No provision specifically authorizing a non pro rata distribution *by an Executor* could be located in the Texas Probate Code (other than some obscure provisions relating to a division and distribution of property subject to a dependent administration being valued and distributed by commissioners appointed by the Court). This is not necessarily fatal in the case of Independent Executors, however, for two reasons: (i) most Wills specifically grant the Executor authority to make non pro rata distributions and (ii) even Wills that fail to authorize non pro rata distributions usually give the Executor all of the powers of Trustees under the Texas Trust Code, therefore incorporating the provisions of Section 113.027 into the Will.

Again, however, there are other technical problems with an Executor making a non pro rata distribution of this type in the case of the death of the participant that are not a concern in the case of a Trustee. Specifically, it is

unwise to name the "estate" as the beneficiary of a plan or IRA (because doing so precludes designated beneficiary treatment). Thus, the Executor, in that particular fiduciary capacity, is not going to have control over the decedent's plan/IRA when it is made payable to the "Trustee in the Will", even though the Executor will have control over both halves of the after-tax (probate) joint community property assets and the decedent's sole management community property assets. Thus, different fiduciaries (the Executor and the Trustee) are *exchanging assets* that they each control, rather than a single fiduciary making a non pro rata division and distribution of assets within that sole fiduciary's control. Some practitioners are using non pro rata divisions and distributions in the Will situation, however. This may be less risky in the case involving an IRA and the death of the non-participant spouse because, arguably, the non-participant spouse's community interest in an IRA titled in the surviving spouse's name is a probate asset. There are no PLRs with these particular facts, however. Thus, again, the safest course is to use a joint revocable trust to make this type of non pro rata distribution.

VIII. SPECIAL CONCERNS IN NAMING A CHARITABLE REMAINDER TRUST AS BENEFICIARY OF RETIREMENT PLANS

A. Distinguish From Naming A Charity As The Beneficiary.

There is a difference between naming a charity and naming a charitable trust as the beneficiary of a retirement plan. One difference would be the amount of the charitable deduction available to the deceased participant's estate at death. With a "split interest" charitable trust, such as a charitable remainder trust, the participant's estate is only entitled to a charitable deduction for the actuarially determined value of the charity's remainder interest in the trust (versus an estate tax charitable deduction for the full value of transfers made directly to qualified charities at death).

B. Distinguish Naming A Charitable Remainder Trust And Naming A QTIP Trust With Remainder To Charity As The Beneficiary.

There are some differences in naming a QTIP Trust with remainder to charity and in naming a charitable remainder trust as the beneficiary of retirement plans.

1. Marital Deduction Issue.

If a QTIP Trust is named as the beneficiary, all of the special concerns discussed above regarding qualifying for the federal estate tax marital deduction apply, making drafting significantly more complex. On the other hand, with a charitable remainder trust ("CRT"), since the trust is not a taxable entity, the full amount of the decedent's interest in the plan can be distributed to the trust without adverse income tax consequences, making the marital deduction issue much simpler. If the spouse is the only non-charitable beneficiary of the CRT, then the marital deduction is allowable for the value of the spouse's interest in the CRT. *IRC §2056(b)(8)(a)*.

2. Income Tax Issues.

Another difference between naming a QTIP Trust with remainder to charity and a CRT as the beneficiary of retirement plans is the income taxability of distributions from the plan. A charitable remainder trust is a tax exempt entity, so that no income tax is due when the full amount of the participant's plan benefits is paid to the trust on the participant's death. Of course, that portion of the unitrust or annuity distribution paid out to the non-charitable beneficiary of the trust each year that represents taxable income (versus corpus) will be subject to income tax in the year distributed. On the other hand, distribution of a retirement plan to a QTIP Trust in the form of an accumulation trust that has charitable organizations as the initial remainder beneficiaries will result in no designated beneficiary under the MRD rules. *See PLR 9820021, supra*. Because such a trust does not qualify for DB treatment, if the participant dies before his RBD, the 5 year rule would apply, and if the participant dies after his RBD, then MRDs would be made over the deceased participant's remaining non-recalculated, single life expectancy. However, if designated beneficiary treatment is desired for a QTIP Trust with remainder to charity, then the QTIP Trust should be drafted in the form of a Conduit Trust.

3. Benefits To Spouse.

Of course, there are differences in the type and amount of benefits a spouse may receive from a QTIP Trust with remainder to charity versus a CRT. For example, the spouse can receive unlimited amounts of principal (in addition to all the income) from the QTIP Trust during her lifetime, as opposed to merely the specified annuity or unitrust amount from a CRT.

4. Benefits To Charity.

There are also differences in the benefits provided to charity with the two different trusts. Because of the possibility of substantial distributions being made to the surviving spouse during her lifetime from the QTIP Trust, there may, in fact, be nothing left in the Trust to pass to charity upon her death. On the other hand, under the qualification rules applicable to charitable remainder trusts, a certain minimum amount, at least, is likely to pass to charity from these trusts when the spouse dies. The Taxpayer Relief Act of 1997 requires that the minimum value of the charity's remainder interest be at least 10% of the value of the initial assets transferred to the trust in order to qualify as a valid CRT.

C. Disadvantage Of Naming A Charitable Trust As Beneficiary.

1. No Designated Beneficiary-But No Longer Hurts Participant During Life.

It is clear that a participant who names a charitable trust as his beneficiary will not have a designated beneficiary but, under the final regulations, this no longer matters in calculating MRDs to the participant during his lifetime. It only makes a difference in the distribution period applicable upon the participant's death. If the participant dies before reaching his RBD, then the 5 year rule applies. If he dies on or after reaching his RBD, then MRDs to the trust can be made over his remaining life expectancy, not recalculated. In the case of a charitable trust named as the participant's beneficiary, however, which may not be subject to income tax (if it is a CRT, for example), there is really no reason to stretch out distributions from the retirement plan after the participant's death anyway. Presumably, the trustee will withdraw the entire amount remaining in the participant's plan/IRA upon his death and put it into the charitable trust account. This is another difference between using a QTIP Trust with remainder to charity and using a CRT with the spouse as the life "income" unitrust/annuity recipient.

2. Other Beneficiaries May Suffer Because Of The Multiple Beneficiary Rule.

If the participant names a charitable trust as the beneficiary of only part of his retirement plan and names human beings as beneficiaries of the remaining part, the multiple beneficiary rule will hurt the individual beneficiaries unless the charity is cashed out before the DB Determination Date (or unless separate accounts are actually created before the DB Determination Date). For an example of a beneficiary designation form naming both individuals and charities as beneficiaries of a single IRA, *see* Exhibit 14 attached (and note the wording at the bottom of Exhibit A).

a. Percentage Or Fractional Share Designation.

Utilizing a percentage or fractional share in the beneficiary designation form should enable separate accounts/segregated shares to be created by the DB Determination Date (so that the charity is no longer a beneficiary of the separate shares created for the individuals). Specifying a pecuniary amount for charity with the balance to individuals should also allow separate account treatment (and easy early cash out of the charity). A more conservative approach would be for the participant to physically divide his IRAs, so that one entire IRA will pass to charity or to a charitable trust and the other IRA(s) will pass to individual(s). Of course, the participant need not take the required distributions pro rata from all of his IRAs as long as he takes the correct amount in total. Treas. Reg. § 1.408-8, A-9. (NOTE: This rule only applies to IRAs and not to qualified plans.) So, if it is desired that only a particular dollar amount pass to the charitable trust, the participant should be able to accomplish that result by taking the distributions from the various IRAs so as to maintain the appropriate balance, more or less, in the IRA that will pass solely to the charitable trust.

b. Post-death Creation Of Separate Accounts/Cashing Out Charity.

Although the participant may want to utilize separate accounts/segregated shares to make things easier for multiple beneficiaries where one or more charities are named along with individuals, it is clear under the final regulations that several post-death planning techniques (e.g., creation of separate accounts, cashing out charity) are available to prevent harm to the individual beneficiary/ies, as discussed earlier. *See* I.B.4.c., *supra*.

3. Loss Of IRD Deduction.

If IRD assets, such as retirement plans and IRAs, pass to a CRT, the income tax deduction available under IRC Section 691(c) for the estate tax attributable to the IRD item will usually be wasted (at least to some extent). Even though the non-charitable beneficiary of the CRT receives either an annuity or a unitrust payment from the CRT during its term, the IRD deduction does not flow out of the CRT to the individual beneficiary. This is because distributions to the individual come first out of taxable income and last out of principal. Since the IRD item reduces the taxable income of the trust, it effectively becomes principal. Only very rarely, and late in the

term, if at all, would any principal of the CRT be distributed to the non-charitable beneficiary and, therefore, carry out the IRC Section 691(c) deduction. *See PLR 199901023 (October 8, 1998).*

4. Avoid Naming A Charitable Beneficiary Of Roth IRA.

There is no income tax advantage in naming a charity or a charitable remainder trust as the beneficiary of a Roth IRA.

D. Direct Rollover Of IRA To Charity.

Off and on during the past 17 years, provisions have been included in the law allowing a living IRA participant over age 70½ to make a "direct rollover" of IRA benefits to charity, versus taking a distribution from his IRA and then making a charitable contribution with it (and versus naming the charity as the beneficiary of his IRA to receive benefits only upon his death). The direct IRA rollover to charity has the advantage of excluding the distribution amount from the participant's income in the first place (up to the annual limit), versus including the amount in income and then taking a charitable deduction. The amount directly given to charity from the IRA also counts toward the participant's MRD for that year. The direct rollover proposal was included as part of The American Taxpayer Relief Act of 2012 (ATRA), passed by Congress on January 2, 2013, and signed into law by President Obama on January 3, 2013. Per ATRA, taxpayers who are at least 70 ½ years old may direct up to $100,000 from their IRA to qualified charities. The amount so directed, called a "Qualified Charitable Distribution" ("QCD"), qualifies as the taxpayer's MRD for the tax year, up to the $100,000 limit. There is no charitable deduction for the QCD (approximately 2/3 of all taxpayers take the standard deduction and would not obtain a charitable deduction anyway). Instead, the QCD reduces the amount of the taxpayer's MRD (up to the limit) for the tax year. Since income taxes have to be paid on MRDs, QCDs reduce the amount upon which income taxes must be paid. Thus, this provision provides direct benefits to charity, using funds that many taxpayers don't need, and reduces the taxable income of charitably inclined taxpayers at the same time. ATRA reinstated this provision for both years 2012 and 2013, although the 2012 options were limited and have now expired. Many IRA owners could not take advantage of the provision for the 2012 tax year because ATRA was not passed until 2013 and they had already taken their 2012 MRD before December 2012. To date, direct IRA rollovers have been permitted to *public* charities only, and not to charitable trusts or other deferred giving arrangements (such as donor-advised funds). The direct IRA rollover to charity provides a very simple way for IRA owners age 70 ½ and older to make inter vivos gifts directly to public charities using funds in their IRAs. Hopefully, this provision will be made permanent one of these days.

