AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: Trusts and Beneficiaries of Qualified Plans and Individual Retirement Arrangements: New Developments

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PANEL: Revenue Ruling 2006-26 – QTIP'ing an IRA

DATE: 10/21/06

COMMITTEE: Fiduciary Income Tax

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ABA 2006 Joint Fall CLE Meeting of the Section of Taxation and Section of Real Property Probate and Trust Law

Fiduciary Income Tax Meeting October 21, 2006

TRUSTS AS BENEFICIARIES OF QUALIFIED PLANS AND INDIVIDUAL RETIREMENT ARRANGEMENTS: NEW DEVELOPMENTS.

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TRUSTS AS BENEFICIARIES OF QUALIFIED PLANS AND INDIVIDUAL RETIREMENT ARRANGEMENTS: NEW DEVELOPMENTS.

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This presentation covers some new developments in trusts as beneficiaries of Qualified Plans and IRAs. It also covers some changes affecting estate planning and taxation of distributions from Qualified Plans¹ and IRAs² resulting from the Pension Protection Act of 2006.

I. Revenue Ruling 2006-26 (2006-22 IRB 939 (05/04/2006)): QTIPing an IRA

Revenue Ruling 2006-26 presented three different factual situations involving the Uniform Principal and Income Act ("UPIA") and qualification of a spousal interest in a trust for QTIP treatment under the Internal Revenue Code (the "Code") § 2056(b). The Ruling modifies and supersedes Revenue Ruling 2000-2, 2000-1 CB 305.

A. <u>Background</u>. In order to qualify for the marital deduction, a QTIP Trust must provide the surviving spouse with a "qualifying income interest for life," that is, the surviving spouse must be entitled to "all the income" from the property.⁴

What is income? A majority of states have adopted a version of the UPIA. UPIA § 104 gives a trustee the power under certain circumstances to "adjust" between principal and income. The UPIA of some states gives a trustee the additional power to convert a trust to a unitrust. After such a conversion, the unitrust amount is the trust's income for fiduciary accounting purposes.

Regulations recognize these provisions of state law. Reg § 1.643(b)-1 provides that, for purposes of the definition of trust "income" under subchapter J of the Code, "an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year." It further provides that a "power to adjust" is a reasonable apportionment of the total return of the trust if it provides that income is a unitrust amount of no less than 3% and no more than 5% of the value of the trust assets. Regulations also provide that a spouse has a "qualifying income interest for life" and is "entitled to all income" of the QTIP property if the spouse is entitled to income under a state law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust.⁵

The UPIA also includes provisions concerning the portion of a distribution from an IRA that is income for fiduciary accounting purposes. In general, UPIA § 409(c) provides that 10%

Plans qualified under Code § 401(a).

Individual retirement accounts under Code §§ 408 and 408A.

Code $\S 2056(b)(7)(B)(i)(II)$.

⁴ Code § 2056(b)(7)(B)(ii)(I).

⁵ See Regs. §§ 20.2056(b)-5(f)(1) and 20.2056(b)-7(d)(2).

of a required minimum distribution ("RMD") is income and 90% is principal, and that any withdrawal from an IRA in any year in excess of the RMD is principal. It also provides that "[i]f, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by [§409(c)], the trustee shall allocate to income the additional amount necessary to obtain the marital deduction." Q: Does this provision create a problem?

B. Terms of Trust. Under the facts of Revenue Ruling 2006-26 (the "Ruling"), the trust gives the surviving spouse the power exercisable annually *to compel the trustee to withdraw* from the IRA all the income and to distribute that income to the spouse. If the spouse does not exercise the power, the trustee must withdraw from the IRA only the RMD. In addition, all income of the trust is payable annually to the spouse for the spouse's life, no person has the power to appoint any part of the trust principal to any person other than the spouse, and the spouse has the right to compel the trustee to invest the trust principal in productive assets. Three situations involving different state laws were described:

C. <u>Three Situations.</u>

1. Situation 1 — Authorized Adjustment between Income and Principal.

In Situation 1, the trustee determines the total return of the assets held in the trust exclusive of the IRA for each calendar year. The trustee then determines the portion of the total return that is to be allocated to income and principal under the state's version of UPIA § 104(a). Under UPIA § 104(a), the trustee is authorized to make adjustments between income and principal to satisfy the trustee's duty of impartiality between the income and remainder beneficiaries. The total amount allocated to income is distributed to the spouse as the income beneficiary. If the spouse exercises the withdrawal power, the trustee also withdraws from the IRA the greater of the amount allocated to income or the RMD and distributes it to the spouse.