IX. SPECIAL CONCERNS IN NAMING A GST TRUST AS BENEFICIARY

A. No GST Exemption Allocation Until Participant's Death.

Unless a participant makes an irrevocable beneficiary designation of his retirement plan benefits before his death to a GST Trust and those benefits are not included in his gross estate for federal estate tax purpose (i.e., one of the transitional rules applies), none of his GST exemption can be applied at that time because of the ETIP rules. Further, it may be that even if one of the estate tax transitional rules applies to exclude the benefits from the participant's estate under Section 2039 or 2033, the benefits may still be includible in the participant's estate under Section 2036 or 2038 because the participant has made an irrevocable transfer but has retained an interest in the property (the plan) for his life. Thus, again, no GST exemption allocation for the plan benefits may be made while the participant is alive. At any rate, allocating GST exemption to plan benefits in this situation might not be a good use of the exemption because the assets could shrink appreciably in value between the date of designation and the date of death, due to required distributions made from the plan to the participant before the participant dies (or due to poor investment returns).

B. GST Exemption Allocation At Death.

If the participant names a GST Trust as the beneficiary of his retirement plans upon his death, his GST exemption may be allocated to that transfer on the estate tax return filed for his estate. Because of the limit on the amount of generation-skipping transfers that each transferor may make, care must be taken to insure that the value of the plan benefits being transferred to the GST Trust will not result in the transfer exceeding the participant's remaining (or available) GST exemption (formula language should be used).

1. IRD Issue.

The usual problem of accelerating IRD by utilizing plan benefits to satisfy a pecuniary gift must be addressed. It would seem that, in this case, designating the Trustee of the GST Trust directly as the beneficiary

of the plan benefits will be the safest choice. Another choice is to use a formula gift of the deceased participant's remaining GST exemption.

2. Various Problems.

If the Plan value exceeds the participant's available GST exemption amount, only that portion which may safely pass to the GST Trust should be designated to pass to the Trustee of the GST Trust. If other beneficiaries will be named for the remaining amount, separate accounts or segregated shares should be used. Using "pre-tax" assets to satisfy a pecuniary amount like the GST exemption is not usually the best way to fund such a gift, although, if the participant dies prematurely, a very long deferral could be achieved with GST trusts for grandchildren because of the young ages of the trust beneficiary/ies. All of the usual trust regulatory requirements must be met, however, including having identifiable beneficiaries. Thus, it is doubtful that this would work for a class of descendants (like grandchildren), no member of which is in being as of the applicable date.

3. Advantages.

If the GST Trust can obtain designated beneficiary treatment, then once the participant has died, distributions from the retirement plan to an accumulation GST Trust can be made over the oldest beneficiary's actual life expectancy. Or, conduit trusts for grandchildren could be used if separate account treatment is desired. If the GST Trust or Trusts are for grandchildren only, this could result in a very long income tax deferral indeed.

4. Potential Problems.

Not infrequently, a charity will be a remainder beneficiary in a long-term GST Trust. Depending on how the trust is drafted (i.e., whether it is a conduit trust or an accumulation trust and when there is an outright beneficiary), the charity may have to be "counted" as a beneficiary, thus precluding designated beneficiary treatment. Further, if no grandchildren are living on the DB Determination Date, then the requirement that all of the beneficiaries of the trust be "identifiable" up front won't be met (designating a class of beneficiaries is acceptable, even if the class can expand, as long as there is at least one member of the class on the relevant date). Further, it is not uncommon in GST Trusts to give the current beneficiary a special power of appointment over the trust. All of the potential problems with powers of appointment previously discussed in this outline must be evaluated and addressed in drafting the instrument.

X. TRUST (OR ESTATE) WAS NAMED AS BENEFICIARY BUT THERE IS A SURVIVING SPOUSE AND SPOUSE DESIRES IRA ROLLOVER

A. Not A Planning Technique: Trying To Salvage Spousal IRA Rollover.

This section is not included for purposes of planning with respect to retirement plan beneficiary designations. These rulings involve "mistakes" in beneficiary designations that were sometimes able to be corrected. These rulings are included in the event a spousal IRA rollover is desired but the participant's spouse was not named directly as the beneficiary of his retirement plan. The regulations state that, in order to make a spousal IRA rollover, the spouse must be the sole beneficiary of the plan/IRA and this requirement will not usually be met if a trust is named as the beneficiary of the plan/IRA "even if the spouse is the sole beneficiary of the trust." *Treas. Reg. §1.408-8, A-5(a).*

B. Illustrative Rulings.

1. Some Favorable Rulings: Spousal IRA Rollover Permitted.

In the following rulings (among others), the surviving spouse was allowed to do an IRA rollover even though she was not named directly as the beneficiary of the participant's retirement plan: PLR 200950058 (December 11, 2009); PLR 200950053 (December 11, 2009); PLR 200943046 (October 23, 2009); PLR 200940031 (October 2, 2009); PLR 200935045 (August 23, 2009); PLR 200934046 (August 21, 2009); PLR 200928043 (July 10, 2009); PLR 200915063 (April 10, 2009); PLR 200833028 (August 15, 2008); PLR 200831025 (August 1, 2008); PLR 200826039 (June 27, 2008); PLRs 200807026 and 200807025 (February 15, 2008); PLR 200724032 (June 15, 2007); PLR 200707159 (February 16, 2007); PLR 200705032 (February 2, 2007); PLR 200703035 (January 19, 2007); PLR 200707159 (December 20, 2006); PLR 200646026 (November 17, 2006); PLR 200510039 (March 11, 2005); PLR 200510032 (March 11, 2005); PLR 200509034 (March 4, 2005); PLR 200505030 (February 4, 2005); PLRs 200449040-41-42 (December 3, 2004); PLR 200344024 (October 31, 2003); PLR 200317040 (April 25, 2003); PLR 200314029 (April 4, 2003); PLR 200305030 (January 31, 2003); PLR 200304037 (January 24, 2003); PLR 200242044 (October 18, 2002); PLR 200236052 (September 6, 2002); PLR 200212036 (March 22,

2002); PLR 200211054 (March 15, 2002); PLR 200210066 (March 8, 2002); PLR 200208031 (February 22, 2002); PLR 200151054 (September 25, 2001); PLR 200136031 (September 10, 2001); PLR 200130056 (July 30, 2001); PLR 200032044 (August 15, 2000); PLR 20027061 (July 10, 2000) (intestacy situation); PLR 199951051 (December 27, 1999); PLR 199913048 (April 5, 1999); PLR 9623056 (June 7, 1996); PLR 9611057 (March 15, 1996); PLR 9537030 (June 21, 1995); PLR 9515042 (January 18, 1995); PLR 9502042 (January 13, 1995); PLR 9451059 (December 23, 1994); PLR 9511039 (December 20, 1994) (partial); PLR 9450041 (December 16, 1994) (interesting situation involving a non-qualified disclaimer); PLR 9450042 (December 16, 1994); PLR 9426049 (April 12, 1994); PLR 9416039 (January 26, 1994); PLR 9402023 (October 18, 1993); PLR 9401039 (October 18, 1993); PLR 9350040 (September 23, 1993); PLR 8911006 (December 12, 1988).

a. Factors Leading To Favorable Ruling.

Even though the participant's estate or a trust was named as the beneficiary of the participant's retirement plan benefits (instead of the spouse), if the surviving spouse was the fiduciary (usually the sole fiduciary) and if she had the right or power to allocate the plan benefits directly to herself or to a trust over which she had a complete right of withdrawal, then a rollover was permitted. Another technique that was used to set up the IRA rollover option for the spouse was to have other beneficiaries execute disclaimers to cause the benefits to end up with the spouse. Further, certain non pro rata distributions, discussed supra, have enabled the surviving spouse to do a spousal IRA rollover of the decedent's retirement benefits.

2. Unfavorable Rulings: No Spousal IRA Rollover Permitted.

In the following rulings, the spousal IRA rollover was not allowed: PLR 9145041 (August 16, 1991); PLR 9303031 (October 29, 1992); PLR 9322005 (February 24, 1993); PLR 9851050 (December 18, 1998) (partially permitted and partially not permitted); PLR 9321032 (February 24, 1993).

a. Reasons For Unfavorable Ruling.

The IRS generally takes the position that if the participant's plan benefits first pass to a trust, trustee or estate, even if they are then distributed to the participant's spouse by the fiduciary, they are not passing to the spouse directly from the plan but only to her through a third party (i.e., the fiduciary). Thus, the spouse is not acquiring the benefits from the participant in a way that clearly entitles her to do a spousal IRA rollover under the rules. As noted above, however, if the spouse is the fiduciary and if she has the power to allocate the entire plan or IRA to herself pursuant to the terms of the instrument or state law, then she may be able to do the rollover despite the fact that she was not named directly as the beneficiary.

XI. CONCLUSION

A. Rules For Allocating Plans/IRAs to Trusts Are Complex.

Despite the release of final regulations eleven years ago relating to distributions from defined contribution plans and IRAs, the rules relating to obtaining designated beneficiary treatment when a trust is named as the beneficiary of retirement plans are still very complex (and subject to constant change). The possibility for an unfavorable income tax result must be weighed against the value of the other objectives sought in naming a trust as the beneficiary. When the estate tax exemption amount is high, as it is today (in 2013), there may be less reason to allocate a qualified plan or IRA to a Bypass Trust. Also, for married decedents who die this year owning a qualified plan or IRA as to which the surviving spouse is the beneficiary, it may be better to use the portability election to solve the problem of wasting the estate tax exemption of the first spouse to die. The portability election preserves favorable income tax treatment for the surviving spouse and for the children when the surviving spouse dies, while transporting the decedent's unused estate tax exemption amount to the surviving spouse. However, portability may not be appropriate for all married couples. A significant reason to allocate plans and IRAs to trusts is the second marriage situation. The easier to draft conduit trust may be appropriate in such cases, as long as the participant doesn't mind the surviving spouse receiving all of the MRDs during her life. And, of course, if the amount in the plan or IRA is significant and the beneficiary is a minor, incapacitated person or a spendthrift, naming a trust for the benefit of that person as the beneficiary of the plan/IRA (rather than naming that person, directly) is usually going to be the right thing to do. In any event, if it is desired that a trust be the recipient of all or any part of the participant's retirement plan upon his death, special drafting will always be needed to insure that the trust qualifies for designated beneficiary treatment as a "qualified see-through trust." Otherwise, the income tax result may be so detrimental that the benefits of naming a trust as beneficiary are outweighed.

B. Consider Obtaining A Private Letter Ruling And/Or Study the Private Letter Rulings Issued.

In some cases involving trusts not specifically drafted to be a "qualified see-through trust," it may be necessary or advisable to obtain a private letter ruling on the various tax aspects of that particular trust being the beneficiary of a retirement plan (assuming it is not a hypothetical situation). A review of private letter rulings involving analogous trusts and facts is also worthwhile (even if PLRs are not precedent, PLRs indicate the IRS's likely position and interpretation of the rules). Of course, as indicated above, it is always best to specifically draft any trust that is intended to be (or might be) the beneficiary of a qualified retirement plan or IRA so that the trust will meet all of the trust regulatory requirements. This is now more important than ever as it may no longer be possible to reform or modify a trust that fails the requirements to be a qualified see-through trust and obtain designated beneficiary treatment. *See, e.g.,* PLR 201021038 (May 28, 2010).

C. Consider Other Alternatives To Trust as Beneficiary.

Before naming a trust as the primary beneficiary of the participant's retirement plans, all other possible alternatives that could achieve the client's goals should be considered, such as the use of life insurance, a non pro rata distribution involving a joint revocable trust holding after-tax assets, a split of the retirement plans between a second spouse and children from a prior marriage, and the portability election. If a trust is needed for a minor beneficiary, the easier to draft conduit trust may work well, especially if a TUTMA custodian for the minor is entitled to receive the MRD while the minor is under age 18 or 21. A conduit trust is not likely to work well for incapacitated persons who are entitled to government benefits or for spendthrifts, however. Thus, the more difficult to draft accumulation trust is probably needed in that case. Also, a Roth IRA Special Needs Trust in the form of an accumulation trust may work well for an incapacitated beneficiary who is entitled to government benefits. Finally, it is recommended that estate planning lawyers learn all of the minimum distribution rules so that they can advise their clients regarding how best to complete their beneficiary designation forms for their qualified plans and IRAs, which could be the most significant asset(s) they own.

Exhibit 1
UNIFORM LIFETIME TABLE
Treas. Reg. § 1.401(a)(9)-9, A-2

Table For Determining Applicable Divisor For MRDs to Participant During His/Her Lifetime*

Age of the participant	*Applicable divisor*	*Age of the participant*	*Applicable divisor*
70	27.4	95	8.6
71	26.5	96	8.1
72	25.6	97	7.6
73	24.7	98	7.1
74	23.8	99	6.7
75	22.9	100	6.3
76	22.0	101	5.9
77	21.2	102	5.5
78	20.3	103	5.2
79	19.5	104	4.9
80	18.7	105	4.5
81	17.9	106	4.2
82	17.1	107	3.9
83	16.3	108	3.7
84	15.5	109	3.4
85	14.8	110	3.1
86	14.1	111	2.9
87	13.4	112	2.6
88	12.7	113	2.4
89	12.0	114	2.1
90	11.4	115 and older	1.9
91	10.8		
92	10.2		
93	9.6		
94	9.1		

*Use Exhibit 2 instead (i) if the sole beneficiary is participant's spouse; (ii) if spouse is more than ten years younger than participant; and (iii) if the distribution is from an IRA, or from a retirement plan so permitting.

Exhibit 2
JOINT AND LAST SURVIVOR TABLE
Treas. Reg. § 1.401(a)(9)-9, A-3

Only for Use by Living Participant Whose Sole Beneficiary Spouse is More than Ten Years Younger

Age of Spouse	Age of Participant												
	70	71	72	73	74	75	76	77	78	79	80	81	82
35	48.7	48.7	48.7	48.6	48.6	48.6	48.6	48.6	48.6	48.6	48.5	48.5	48.5
36	47.8	47.7	47.7	47.7	47.7	47.7	47.6	47.6	47.6	47.6	47.6	47.6	47.6
37	46.8	46.8	46.8	46.7	46.7	46.7	46.7	46.7	46.6	46.6	46.6	46.6	46.6
38	45.9	45.9	45.8	45.8	45.8	45.7	45.7	45.7	45.7	45.7	45.7	45.7	45.6
39	44.9	44.9	44.9	44.8	44.8	44.8	44.8	44.8	44.7	44.7	44.7	44.7	44.7
40	44.0	44.0	43.9	43.9	43.9	43.8	43.8	43.8	43.8	43.8	43.7	43.7	43.7
41	43.1	43.0	43.0	43.0	42.9	42.9	42.9	42.9	42.8	42.8	42.8	42.8	42.8
42	42.2	42.1	42.1	42.0	42.0	42.0	41.9	41.9	41.9	41.9	41.8	41.8	41.8
43	41.3	41.2	41.1	41.1	41.1	41.0	41.0	41.0	40.9	40.9	40.9	40.9	40.9
44	40.3	40.3	40.2	40.2	40.1	40.1	40.1	40.0	40.0	40.0	40.0	39.9	39.9
45	39.4	39.4	39.3	39.3	39.2	39.2	39.1	39.1	39.1	39.1	39.0	39.0	39.0
46	38.6	38.5	38.4	38.4	38.3	38.3	38.2	38.2	38.2	38.1	38.1	38.1	38.1
47	37.7	37.6	37.5	37.5	37.4	37.4	37.3	37.3	37.2	37.2	37.2	37.2	37.1
48	36.8	36.7	36.6	36.6	36.5	36.5	36.4	36.4	36.3	36.3	36.3	36.2	36.2
49	35.9	35.9	35.8	35.7	35.6	35.6	35.5	35.5	35.4	35.4	35.4	35.3	35.3
50	35.1	35.0	34.9	34.8	34.8	34.7	34.6	34.6	34.5	34.5	34.5	34.4	34.4
51	34.3	34.2	34.1	34.0	33.9	33.8	33.8	33.7	33.6	33.6	33.6	33.5	33.5
52	33.4	33.3	33.2	33.1	33.0	33.0	32.9	32.8	32.8	32.7	32.7	32.6	32.6
53	32.6	32.5	32.4	32.3	32.2	32.1	32.0	32.0	31.9	31.8	31.8	31.8	31.7
54	31.8	31.7	31.6	31.5	31.4	31.3	31.2	31.1	31.0	31.0	30.9	30.9	30.8
55	31.1	30.9	30.8	30.6	30.5	30.4	30.3	30.3	30.2	30.1	30.1	30.0	30.0
56	30.3	30.1	30.0	29.8	29.7	29.6	29.5	29.4	29.3	29.3	29.2	29.2	29.1
57	29.5	29.4	29.2	29.1	28.9	28.8	28.7	28.6	28.5	28.4	28.4	28.3	28.3
58	28.8	28.6	28.4	28.3	28.1	28.0	27.9	27.8	27.7	27.6	27.5	27.5	27.4
59	28.1	27.9	27.7	27.5	27.4	27.2	27.1	27.0	26.9	26.8	26.7	26.6	26.6
60		27.2	27.0	26.8	26.6	26.5	26.3	26.2	26.1	26.0	25.9	25.8	25.8
61			26.3	26.1	25.9	25.7	25.6	25.4	25.3	25.2	25.1	25.0	24.9
62				25.4	25.2	25.0	24.8	24.7	24.6	24.4	24.3	24.2	24.1
63					24.5	24.3	24.1	23.9	23.8	23.7	23.6	23.4	23.4
64						23.6	23.4	23.2	23.1	22.9	22.8	22.7	22.6
65							22.7	22.5	22.4	22.2	22.1	21.9	21.8
66								21.8	21.7	21.5	21.3	21.2	21.1
67									21.0	20.8	20.6	20.5	20.4
68										20.1	20.0	19.8	19.7
69											19.3	19.1	19.0
70												18.5	18.3
71													17.7

JOINT AND LAST SURVIVOR TABLE (continued)

Age of Spouse	Age of Participant												
	83	84	85	86	87	88	89	90	91	92	93	94	95
35	48.5	48.5	48.5	48.5	48.5	48.5	48.5	48.5	48.5	48.5	48.5	48.5	48.5
36	47.6	47.6	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.5
37	46.6	46.6	46.6	46.6	46.6	46.6	46.6	46.6	46.6	46.6	46.6	46.6	46.5
38	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6
39	44.7	44.7	44.7	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6
40	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.6
41	42.8	42.7	42.7	42.7	42.7	42.7	42.7	42.7	42.7	42.7	42.7	42.7	42.7
42	41.8	41.8	41.8	41.8	41.8	41.8	41.7	41.7	41.7	41.7	41.7	41.7	41.7
43	40.9	40.8	40.8	40.8	40.8	40.8	40.8	40.8	40.8	40.8	40.8	40.8	40.8
44	39.9	39.9	39.9	39.9	39.9	39.9	39.8	39.8	39.8	39.8	39.8	39.8	39.8
45	39.0	39.0	38.9	38.9	38.9	38.9	38.9	38.9	38.9	38.9	38.9	38.9	38.9
46	38.0	38.0	38.0	38.0	38.0	38.0	38.0	38.0	37.9	37.9	37.9	37.9	37.9
47	37.1	37.1	37.1	37.1	37.0	37.0	37.0	37.0	37.0	37.0	37.0	37.0	37.0
48	36.2	36.2	36.2	36.1	36.1	36.1	36.1	36.1	36.1	36.1	36.1	36.1	36.1
49	35.3	35.3	35.2	35.2	35.2	35.2	35.2	35.2	35.2	35.1	35.1	35.1	35.1
50	34.4	34.3	34.3	34.3	34.3	34.3	34.3	34.2	34.2	34.2	34.2	34.2	34.2
51	33.5	33.4	33.4	33.4	33.4	33.4	33.3	33.3	33.3	33.3	33.3	33.3	33.3
52	32.6	32.5	32.5	32.5	32.5	32.5	32.4	32.4	32.4	32.4	32.4	32.4	32.4
53	31.7	31.7	31.6	31.6	31.6	31.6	31.5	31.5	31.5	31.5	31.5	31.5	31.5
54	30.8	30.8	30.7	30.7	30.7	30.7	30.7	30.6	30.6	30.6	30.6	30.6	30.6
55	29.9	29.9	29.9	29.8	29.8	29.8	29.8	29.8	29.7	29.7	29.7	29.7	29.7
56	29.1	29.0	29.0	29.0	28.9	28.9	28.9	28.9	28.9	28.8	28.8	28.8	28.8
57	28.2	28.2	28.1	28.1	28.1	28.0	28.0	28.0	28.0	28.0	28.0	27.9	27.9
58	27.4	27.3	27.3	27.2	27.2	27.2	27.2	27.1	27.1	27.1	27.1	27.1	27.1
59	26.5	26.5	26.4	26.4	26.4	26.3	26.3	26.3	26.3	26.2	26.2	26.2	26.2
60	25.7	25.6	25.6	25.5	25.5	25.5	25.4	25.4	25.4	25.4	25.4	25.3	25.3
61	24.9	24.8	24.8	24.7	24.7	24.6	24.6	24.6	24.5	24.5	24.5	24.5	24.5
62	24.1	24.0	23.9	23.9	23.8	23.8	23.8	23.7	23.7	23.7	23.7	23.6	23.6
63	23.3	23.2	23.1	23.1	23.0	23.0	22.9	22.9	22.9	22.9	22.8	22.8	22.8
64	22.5	22.4	22.3	22.3	22.2	22.2	22.1	22.1	22.1	22.0	22.0	22.0	22.0
65	21.7	21.6	21.6	21.5	21.4	21.4	21.3	21.3	21.3	21.2	21.2	21.2	21.1
66	21.0	20.9	20.8	20.7	20.7	20.6	20.5	20.5	20.5	20.4	20.4	20.4	20.3
67	20.2	20.1	20.1	20.0	19.9	19.8	19.8	19.7	19.7	19.6	19.6	19.6	19.6
68	19.5	19.4	19.3	19.2	19.2	19.1	19.0	19.0	18.9	18.9	18.8	18.8	18.8
69	18.8	18.7	18.6	18.5	18.4	18.3	18.3	18.2	18.2	18.1	18.1	18.0	18.0
70	18.2	18.0	17.9	17.8	17.7	17.6	17.6	17.5	17.4	17.4	17.3	17.3	17.3
71	17.5	17.4	17.3	17.1	17.0	16.9	16.9	16.8	16.7	16.7	16.6	16.6	16.5
72	16.9	16.7	16.6	16.5	16.4	16.3	16.2	16.1	16.0	16.0	15.9	15.9	15.8
73		16.1	16.0	15.8	15.7	15.6	15.5	15.4	15.4	15.3	15.2	15.2	15.1
74			15.4	15.2	15.1	15.0	14.9	14.8	14.7	14.6	14.6	14.5	14.5
75				14.6	14.5	14.4	14.3	14.2	14.1	14.0	13.9	13.9	13.8
76					13.9	13.8	13.7	13.6	13.5	13.4	13.3	13.2	13.2
77						13.2	13.1	13.0	12.9	12.8	12.7	12.6	12.6
78							12.6	12.4	12.3	12.2	12.1	12.0	12.0
79								11.9	11.8	11.7	11.6	11.5	11.4
80									11.3	11.2	11.1	11.0	10.9
81										10.7	10.6	10.5	10.4
82											10.1	10.0	9.9
83												9.5	9.4
84													9.0