In addition, the state has a provision similar to UPIA § 409(c) providing that when a payment such as an RMD is made from an IRA to the trust, the trustee must allocate 10% of the required payment to income and the balance to principal unless an exception applies. The law also states that the trustee is required to allocate to income any additional amount necessary to obtain the marital deduction.

Under the Ruling, the IRS noted that the 10% allocation to income, *standing alone*, does *not* satisfy the QTIP requirement because the amount of the RMD is *not* based on the total return of the IRA. It also noted that the 10% allocation to income does *not* represent the income of the IRA without regard to a power to adjust between principal and income. It concluded that the state's version of § 409(d) of the UPIA which requires the additional allocation to meet the marital deduction requirements "may not qualify the arrangement under Section 2056." It based this reasoning on Revenue Ruling 65-144 (1965-1 CB 422) and the position that savings clauses are ineffective to reform an instrument for federal tax purposes. The Ruling also noted that *if* the terms of a trust did not require distribution to the spouse of at least the income of the IRA in the event that the spouse exercises the right to withdraw from the IRA, the requirements of Code § 2056 may *not* be satisfied unless the trust terms provide that the version of UPIA § 409(c) is not to apply.

2. Situation 2 — Unitrust Income Determination.

In situation 2, the trustee determines the income of the trust (excluding the IRA) and the income of the IRA under a statute in which income is defined as the unitrust amount of 4% of the fair market value of the assets determined annually. The Ruling determined that this formula satisfies the requirements of Code § 2056 since the spouse has the power to unilaterally access all the income of the IRA and the income of the trust is payable to the spouse annually. The Ruling holds that the IRA and the trust meet the requirements of Code § 2056. The Ruling also notes the result would be the same if the state had enacted both a statutory unitrust regime and a version of UPIA § 104(a).

3. Situation 3 — "Traditional" Definition of Income.

In the situation 3, the state has *not* enacted the UPIA and there is *no* statutory power to allocate receipts and disbursements between income and principal. Income is traditional fiduciary accounting income such as interest and dividends. Under the terms of the trust, if the spouse exercises the power to compel the trustee to withdraw the income of the IRA, the trustee must withdraw the greater of the RMD amount or the income of the IRA.

The Ruling holds that both the IRA and the trust meet the requirements of Code § 2056 since the spouse receives the income of the trust at least annually and the spouse has the power to unilaterally access all of the IRA income. The Ruling noted the result would be the same if the state had enacted § 104(a) of the UPIA but the trustee decided to make no adjustments pursuant to that provision.

D. Ruling.

The Ruling concluded that if a marital trust is the named beneficiary of a decedent's IRA or defined contribution plan, the surviving spouse under the circumstances described in situations 1, 2 and 3 will be considered to have a qualifying income interest for life in the IRA or defined contribution plan and in the trust for purposes of the estate tax marital deduction. It also noted that if the marital deduction is sought, the QTIP election must be made *both* for the IRA and the trust.

The bottom line is that to qualify for the marital deduction, the trustees may *not* solely rely upon a provision of state law which provides that only 10% of a RMD is to be allocated to income. Instead, the spouse must have the power to unilaterally access all the income of the IRA and the income of the trust payable at least annually. Income for these purposes must be determined either (1) under a state law power to adjust or unitrust regime that complies with the requirements of Reg § 1.643(b)-1, or (2) in the traditional fiduciary accounting manner in which income is interest, dividends and other items.

E. Significance.

If you have already included in your trust agreements language to comply with Revenue Ruling 2000-2, additional language should not be necessary to comply with Revenue Ruling 2006-26. However, if the trust is relying only upon UPIA § 409(d) wherein only 10% of an RMD is allocated to income, the trust would *not* qualify for QTIP treatment.

On another issue, the Ruling noted that taxpayers should be aware that if any distribution from the IRA may be held in trust for future distribution rather than being distributed to the spouse currently, the spouse is *not* the *sole* beneficiary of the IRA. Accordingly, both the spouse and the remainder beneficiaries must be taken into account to determine designated beneficiary for RMD purposes.