Exhibit 3
SINGLE LIFE TABLE
Treas. Reg. § 1.401(a)(9)-9, A-1

Table For Determining Applicable Divisor For Designated Beneficiary*

Age	Divisor	Age	Divisor	Age	Divisor
0	82.4	37	46.5	74	14.1
1	81.6	38	45.6	75	13.4
2	80.6	39	44.6	76	12.7
3	79.7	40	43.6	77	12.1
4	78.7	41	42.7	78	11.4
5	77.7	42	41.7	79	10.8
6	76.7	43	40.7	80	10.2
7	75.8	44	39.8	81	9.7
8	74.8	45	38.8	82	9.1
9	73.8	46	37.9	83	8.6
10	72.8	47	37.0	84	8.1
11	71.8	48	36.0	85	7.6
12	70.8	49	35.1	86	7.1
13	69.9	50	34.2	87	6.7
14	68.9	51	33.3	88	6.3
15	67.9	52	32.3	89	5.9
16	66.9	53	31.4	90	5.5
17	66.0	54	30.5	91	5.2
18	65.0	55	29.6	92	4.9
19	64.0	56	28.7	93	4.6
20	63.0	57	27.9	94	4.3
21	62.1	58	27.0	95	4.1
22	61.1	59	26.1	96	3.8
23	60.1	60	25.2	97	3.6
24	59.1	61	24.4	98	3.4
25	58.2	62	23.5	99	3.1
26	57.2	63	22.7	100	2.9
27	56.2	64	21.8	101	2.7
28	55.3	65	21.0	102	2.5
29	54.3	66	20.2	103	2.3
30	53.3	67	19.4	104	2.1
31	52.4	68	18.6	105	1.9
32	51.4	69	17.8	106	1.7
33	50.4	70	17.0	107	1.5
34	49.4	71	16.3	108	1.4
35	48.5	72	15.5	109	1.2
36	47.5	73	14.8	110	1.1
				111+	1.0

*If participant's spouse is sole beneficiary, use table to obtain divisor for spouse's age each year. Otherwise, use table to obtain divisor for age of (oldest) beneficiary as of birthday in year following participant's death, reduced by one each year thereafter.

Exhibit 4
BENEFICIARY DESIGNATION
FOR RETIREMENT PLANS
AND IRAs OF BILLY SIMPLE

[Typical Beneficiary Designation for Married Participant]

(a) Primary Beneficiary: All to my wife, Nancy Simple.

(b) Contingent Beneficiary: If my wife does not survive me, to the Trustee(s) named in my Last Will [**or,** named in Last Will of Billy Simple].[1]

[1]If wife fails to survive, this wording will preclude separate account treatment for shares passing to beneficiaries named in Will – *see* I.B.6. in outline. If contingent beneficiaries are all competent adults, consider spelling out division among the contingent beneficiaries in beneficiary designation form, to allow for separate account treatment.

Exhibit 5
BENEFICIARY DESIGNATION
FOR RETIREMENT PLANS
AND IRAs OF JOSEPH WORTHY

[Common alternative to Typical Designation]

(a) Primary Beneficiary: All to my wife, Sarah Worthy.

(b) Contingent Beneficiary: If my wife does not survive me, in equal shares to my children,[1] [names]_____; however, if a child fails to survive me but leaves one or more descendants who survive me, that child's share shall be distributed per stirpes to that child's descendants, subject to the contingent trust created in my Last Will for any descendant under age _____.

Alternative wording for (b):

(b) Contingent Beneficiary: If my wife does not survive me, in equal shares to my children who survive me; however, if any child who fails to survive me leaves one or more descendants who survive me, the share that child would have received (if he or she had survived) shall be distributed per stirpes to his or her descendants who survive me; provided that, any distribution to be made to an individual who has not yet attained the age of twenty-one years shall not be distributed to that individual outright, but instead shall be distributed to the personal representative of my estate ("my Executor"), as Custodian for that individual under the Texas Uniform Transfers to Minors Act (TUTMA).[2] If my Executor fails or ceases to serve as Custodian, one shall be appointed by my Executor.

[1]If wife fails to survive, this wording should allow separate account treatment for children if creation of separate accounts after death is done correctly and timely – *see* I.B.6. in outline.

[2]Since a TUTMA account is "indefeasibly vested in the minor" (Texas Property Code § 114.012 (b)), a minor beneficiary should qualify as a designated beneficiary (and should be able to use his/her own life expectancy for calculating MRDs if a separate account is timely created).

Exhibit 6
BENEFICIARY DESIGNATION
FOR RETIREMENT PLANS
AND IRAs OF JOHN HARDY

[Disclaimer Option in Beneficiary Designation]

(a) Primary Beneficiary: All to my wife, Susan Hardy, if she survives me; provided that, if my wife disclaims all or any portion of my interest in the proceeds passing to her, the disclaimed proceeds shall be paid to the Trustee(s) of the Disclaimer [Bypass] Trust created in my Last Will.[1]

(b) Contingent Beneficiary: If my wife does not survive me, to the Trustee(s) named in my Last Will.[2]

[1]If wife survives and disclaims, because the disclaimed amount is directed to a specific trust per the beneficiary designation itself, the amounts passing to the wife and to the trust can be treated as separate shares (note, however, that unless the Bypass Trust is in the form of a conduit trust, the wife's life expectancy, *not* recalculated, will be used for calculating MRDs to the Bypass Trust, assuming the trust qualifies for look-through treatment in the first place, because the wife will (usually) be the oldest beneficiary out of multiple beneficiaries of the trust. Undisclaimed retirement plan benefits can be considered to be owned by the wife as the participant or can actually be rolled over by the wife to a spousal IRA rollover, making the wife the (new) participant with respect to the IRA rollover and allowing her to use the Uniform Lifetime Table for distributions from the IRA rollover. In that case, MRDs do not have to begin until *her* RBD and will be based on her life expectancy, recalculated, plus 10 years.

[2]This wording will preclude separate account treatment for contingent beneficiaries – *see* I.B.6. in outline.

Exhibit 7
BENEFICIARY DESIGNATION
FOR RETIREMENT PLANS
AND IRAs OF DOCTOR PROCTER

[Split Between Spouse & QTIP Trust]

(a) Primary Beneficiary: Pay that amount representing my wife's community property interest in the plan/account [**or,** pay one-half (½) of the proceeds] to my wife, Caroline Procter, and pay that amount representing my community property interest in the plan/account [**or,** pay one-half (½) of the proceeds] to the Trustee of the QTIP Trust created in my Last Will.[1]

(b) Contingent Beneficiary: If my wife does not survive me, to the Trustee(s) named in my Last Will.

[1]This beneficiary designation assumes that the participant has waived and the spouse has consented to the waiver of REACT benefits applicable to defined benefit plans in a legally effective manner. Note also that most plan administrators will not accept a beneficiary designation of an unspecified percentage that has to be legally determined after death, so, in most cases, the beneficiary designation will need to use actual percentages (such as 50-50), which is fine if the qualified plan is 100% community property. If the participant's qualified plan is part community property and part separate property (such as could occur in a second marriage situation), consider having the spouses enter into some sort of Marital Property Agreement clarifying what percentage is owned by the participant as his separate property and what percentage is owned by the couple as community property so that the precise percentages can be used in the beneficiary designation form. The surviving spouse should always receive, outright, the portion of the participant's qualified plan that she owns (at least).

Exhibit 8
BENEFICIARY DESIGNATION FOR RETIREMENT PLANS AND IRAs OF I. M. SINGLE

All to my children who survive me, in equal shares. However, if any child who fails to survive me leaves one or more descendants who survive me, the share that child would have received (if he or she had survived) shall be distributed per stirpes to his or her descendants who survive me; provided that, any distribution to be made to an individual who has not yet attained the age of twenty-one years shall not be distributed to that individual outright, but instead shall be distributed to the personal representative of my estate ("my Executor"), as Custodian for that individual under the Texas Uniform Transfers to Minors Act (TUTMA). If my Executor fails or ceases to serve as Custodian, one shall be appointed by my Executor.[1]

[1]Separate account treatment should be fully available to all resulting beneficiaries.

Exhibit 9
BENEFICIARY DESIGNATION FOR
RETIREMENT PLANS AND IRAs OF I. M. BLEST

(a) All of such proceeds shall be paid as follows:

(1) Twenty-five percent (25%) of the proceeds shall be paid to the trust created for the primary benefit of Aaron B. Blest under Participant's Will, if Aaron B. Blest survives Participant; provided that, if he predeceases Participant but leaves one or more descendants who survive Participant, the share of such proceeds that the trust for Aaron B. Blest would have received (if Aaron B. Blest had survived) shall be distributed per stirpes to the trusts created under Participant's Will for the descendants of Aaron B. Blest who survive Participant.

(2) Twenty-five percent (25%) of the proceeds shall be paid to the trust created for the primary benefit of Carl D. Blest under Participant's Will, if Carl D. Blest survives Participant; provided that, if he predeceases Participant but leaves one or more descendants who survive Participant, the share of such proceeds that the trust for Carl D. Blest would have received (if Carl D. Blest had survived) shall be distributed per stirpes to the trusts created under Participant's Will for the descendants of Carl D. Blest who survive Participant.

(3) Twenty-five percent (25%) of the proceeds shall be paid to the trust created for the primary benefit of Elliott F. Blest under Participant's Will, if Elliott F. Blest survives Participant; provided that, if he predeceases Participant but leaves one or more descendants who survive Participant, the share of such proceeds that the trust for Elliott F. Blest would have received (if Elliott F. Blest had survived) shall be distributed per stirpes to the trusts created under Participant's Will for the descendants of Elliott F. Blest who survive Participant.

(4) Twenty-five percent (25%) of the proceeds shall be paid to the trust created for the primary benefit of Gayle S. Blest Doubly under Participant's Will, if Gayle S. Blest Doubly survives Participant; provided that, if she predeceases Participant but leaves one or more descendants who survive Participant, the share of such proceeds that the trust for Gayle S. Blest Doubly would have received (if Gayle S. Blest Doubly had survived) shall be distributed per stirpes to the trusts created under Participant's Will for the descendants of Gayle S. Blest Doubly who survive Participant.

(b) If there is no trust that is entitled to an interest in the proceeds to be paid under one or more of the numbered subparagraphs in paragraph (a), then the proceeds which would otherwise have been paid under that subparagraph shall be paid to the other trusts that are entitled to receive a portion of the proceeds passing under the other subparagraphs in the foregoing paragraph (a), each such trust receiving such portion of such proceeds as the interest which such trust is entitled to receive under the foregoing paragraph (a) bears to the total of the interests of all such trusts that are entitled to receive proceeds under the foregoing paragraph (a) [**NOTE:** this redistribution wording, while somewhat awkward, should work even if the percentages are unequal].

NOTE: Separation of shares into separate trusts is occurring in the beneficiary designation itself (and not in the Participant's Will), making separate account treatment at least theoretically possible (but remember issue of remainder beneficiaries of accumulation trusts being taken into account for determining designated beneficiary – the wording in the Will regarding the type of trust [conduit vs. accumulation] and the potential beneficiaries of each trust will be determinative regarding whether there is a DB and who the actual DB is for purposes of calculating post-death MRDs) – see I.B.6. in outline.

Exhibit 10
BENEFICIARY DESIGNATION FOR RETIREMENT PLANS
AND IRAs OF N. SECOND MARRIAGE

If my wife, Happy Marriage ("my wife"), survives me, two-thirds (2/3) shall be distributed to the Trustee(s) named in my Will to be administered as provided in Article 4 (providing for a Marital Trust for my wife during her lifetime), and one-third shall be distributed to my children who survive me, in equal shares.

If my wife does not survive me, one hundred percent shall be distributed to my children who survive me, in equal shares.

However, whether or not my wife survives me, if any child of mine who fails to survive me leaves one or more descendants who survive me, the share that child would have received (if he or she had survived) shall be distributed per stirpes to his or her descendants who survive me; provided that, any distribution to be made to an individual who has not yet attained the age of twenty-one years shall not be distributed to that individual outright, but instead shall be distributed to the personal representative of my estate ("my Executor"), as Custodian for that individual under the Texas Uniform Transfers to Minors Act (TUTMA). If my Executor fails or ceases to serve as Custodian, one shall be appointed by my Executor.

NOTE: This beneficiary designation assumes that the couple entered into a Marital Property Agreement making all qualified plans in the Participant's name the Participant's separate property. It also assumes that the Participant has waived, and the Participant's spouse has consented to the waiver of, REACT benefits with respect to the qualified plan.

Exhibit 11
(WORDING PLACED ON THE IRA BENEFICIARY DESIGNATION FORM ITSELF)

BENEFICIARY DESIGNATION FOR
IRAs AND IRA ROLLOVERS IN THE NAME OF
ELEANOR RIGBY JONES

Primary Beneficiaries	**Share**	**Relationship**	**Address & Telephone Number**
John Paul Jones**,** or his descendants, per stirpes, subject to an age 25 Contingent Trust in Will of Eleanor Rigby Jones	50%	son	9876 Marvel Lane Sugar Land, Texas 77479 (281) 123-4567
George Ringo Jones**,** or his descendants, per stirpes, subject to an age 25 Contingent Trust in Will of Eleanor Rigby Jones	50%	son	4567 Crest Street Houston, Texas 77087 (713) 654-3210
Contingent Beneficiary	**Share**	**Relationship**	**Address & Telephone Number**
The Testamentary Trustee named in the Will of Eleanor Rigby Jones	100%	Testamentary Trustee	(Trustee appointed in Will is John Paul Jones, otherwise George Ringo Jones–see addresses and phone numbers above)

Commentary: This is a longer way to provide for a "per stirpes" distribution subject to contingent trusts in a Will, but it preserves separate account treatment under the minimum distribution rules for the primary beneficiaries.

Exhibit 12

SCHEDULE A

**BENEFICIARY DESIGNATION FOR
IRAs AND IRA ROLLOVERS ("IRAs") IN THE NAME OF
N.O.T. HAPPY ("PARTICIPANT")**

The beneficiaries of all of such IRAs are as follows:

(1) If Participant's wife, Vera Happy ("Vera"), survives Participant, allocate all of such proceeds to the then acting Trustee(s) of the Marital Trust created in Participant's Will for the lifetime benefit of Vera.

(2) If Vera fails to survive Participant, allocate all of such proceeds as follows:

(A) Fifty percent (50%) of such IRAs shall be allocated to the then acting Trustee(s) of the Descendant's Trust created for the primary benefit of Jane Happy ("Jane") under Participant's Will, if Jane survives Participant; provided that, if Jane fails to survive Participant but leaves one or more descendants who survive Participant, the share of such proceeds that would have been allocated to the trust for Jane (if Jane had survived) shall instead be allocated in per stirpes shares to the then acting Trustee(s) of the Descendant's Trusts created in Participant's Will for the descendants of Jane who survive Participant; provided further that, if neither Jane nor any descendant of Jane survives Participant, such proceeds shall instead be allocated to the individuals or trusts designated in Section 9.16 of Participant's Will who are to receive Jane's (and her descendants', by right of representation) share in such event.

(B) Fifty percent (50%) of such IRAs shall be allocated to the then acting Trustee(s) of the Descendant's Trust created for the primary benefit of Dick Happy ("Dick") under Participant's Will, if Dick survives Participant; provided that, if Dick fails to survive Participant but leaves one or more descendants who survive Participant, the share of such proceeds that would have been allocated to the trust for Dick (if Dick had survived) shall instead be allocated in per stirpes shares to the then acting Trustee(s) of the Descendant's Trusts created in Participant's Will for the descendants of Dick who survive Participant; provided further that, if neither Dick nor any descendant of Dick survives Participant, such proceeds shall instead be allocated to the individuals or trusts designated in Section 9.16 of Participant's Will who are to receive Dick's (and his descendants', by right of representation) share in such event.

If there is more than one designated beneficiary of Participant’s IRAs, then it is Participant's desire that, as of the date required by the final Treasury Regulations, a separate account shall be established and maintained for each beneficiary, bearing its own pro rata share of gains and losses and otherwise separately accounted for to comply with such Regulations.

Exhibit 13

SCHEDULE A

BENEFICIARY DESIGNATION FOR INDIVIDUAL RETIREMENT ACCOUNTS ("IRAs") IN THE NAME OF PATRICIA ANN BROOKS ("PARTICIPANT")

(A) Per Stirpes Distribution to Participant's Descendants. If any child or other descendant of Participant survives Participant, distribute all of such IRAs in equal shares to the children of Participant who survive Participant[1]; provided that, if any child of Participant fails to survive Participant but leaves one or more descendants who survive Participant, the share that would have been distributed to that deceased child (had he or she survived) shall instead be distributed per stirpes to his or her descendants who survive Participant; provided further that, the preceding distributions are subject to the provisions of Paragraph 2.5 of Participant's Will (providing for Contingent Trusts for Participant's grandchildren and more remote descendants who are under age twenty-five at the time of Participant's death). Participant's children, and their social security numbers, are:

1. Christopher Brooks; social security number _____.
2. Michelle Brooks; social security number _____.
3. Leslie Brooks; social security number _____.
4. Nicole Brooks; social security number _____.
5. Patrick Brooks; social security number _____.

(B) Contingent Distribution if No Descendant Survives Participant. If no descendant of Participant survives Participant, then distribute all of such IRAs to the Trustee(s) named in Participant's Will.

[1]Each child who survives Participant should be able to use his/her own life expectancy for calculating MRDs from his/her share if separate accounts are timely and correctly established after Participant's death.

Exhibit 14

SCHEDULE A

BENEFICIARY DESIGNATION FOR THE DEER COMPANY 401(k) PLAN (the "Plan")
IN WHICH JANE DOE IS A PARTICIPANT (the "Participant")

C. If Participant's interest in the Plan has a value of at least Four Hundred Thousand Dollars ($400,000) at the time of Participant's death, distribute these Specific Dollar Amounts to these Specified Charities:

1. Seventy-Five Thousand Dollars ($75,000) to _____ Church, _____ Road, Houston, Texas 77___.

2. Seventy-Five Thousand Dollars ($75,000) to _____ University, _____ Street, _____, Texas _____.

3. Seventy-Five Thousand Dollars ($75,000) to American _____, P.O. Box _____, Houston, Texas 77___.

HOWEVER, if Participant's interest in the Plan has a value of less than Four Hundred Thousand Dollars ($400,000) but more than One Hundred Thousand Dollars ($100,000) at the time of Participant's death, then, in lieu of the amounts provided above, distribute Twenty Thousand Dollars ($20,000) to each of the Specified Charities named above and distribute the balance of Participant's interest in the Plan to the beneficiaries named in Part B. If Participant's interest in the Plan has a value of less than One Hundred Thousand Dollars ($100,000) at the time of Participant's death, then do not distribute any amount to the Specified Charities named above.

D. Distribute the amount remaining in the Plan after making the distributions provided for in Part A (or all of Participant's interest in the Plan if such interest has a value of less than One Hundred Thousand Dollars ($100,000) at the time of Participant's death) to the following individuals in the percentages shown:

1. 30% to Ward Cleaver (social security number: _____; date of birth: _____), _____ Street, Houston, Texas 77____.

2. 27% to Darrin Stevens (social security number: _____; date of birth: _____), _____ Drive, Lafayette, Louisiana 70___.

3. 23% to Clint Huxtable (social security number: _____; date of birth: _____), _____ Lane, Houston, Texas 77___.

4. 20% to Mrs. Miniver (social security number: _____; date of birth: _____), ___ Street, Hillsboro, Kansas 670__.

If any beneficiary listed in Part B above fails to survive Participant, distribute the share that would have been paid to that beneficiary proportionately to the other beneficiaries of Part B who survive Participant (based on their relative shares). If only one beneficiary named in Part B survives Participant, distribute all of the amount being distributed per Part B to that beneficiary.

Because Participant has named multiple beneficiaries of Participant's Plan, it is Participant's desire that (i) the Specified Charities be paid the amounts due them (if any) by the date required by the final Treasury Regulations for determining "designated beneficiary" treatment (generally, by September 30 of the year following the year of Participant's death), so that only individual beneficiaries will remain as of that date (qualifying for designated beneficiary treatment) and (ii) a separate account be established and maintained for each individual beneficiary named in Part B by the date required by the final Treasury Regulations (generally, by December 31 of the year following the year of Participant's death), bearing its own pro rata share of gains and losses and otherwise separately accounted for to comply with such Regulations.