F. Rebuttal?

G. <u>Sample Form.</u>

Following is Will language to allocate the least amount of Retirement Accounts necessary to fund the Family Trust. Use if a testamentary trust is named the beneficiary and if the marital share is in a QTIP Trust and to comply with Rev Rul 2006-26 (2006-22 IRB 939). Use the alternative for a conduit QTIP Trust.

"Allocation To Marital Income Trust (i.e., a QTIP Trust):

- 1. If my trustee is named beneficiary of my interest in one or more retirement plans which are qualified under Code § 401(a), § 403(b), §457 or one or more Individual Retirement Accounts qualified under Code § 408, Code § 408A or other sections of the Code ("Retirement Accounts"), my trustee shall allocate the benefits payable from such Retirement Accounts to the Marital Income Trust if possible to do so without underfunding the Family Trust.
- 2. If one or more Retirement Accounts are payable to the Marital Income Trust, the following provisions shall apply:
 - a. My trustee shall direct the trustee or custodian of each Retirement Account to make distributions at least annually to this trust of an amount equal to the amount required to be distributed from such Retirement Account under Code § 401(a)(9).
 - b. My trustee shall pay to or apply for the sole benefit of my [wife/husband] at least annually all or such portion of the net income of each Retirement Account as my [wife/husband] shall request on a cumulative basis.

-OR-

[Alternative For Conduit Trust:

My trustee shall pay to or apply for the sole benefit of my [wife/husband] at least annually all or such portion of the net income of each Retirement Account as my [wife/husband] shall request on a cumulative basis.

My trustee shall also distribute directly to my [wife/husband] all amounts which my trustee receives from each Retirement Account and shall *not* accumulate any such amounts in trust.]

- c. My trustee shall take all necessary action to assure that the interest of my [wife/husband] qualifies as a qualifying income interest for life pursuant to Code § 2056(b)(7).
- d. My trustee shall allocate to the income of the Marital Income Trust all the net income earned by the Retirement Account. My trustee shall allocate to principal of the Marital Income Trust the balance of the Retirement Account.
- e. My [wife/husband] shall have the power to direct my trustee to compel any Retirement Account to be invested in income-producing assets.
- f. My trustee shall elect to qualify each Retirement Account payable to this trust as a QTIP trust pursuant to Code § 2056(b)(7).
- g. My trustee shall not apply an asset of any Retirement Account to pay any of my debts, death administration expenses or death taxes other than those death taxes incurred by such Retirement Account."

II. The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) (P.L. 109-222).

- A. Old Law. Prior to 2010, a taxpayer with more than a \$100,000 of Adjusted Gross Income (AGI) could not convert a IRA into a Roth IRA. For many taxpayers, a conversion to a Roth IRA is very desirable. The advantage of a conversion is that after the funds are in the Roth IRA, the taxpayer will not pay income tax on the funds or their earnings if the withdrawal is qualified. A withdrawal is "qualified" if: (1) the funds have been in the Roth IRA for five-taxable-years, and (2) the withdrawal is made after age 59-1/2 or because of disability. Distributions which are not qualified may also be subject to a 10% additional income tax. The additional 10% income tax does *not* apply if certain exceptions apply. The disadvantage is that a taxpayer who makes a conversion must pay income tax on the amount withdrawn from the IRA.
- B. New Law. TIPRA *eliminated* the \$100,000 maximum AGI limit for taxpayers to convert an IRA to a Roth IRA. The provision is effective in 2010. In addition, a taxpayer who converts in 2010 is given two years, 2011 and 2012, in which to pay the income tax on the 2010 conversion. This provision was intended as a revenue raiser. The Joint Committee on Taxation estimated that the provision would raise \$6.4 billion in revenue over the next ten years.

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⁶ Code $\S 408A(c)(3)(B)(i)$.

Note that the "five-taxable-years" are calculated from the date of the conversion.

See Code § 72(t).

⁹ Sec. 512, P.L. 109-222.

C. <u>Significance</u>? There are more opportunities for a conversion to a Roth IRA after.

Planning Pointer: This change allows an "end around" the income limitations for contributions to a Roth IRA. The income limitations are still in place although indexed after 2006. However, an individual with income in excess of the limitations could make nondeductible contributions to an IRA and then convert the IRA to a Roth IRA under the new law after 2009 regards of AGI. A conversion also allows taxpayers to lock in current tax rates.

III. Pension Protection Act of 2006, P.L. 109-280 ("Act"). Following is a brief summary of some (but *not* all) developments affecting distributions from Qualified Plans and IRAs.