COMMENT: When a Participant wants to split a qualified plan or IRA between charities and individuals, the beneficiary designation form should be set up so that the charities can easily be "cashed out" before the DB Determination Date, so that the remaining individual beneficiaries can create separate accounts, with each individual beneficiary then being able to use his/her own life expectancy to calculate post-death MRDs from his/her separate account.

Exhibit 15

SCHEDULE A

BENEFICIARY DESIGNATION
FOR INDIVIDUAL RETIREMENT ACCOUNTS (IRAs)
IN THE NAME OF DONALD D. DUCK (the "Participant")

(a) Primary Beneficiary (all to Participant's spouse): Distribute all of Participant's IRAs to Participant's wife, Daisy C. Duck ("Participant's Wife"), if she survives Participant. Participant's Wife's date of birth is 10-18-1945 and her Social Security Number is 123-45-6789.

(b) Contingent Beneficiaries (per stirpes distribution to descendants): If Participant's Wife fails to survive Participant, distribute such IRAs in equal shares to Participant's children, Dilly Duck and Dolly Duck (jointly, "Participant's children" and severally "a child of Participant"), if both of them survive Participant, or all to the survivor of them, if only one of them survives Participant; provided that, notwithstanding the foregoing, if any child of Participant fails to survive Participant but leaves one or more descendants who survive Participant, distribute the share that such deceased child would have received (if he or she had survived) per stirpes to his or her descendants who survive Participant. All of the preceding distributions are subject to the Contingent Trust provisions in Participant's Last Will, creating a Contingent Trust for any descendant who is under age 25 or is mentally incapacitated at the time of Participant's death. Participant's children's dates of births and Social Security Numbers are as follows:

Child's Name	Child's Date of Birth	Child's Social Security Number
Dilly Duck	12-30-1973	987-65-4321
Dolly Duck	10-16-1979	654-32-1098

COMMENTARY: Assume the participant's spouse predeceases him so that the Contingent Beneficiary designation applies. Many clients want to use a *per stirpes* distribution for their IRA just as they are using for their probate assets passing under their Will. If they merely name their two children as the equal contingent beneficiaries (i.e., 50% each) on the IRA beneficiary designation form and one child predeceases the participant (or dies at the same time) and the participant does not submit a new beneficiary designation form to the IRA custodian before he dies, the IRA custodian will distribute 100% of the IRA to the one surviving child, which is different from how the probate assets will be distributed under the participant's Will (and probably not what the participant intended). Some, but not all, IRA beneficiary designation forms contain a box that can be checked if the participant desires a "per stirpes" distribution of his/her IRA in this situation. Most clients also want the portion of an IRA being distributed to a child or grandchild who is under a certain age (or mentally incapacitated) to be held in a contingent trust for such beneficiary created in his/her Will. Beneficiary designation forms do not have a box to check for that. Note that if the children are both over the contingent trust age already, rather than naming "the Trustee in the Participant's Will" as the contingent beneficiary of the IRA--which provides the good results of (i) obtaining the *per stirpes* distribution *and* (ii) subjecting the IRA distribution to the contingent trust provisions in the participant's Will, but produces the negative result of requiring both children to use the older child's life expectancy for calculating MRDs after the participant's death (because of the "Trustee designation"–*see*I.B.6 of outline), using a Schedule A beneficiary designation attachment insures separate account treatment for each child while also obtaining the other desired results.

Exhibit 16

SCHEDULE A

BENEFICIARY DESIGNATION FOR LIFE INSURANCE, RETIREMENT PLANS, ANNUITIES, AND IRAS (collectively, "Nonprobate Assets") OWNED BY OR IN THE NAME OF CHICKEN LITTLE ("Owner")

The beneficiaries of all of Owner's Nonprobate Assets (i.e., assets that pass by beneficiary designation form on Owner's death) are as follows:

Distribute all of such Nonprobate Assets in equal shares to Owner's siblings, Henny Penny, Loosey Goosey, and Turkey Lurkey (collectively, Owner's "siblings" and individually, a "sibling" of Owner), who survive Owner, or all to the survivor of Owner's siblings if only one of them survives Owner and no sibling of Owner who fails to survive Owner leaves any descendant who survives Owner; provided that, if any sibling of Owner fails to survive Owner but leaves one or more descendants who survive Owner, the share to which that deceased sibling of Owner would have been entitled (if he or she had survived) shall be distributed per stirpes to his or her descendants who survive Owner, subject to the provisions of Article 4 of Owner's Last Will (providing for Contingent Trusts for beneficiaries who are under age twenty-five or mentally incapacitated at the time of Owner's death).

_____ _____
CHICKEN LITTLE, OWNER DATE SIGNED

Sibling	**Address**	**Telephone**	**Date of Birth**	**Social Security Number**
Henny Penny	_____ Street _____, Texas _____	(___) ___-____		
Loosey Goosey	_____ Street _____, Texas _____	(___) ___-____		
Turkey Lurkey	_____ Street _____, Texas _____	(___) ___-____		

COMMENTARY: This is an "omnibus" Schedule A beneficiary designation attachment that can be used with any non-probate asset that passes by beneficiary designation. As with all beneficiary designation forms and beneficiary designation attachments, the client should make sure that what he or she submits is accepted by the insurance company, plan administrator or IRA custodian (as applicable).

Exhibit 17

BENEFICIARY DESIGNATION CONSIDERATIONS

1. The Participant's "Estate" (or "the Executor named in Participant's Will") should *almost never* be named as the beneficiary of the Participant's retirement plans/IRAs. An Estate is not a Designated Beneficiary, so naming the Estate will accelerate the income taxes on the Participant's Plan or IRA.

2. If the Participant is married and he/she is not going to name his/her spouse as the primary beneficiary of his/her defined contribution plan, or he/she wants to waive the QJSA for his/her defined benefit plan, the spouse must consent to that per REACT (i.e., so that someone other than the spouse can be named as the beneficiary). Remember that a waiver of the required spousal benefits for qualified plans made in a prenuptial agreement by a person prior to marriage is not sufficient – such a waiver must be ratified by the spouse after the wedding in order to be valid. Further, the participant's waiver and the spouse's consent must be submitted to the Plan Administrator on the required forms in a timely manner to be effective.

3. Be careful when naming multiple beneficiaries of a retirement plan/IRA (or when advising beneficiaries post-death) if a charity (or other non-human beneficiary) is among the multiple beneficiaries: in order to establish separate accounts for the individual beneficiaries (so that each individual can use his/her own life expectancy to calculate MRDs after the participant's death), the charity (or other non-human beneficiary) must be "cashed out" before the DB Determination Date.

4. Issues regarding naming trusts as beneficiaries of retirement plans/IRAs:

   Question 1: Are the retirement benefits significant enough in size to justify the complexity and the tradeoffs (such as the less favorable distribution method that will result)?

   Question 2: Does the Participant already have sufficient other assets to fully fund a bypass trust? If not, would underfunding the bypass trust actually result in any (or much) estate tax exposure on the second spouse's death?

   Question 3: Would use of conduit trusts be compatible with the participant's estate planning goals (conduit trusts, which are easier to draft than accumulation trusts, easily qualify for designated beneficiary treatment under the minimum distribution rules and *may* be an appropriate form of trust in certain circumstances–although be careful not to use a conduit trust when it would defeat the participant's other estate planning goals).

5. Issues regarding separate accounts:

   Question 1: Is it possible to indicate the division of the benefits among multiple beneficiaries in the beneficiary designation form? (Such a division in the beneficiary designation form itself preserves the ability to achieve separate account treatment after death; although, in some cases, even if trusts are provided with separate shares in the beneficiary designation form, true separate account treatment may not in fact be possible if the trusts are accumulation trusts because remainder beneficiaries of accumulation trusts must be taken into account in determining the DB).

   Question 2: How crucial is it that the participant's beneficiaries receive separate account treatment? If all of the beneficiaries are of a similar age, it may not be that important.

6. Beneficiary Designation Problems when naming a Trustee as the Beneficiary:

   a. Plan administrators and IRA custodians/trustees frequently want participants to name a "Trust" (and not a "Trustee") in the beneficiary designation form (others will not accept a beneficiary designation naming a "Trust"). This is not a problem if the Participant's estate plan is set out in a Living Trust Agreement – in fact that advantage may be one of the reasons

for selecting the Living Trust format over a Will as the participant's estate planning vehicle. Even though brand new trusts will be created upon the participant/Living Trust grantor's death to receive plan and IRA benefits, plan administrators and IRA custodians routinely accept a beneficiary designation: "To the then acting Trustee(s) of the Robert Smith Living Trust under trust agreement dated May 8, 2000, as amended". In the case of a Will, however, near fanatic resistance seems to be encountered when trying to get a plan administrator or IRA custodian to accept "The Trustee named in Participant's Will" as the beneficiary.

b. One way to finesse this is to provide for a special name for all trusts in the Will that could receive retirement plan benefits and then to use that name in the allocation paragraph contained in the Will (i.e., in the paragraph that instructs the testamentary Trustee regarding the distribution of the retirement plan benefits "passing to" the Trustee among the beneficiaries named in the Will, including various trusts). Then the "Trustee of the [Special Name] Trust created in Participant's Will" can be listed as the beneficiary. This possible solution is also beneficial if the plan administrator/IRA custodian asks the participant to specify *the* section in the Will that creates "*the* Trust".

c. Some plan administrators and IRA custodians/trustees do not like "generic" trustee designations (for example: "To *the Trustee* named in Participant's Will"). They want the name, address and phone number of the Trustee (and the tax identification number of the trust). Obviously, this requirement is silly when naming a trustee who will only begin serving as trustee of trusts that are created upon the participant's death. The participant's death will occur some time in the future, and the person(s) who are currently named in the Will or Living Trust Agreement to serve as trustee may not in fact turn out to be "the Trustee" at that time. This plan administrator/IRA custodian requirement can usually be "finessed" by switching from a "generic" trustee designation to a "specific" trustee designation, such as "To John Jones, Trustee under the Will of [Participant's name] (or his successor)." The parenthetical is necessary if the specific trustee wording is used because, even though John Jones is currently the first named trustee in the Participant's Will, he may not, in fact, turn out to be the trustee at the time of the participant's death.

Exhibit 18
ROTH IRAs

I. ROTH IRA INCOME TAX RULES

A. Notable Aspects of Roth IRAs

7. No Income Tax Deduction For Contributions. Contributions made to Roth IRAs are not tax-deductible when made. Contributions are made with after-tax funds. "Regular" contributions to Roth IRAs (not conversions) must be made in cash.

8. No MRDs During Participant's Life. The owner or participant of a Roth IRA does not have to take minimum required distributions (MRDs) from his/her Roth IRA upon reaching age 70½, as must be done with a traditional IRA.

9. No Maximum Age For Making Contributions. There is no upper age limit on making a contribution to a Roth IRA as there is for a traditional IRA.

10. No Income Tax on Qualified Distributions. "Qualified Distributions" (defined below) from Roth IRAs are income tax-free.

B. Distributions During Roth IRA Owner's Lifetime

11. MRD Rules Not Applicable During Roth IRA Owner's Lifetime. As noted, the MRD rules that apply to traditional IRAs (and qualified retirement plans) *do not apply* to Roth IRAs during the Roth IRA owner's lifetime.

12. Roth IRA Withdrawal Ordering Rules. Withdrawals from Roth IRAs are deemed to occur in the following order (unless the participant made excess contributions): (i) regular contributions to the Roth IRA, (ii) rollovers/conversions to the Roth IRA from a traditional IRA or qualified plan, and (iii) earnings.

13. Income Taxation of Withdrawals During Roth IRA Owner's Lifetime

    a. Withdrawals of Contributions During Roth IRA Owner's Lifetime. Withdrawals of contributions made to the Roth IRA (excluding rollovers/conversions from traditional IRAs and qualified plans) may be made at any time without paying tax or a penalty. This is merely a return of the Roth IRA owner's (after-tax) investment.

    b. Withdrawals of Rollover/Conversion Amounts. Withdrawals of rollover/conversion amounts from a Roth IRA by the Roth IRA owner won't incur any income taxes (because income taxes have already been paid on the conversion); however, early withdrawal penalties could apply for withdrawals "within 5 years" if the taxpayer is under age 59½ at the time of the withdrawal.

    c. Withdrawals of Earnings. Withdrawals of *earnings* in the Roth IRA by the Roth IRA owner are subject to income tax unless the withdrawal is a "Qualified Distribution" (see next section).

C. Taxation of Earnings that are Withdrawn or Distributed from Roth IRA. There are two types of distributions of earnings from Roth IRAs: Qualified Distributions and Non-Qualified Distributions. The taxation of a distribution of earnings from a Roth IRA depends on whether the distribution is Qualified or Non-Qualified.

14. Qualified Distributions–Two Tests. Earnings that are withdrawn from a Roth IRA will be treated as "Qualified Distributions" and, therefore, non-taxable, if two tests are satisfied: a 5 year test and a type of distribution test. *Both tests* must be satisfied to avoid income taxation on a distribution of earnings from a Roth IRA.

a. The "5 Year Test". The 5 year test is met if the earnings are withdrawn after the first day of the 5th year following the year that the Roth IRA was initially established. Technically, the 5-tax-year period begins to run on January 1 of the first year for which a contribution (including a conversion) was made to *any* Roth IRA maintained for that particular participant.

b. The "Type of Distribution Test". Earnings withdrawn due to any of the following reasons/situations will be non-taxable, *assuming the 5 Year Test has been met*: (i) distributions made after the taxpayer reaches age 59½; (ii) distributions made to a beneficiary after the Roth IRA owner's death; (iii) distributions made on account of disability; and (iv) qualified first-time home buyer distributions.

2. Non-Qualified Distributions. If earnings withdrawn from a Roth IRA are not *Qualified Distributions*, they will be subject to tax as ordinary income in the year received. Such a withdrawal will also trigger an early distribution penalty if the Roth IRA owner is under age 59½ at the time of the withdrawal.

D. Distribution Rules after Roth IRA Owner's Death

7. **10% Penalty after Roth IRA Owner's Death.** The 10% early distribution penalty does not apply after the Roth IRA owner's death except in one case: if the surviving spouse is the beneficiary and elects to treat the decedent's Roth IRA as his/her own (such as would occur with a spousal rollover) and then the spouse makes withdrawals that fail the age 59½ distribution test, the 10% penalty will apply.

8. **Taxation of Post-Death Withdrawals.** Beneficiaries of inherited Roth IRAs can withdraw the earnings tax-free, even if the beneficiary is under age 59½ and even if the decedent was under 59½ when he died–but only if the 5 Year Test is satisfied. Withdrawals of other amounts (e.g., contributions and rollover/conversion amounts), even within the 5 year qualification period, are tax-free.

3. **Post-Death MRDs to Non-Spouse Beneficiaries.** For the beneficiary of an inherited Roth IRA other than the surviving spouse of the deceased Roth IRA owner, MRDs must be taken based on the MRD rules applicable to traditional IRAs in the situation where the participant/IRA owner dies before reaching his/her required beginning date. Thus, non-spouse beneficiaries must either commence MRDs by December 31 of the year following the year of the Roth IRA owner's death, calculating MRDs based on the beneficiary's single (non-recalculated) life expectancy, *or* take all amounts out of the inherited Roth IRA by December 31 of the year that contains the 5th anniversary of the Roth IRA owner's death (i.e., pursuant to the "5 year rule").

4. **Options for Spouse as Beneficiary.** A spouse beneficiary can elect to treat the decedent's Roth IRA as his/her own (such as would occur with a spousal Roth IRA rollover), therefore becoming the new Roth IRA owner, with all of the Roth IRA rules then applicable to the spouse as the participant. As an alternative, a spouse beneficiary can remain in the position of being the deceased Roth IRA owner's beneficiary and take MRDs over his/her life expectancy, but delay commencing MRDs from the inherited Roth IRA until the deceased Roth IRA owner would have reached age 70½. In that case, the spouse can also take discretionary distributions before reaching age 59½ without a penalty.

5. Basis of Distributions from Roth IRA. The tax basis of an asset distributed from a Roth IRA is its fair market value on the date of the distribution.

II. ESTATE TAX AND RELATED ISSUES ON DEATH OF ROTH IRA OWNER

A. Estate Asset. The decedent's interest in a Roth IRA is included as an asset of his/her estate for federal estate tax purposes at its fair market value on the date of death (or on the alternate valuation date, if applicable).

B. Community Property Issues. Community property rules apply to Roth IRAs. Thus, all amounts in a Roth IRA acquired or accumulated by a married Roth IRA owner while living in Texas are going to be community property. This is true even though the Roth IRA is titled in the name of just one spouse–the participant or "listed owner"–and even though only that spouse has "control" over the Roth IRA. With such "sole management community property", the spouse whose name is on the account is the *manager* of the account on behalf of both spouses (but not the sole owner). Since the funds in a married participant's Roth IRA are community property, when completing the beneficiary designation form, the participant should name his/her spouse as the beneficiary of *at least ½* of the Roth IRA (because he/she already owns half under community property law). Otherwise, the result will be potential adverse gift tax consequences for the surviving spouse and possibly even litigation (for fraud on the community).

C. Estate Tax Marital Deduction. If the participant's interest in his/her Roth IRA passes to his/her U.S. citizen spouse at death, estate taxes will be deferred because of the unlimited marital deduction. If the Roth IRA participant's spouse is *not* a U.S. citizen and the marital deduction is desired, the Roth IRA would need to be placed in a Qualified Domestic Trust, or QDOT, to qualify the transfer for the federal estate tax marital deduction.

D. Spouse as Beneficiary. If a Roth IRA passes to the participant's spouse on his death, many Roth IRA Agreements are set up for an *automatic* spousal IRA rollover, meaning that the surviving spouse becomes the new participant of the Roth IRA (if the spousal rollover is not automatic, most surviving spouses opt to do the rollover anyway). The benefit of the spousal rollover is that no MRDs have to be taken from the rolled-over Roth IRA during the surviving spouse's lifetime (same as for the original participant). Further, Qualified Distributions to the surviving spouse will be income tax-free.

E. Non-Spouse Beneficiaries. If a Roth IRA passes on the participant's death to non-spouse *designated beneficiaries* and if separate inherited Roth IRA accounts are timely created, each beneficiary can use his/her own life expectancy for calculating MRDs from his/her inherited Roth IRA. In this situation, MRDs from an inherited Roth IRA must commence by December 31 of the year following the year of the Roth IRA owner's death. Unlike with traditional inherited IRAs, however, Qualified Distributions from an inherited Roth IRA to the participant's beneficiaries are tax-free. If the Roth IRA owner dies without having a designated beneficiary under the MRD rules, then the actual beneficiary/ies must withdraw the amounts in the deceased participant's Roth IRA pursuant to the 5 year rule.

F. Traditional IRA versus Roth IRA: Estate Tax Considerations. A traditional IRA has an *overstated* value for federal estate tax purposes because it is a "pre-tax" asset (i.e., it has a built-in income tax liability that artificially increases its value for estate tax purposes). Further, the transfer of a traditional IRA results in double taxation–it is subject to estate taxes in the participant's estate and income taxes as the funds are withdrawn by the beneficiaries. Sometimes the double tax applies in the same year (where all or a portion of the traditional IRA has to be liquidated and withdrawn to pay the decedent's estate taxes). Considering the estate tax rules applicable in 2009 as an example, with a 45% estate tax rate and a 35% top income tax rate, the combined tax rate on a traditional IRA upon the IRA owner's death can be substantial. Fortunately, there is an income tax deduction (but not a tax credit) to help alleviate this double taxation on traditional IRAs. Some researchers believe that if the beneficiary of a deceased participant's traditional IRA utilizes the stretch option (only takes the MRD each year) and takes the allowable income tax deduction (with respect to the estate taxes caused by inclusion of the IRA in the participant's estate), the net result to the beneficiary, long term, is comparable to the net result of the beneficiary inheriting a Roth IRA. As noted, the Roth IRA is subject to estate tax in the participant's estate just like a traditional IRA. A converted Roth IRA will have a lower value for estate tax purposes than the traditional IRA from which it came (and, further, the participant's estate will be smaller due to the income taxes paid on the conversion). The conversion might lower the value of the participant's estate enough to avoid estate taxes. Obviously, however, in view of the expanded conversion opportunity available beginning in 2010 (see below), some Roth IRA participants will still have taxable estates at death. While the Roth IRA may incur estate taxes in the participant's estate, assuming all distributions from the Roth IRA to the participant's post-death beneficiaries are Qualified Distributions, there will not be an income tax deduction for the estate taxes paid on the Roth IRA because there aren't any income taxes on the post-death Roth IRA distributions in that case (i.e., no "double tax").

III. CONVERSION OF TRADITIONAL IRA TO ROTH IRA

A. Eligibility and Conversion Rules – in General

1. **Conversion Methods.** A Roth IRA conversion may be accomplished by means of (i) a rollover, (ii) a trustee-to-trustee transfer or (iii) an account redesignation. Because traditional "rollovers" have been tax-free (e.g., rollover of a lump sum distribution from a qualified plan to an IRA on separation of service), and because transferring funds in a traditional IRA or qualified plan to a Roth IRA rollover is not tax-free, most people use the term "conversion" to refer to the process of moving funds from a traditional IRA to a Roth IRA.

2. **Married Filing Separately Prohibition.** Prior to 2010, if a married taxpayer filed his/her income tax return "married filing separately", he/she could not convert a traditional IRA to a Roth IRA unless he/she lived apart from his/her spouse the entire year. Starting in 2010, even a taxpayer who is married, filing separately, can convert.

3. **No Age Limit On Conversion.** A participant of any age can convert to a Roth IRA. However, if the participant is under age 59½ when the conversion is done, be mindful of certain other rules that may affect the income taxation of a distribution of earnings from the Roth IRA, including the imposition of an early distribution penalty (*see* I.B, C and D, above).

4. **Modified AGI Limitation on Conversion Before 2010.** Prior to January 1, 2010, if the taxpayer's modified AGI was greater than $100,000, he/she was not eligible to make the Roth IRA conversion. This figure applied whether the taxpayer was single or married and applied to the modified AGI of the *couple*, not each spouse.

5. **Conversion of Qualified Plan.** Prior to 2008, a "standard" qualified retirement plan could not be converted directly to a Roth IRA. It first had to be rolled over into a traditional IRA rollover and then that IRA rollover could be converted to a Roth IRA. After 2008, a qualified retirement plan can be converted directly to a Roth IRA without first being rolled over to a traditional IRA. The benefit of a direct conversion of a qualified plan to a Roth IRA over the "two-step" method is that, with the direct conversion, a larger portion of the conversion will be tax-free since the denominator used to produce the tax-free percentage is the total value of the plan. Compare that to conversion of just one traditional IRA out of several IRAs owned (or part of one traditional IRA)–the denominator used to produce the tax-free percentage is the combined total value of all of that participant's IRAs. With respect to a "Roth Qualified Plan" (such as a Roth 401(k) plan or a Roth 403(b) plan, new types of plans allowed since 2006), a direct conversion or rollover to a Roth IRA was always allowed (even before 2008).

6. **Trap for the Unwary: An "inherited IRA" (an IRA inherited by anyone other than the participant's spouse) <u>cannot</u> be converted to a Roth IRA.** On the other hand, *if a particular qualified plan allows it*, the non-spouse beneficiary of the participant's qualified plan can direct the inherited plan funds to an inherited Roth IRA account. (Note that, prior to 2010, the beneficiary could not do this unless his/her modified AGI was under $100,000). Qualified plans are required to allow this option beginning in 2010. Thus, for beneficiaries who would prefer a Roth IRA, it is better to inherit a qualified plan than a traditional IRA.

7. **Spousal Inherited IRA.** Before 2010, a spouse who inherited a traditional IRA from the deceased participant first had to do a spousal IRA rollover (or make it his/her own) and then he/she could convert the traditional IRA to a Roth IRA. That's because the spouse had to become the *owner* of the inherited IRA to be able to do the Roth conversion–otherwise, if he/she was merely the deceased participant's *beneficiary*, the prohibition discussed in 6 immediately preceding applied.

8. **Partial Conversions.** Partial conversions are allowable, but a taxpayer cannot convert only the nontaxable part of his/her IRA.

9. **Exception to Disallowance of Double Rollover in One Year.** A taxpayer can convert a traditional IRA to a Roth IRA even if the taxpayer moved his/her traditional IRA from one IRA custodian to another IRA custodian within the previous 12 months (this is an exception to the rule disallowing more than one IRA "rollover" in 12 months).

10. **IRA Participants Taking Substantially Equal Payments.** If a taxpayer under age 59½ was taking substantially equal periodic payments from a traditional IRA pursuant to the exception to the 10% early withdrawal penalty in Code Section 72(t), he/she is not precluded from converting his/her traditional IRA to a Roth IRA, but he/she must continue taking the periodic withdrawals (from the

new, converted Roth IRA) pursuant to the original payment scheme until over age 59½ to avoid triggering the 10% penalty on conversion.

11. The 10% Early Withdrawal Penalty. The 10% early withdrawal penalty (applicable to distributions from traditional IRAs taken by a taxpayer who has not yet reached age 59½) is not triggered merely by making the Roth conversion; however, if earnings in the IRA are withdrawn "too soon"– perhaps to pay the income tax on the conversion – the penalty will be triggered.

12. Withdrawal Within 5 Years. Following the conversion to a Roth IRA, a penalty applies to all withdrawals taken "within 5 years" by a taxpayer under age 59½. "Within 5 years", however, does not mean within 60 months–a shorter period actually applies. The penalty applies if the withdrawal occurs before the first day of the fifth taxable year following the year of the conversion.

13. Conversion of Assets. The same assets held in the traditional IRA must be rolled into the Roth IRA upon conversion. This is an exception to the rule that contributions to a Roth IRA must be made in cash (only).

14. Income Taxation on Conversion. Conversion of a traditional IRA to a Roth IRA triggers ordinary income tax on the amount in the IRA, excluding nondeductible contributions. Assets other than cash in the IRA are valued at their fair market value on the conversion date.

15. Inability to Convert MRD in Year of Conversion. A taxpayer who is over age 70½ and already taking MRDs from his/her traditional IRA can convert to a Roth IRA; however, in the year of the conversion, he/she cannot convert the MRD for that year (in other words, the amount of that year's MRD is ineligible for the conversion).

16. Effect of MRD on Income Limit for Roth Conversion Prior to 2005. For years prior to 2005, the MRD due from the traditional IRA in the year of conversion had to be counted in determining whether the taxpayer's modified AGI exceeded the $100,000 limit. Beginning in 2005 and through December 31, 2009, the MRD for that year did not have to be taken into account for determining eligibility for the Roth conversion (note that no MRDs were required in 2009 due to special Congressional legislation).

17. Conversion Deadline. The deadline for *converting* a traditional IRA to a Roth IRA is December 31 of the particular year (not April 15 of the following year).

B. Expanded Roth Conversion Opportunity Available Starting in 2010

1. In General. Beginning January 1, 2010, *any* taxpayer can convert a traditional IRA (and certain employer-sponsored retirement accounts) to a Roth IRA, even if he has modified AGI above $100,000. In other words, there will no longer be an income limit for making a Roth conversion. Further, beginning in 2010, even a taxpayer who is married filing separately is eligible to do a Roth conversion.

2. Income Tax On 2010 Roth Conversion. Income taxes on a Roth IRA conversion done in 2010 will be due ½ in 2011 and ½ in 2012, *unless the taxpayer makes the election to pay all of the tax in 2010*.

3. Ability to "Un-Do" the Conversion. There are situations where a person who converted a traditional IRA to a Roth IRA may want or need to "un-do" the conversion. Perhaps the person exceeded the modified AGI limit in the year of the conversion. Or, perhaps the person converted at a time when the value of his traditional IRA was at an all time high. A taxpayer who wants to "un-do" a Roth conversion will have until October 15 (assuming he extends his income tax return) of the year following the year of the conversion to convert back to a traditional IRA. The recharacterization must be done as a trustee-to-trustee transfer. Both the Roth IRA custodian and the traditional IRA custodian must be notified of the recharacterization in writing, meaning that the appropriate forms have to be completed and submitted. If only a portion of the Roth IRA is being recharacterized, then gain or loss must be allocated between the amount remaining in the Roth IRA and the amount being recharacterized back to the traditional IRA.

C. Advantages and Disadvantages of Roth IRA Conversions

1. Advantages of Conversion

a. Due to the income tax payment on conversion, the resulting Roth IRA is a "better" asset for estate planning purposes–it is worth more to Estate beneficiaries than a traditional IRA of the same value and is a better choice for funding trusts (because it is not a "pre-tax" asset). The way to make the Roth IRA truly "bigger" than the traditional IRA used in the conversion is to pay the income taxes due on conversion *from sources other than the IRA.*

b. Payment of the income taxes on the conversion reduces the size of the taxpayer's estate for estate tax purposes.

c. The minimum distribution rules that apply to traditional IRA owners once they reach their required beginning date (generally, April 1 of the year following the year the IRA owner reaches age 70½) do not apply to Roth IRAs. The MRD rules don't apply until after the Roth IRA owner's death. Thus, if funds from the IRA are not needed during retirement (perhaps due to having a pension or other sources of income), the IRA owner can increase the value of what his/her beneficiaries will receive by allowing the Roth IRA to continue to grow, tax-free, after the conversion.

d. Roth IRAs are more flexible than traditional IRAs. For example, distributions can be taken from a Roth IRA before age 59½ without suffering the 10% early withdrawal penalty applicable to traditional IRAs. Be aware, however, that if the Roth IRA was created by conversion of a traditional IRA, the "5 year test" must be satisfied before early withdrawals from the Roth IRA will avoid penalty.

2. Disadvantages of Conversion

a. Income taxes must be paid on the conversion. In general, it is usually better to pay income taxes *later*, rather than sooner. Further, *some* taxpayers may be in a higher income tax bracket at the time of the conversion than they will be in later on, so the income tax on the conversion will end up being paid at a higher rate. In addition, if money from the traditional IRA must be used to pay the conversion tax and if the taxpayer is less than 59½ years old at the time, a penalty will apply on the conversion.

b. If the tax-free nature of taking withdrawals from the Roth IRA is so appealing that it causes the taxpayer to withdraw greater amounts each year than he/she would otherwise have withdrawn from his/her traditional IRA, there is a risk that the taxpayer will exhaust his/her funds too soon.

c. In some states, traditional IRAs may have creditor protection while Roth IRAs may not (a participant's Roth IRA is protected in Texas).

D. Additional Considerations Regarding the Conversion

1. Author's Comment. There are many articles that discuss the pros and cons of converting a traditional IRA to a Roth IRA. There isn't just one correct answer–everyone's situation is different. However, a consensus that keeps appearing is that, for the most part and for most people, the conversion is not a "slam dunk". The end result may be pretty close to neutral–slightly better or slightly worse than not converting. Keep in mind that one reason the federal government removed the income limitation in 2010 is to raise revenue (that should indicate something).

2. Factors Weighing Against Roth Conversion

a. Conversion to a Roth IRA makes less sense if the participant must use funds from his/her traditional IRA (or another retirement fund) to pay the income taxes caused by the conversion.

b. A Roth conversion won't be optional if the participant is likely to begin needing to spend his/her retirement funds soon.

c. The Roth conversion may not make sense if the beneficiaries of the participant's IRA are not likely to utilize the "stretch" distribution method after the participant's death (i.e., they are just going to withdraw most or all of the inherited amount fairly quickly).

d. If the participant is likely to be in a lower income tax bracket in the future compared to now, then the Roth conversion may not be advantageous.

3. Factors Weighing In Favor Of Roth Conversion

a. A single participant with a very large IRA rollover and a *taxable* estate (over $5,250,000 in 2013) could reduce his estate below $5,250,000 by converting his large rollover IRA to a Roth IRA.

b. For several years--during the Recession and shortly thereafter--the values of many securities held in traditional IRAs were somewhat lower compared to a few years before that, so the income taxes on the Roth conversion were lower due to the lower value of the IRAs. Also, the top income tax rate in 2010-2012 (35%) was lower than it is now, in 2013 (39.6%). For those reasons, many people did Roth conversions in 2010 through 2012. These "favorable" factors do not really apply any more, however.

c. If a taxpayer with a traditional IRA expects to be in a higher income tax bracket in the future, then a Roth conversion may make sense.

4. Crunching the Numbers. It is probably best to let your client's CPA or financial advisor analyze and calculate the possible advantages and disadvantages of a client with a large traditional IRA doing the Roth conversion.