A. Rollover of Inherited IRAs.

- 1. Old Law: The law prior to the Act (the "Old Law") did *not* allow nonspouse beneficiaries to roll over inherited Qualified Plan accounts to IRAs. Such rollovers were permitted only for surviving spouses.
- 2. New Law: Effective for distributions *after* 2006, the Act permits "a direct trustee-to-trustee transfer" (note, *not* a "rollover") of distributions from an decedent's eligible retirement plan to a nonspouse beneficiary's IRA. The transfer is treated as an eligible rollover distribution. The change applies to amounts payable to a beneficiary under a Code § 401(a) Qualified Plan, Code § 403(a) or Code § 403(b) annuity or a governmental Code § 457 Plan. To the extent provided by IRS, the change also applies to benefits payable to a trust maintained for a designated beneficiary to the same extent it applies to the beneficiary. Distributions from the beneficiary's IRA are subject to the RMD rules that apply to inherited IRAs of nonspouse beneficiaries.¹²
- 3. Significance: A beneficiary who is entitled to only a lump-sum distribution now has the flexibility to stretch-out distributions over the applicable life expectancy by means of a "direct trustee-to-trustee transfer" to an IRA. A direct trustee-to-trustee transfer includes a "direct rollover" but does *not* include a withdrawal by a beneficiary and a rollover within 60 days.

Planning Pointer: Delay distributions to a nonspouse beneficiary to after December 31, 2006 when trustee-to-trustee transfers to an IRA are effective.

¹¹ Signed Aug 17, 2006.

See III H below.

Act § 829(a)(1) adding Code § 402(c)(11)(A).

B. Rollovers of After-Tax Contributions to a Code § 403(a) Annuity Contract.

- 1. Old Law: A participant could make a direct rollover of after-tax contributions from a qualified retirement plan to a defined contribution plan and from a tax-sheltered annuity to another tax-sheltered annuity if the recipient plan provided for a separate accounting of these contributions and earnings. After-tax contributions could also be rolled over to an IRA but the IRA owner had to account for the amount of after-tax contributions.
- 2. New Law: Effective for tax years beginning after 2006, the Act permits after-tax contributions to be rolled over from a qualified retirement plan to either: (1) a defined contribution or a defined benefit plan; or (2) a tax-sheltered annuity. The transfer must be made by a direct rollover, and the receiving plan must separately account for after-tax contributions and their earnings.¹³
- 3. Significance: This provides greater flexibility for rolling over after-tax contributions.

C. Direct Rollovers to Roth IRAs.

- 1. Old Law: Taxpayers with modified AGI of \$100,000 or less could roll over amounts in an IRA to a Roth IRA. The amount rolled over was includible in income but the 10% additional income tax did not apply. Participants in qualified retirement plans, tax-sheltered annuities, or a governmental Code § 457 plans could roll over distributions from the plan or annuity into an IRA, if certain requirements were met. However, distributions from such plans could *not* be rolled over into a Roth IRA. Such distribution first had to be rolled over into an IRA, and then rolled over from the IRA to a Roth IRA.
- 2. New Law: Effective for distributions made *after* 2007, the Act allows distributions from qualified retirement plans, tax-sheltered annuities, and governmental Code § 457 plans to be rolled over *directly* into a Roth IRA, subject to the usual rules that apply to rollovers from an IRA to a Roth IRA.¹⁴
- 3. Significance: The Act provides a more efficient way to roll over distributions to a Roth IRA. No longer is the intermediate step of rollover to an IRA required.

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¹³ Act § 822(a) amending Code § 402(c)(2)(A).

Act § 824(a) and (b) amending Code §§ 408A(e), 408A(c)(3)(B) and 408A(d)(3).

D. Surviving Spouse's Pension.

1. QDRO.

- a. Old Law: A QDRO is a qualified domestic relations order that meets certain procedural requirements and creates a right for an alternate payee, including a former spouse or child, to a plan benefit payable to a participant.
- b. New Law: Within one year of the enactment date, the Department of Labor must issue regs providing that a domestic relations order will not fail to be a QDRO merely because it is issued after, or revises, another order or because of the time it is issued.¹⁵

2. Railroad Retirement Annuities.

a. New Law: Effective one year after the enactment date, the Act entitles a divorced spouse to railroad retirement annuities independent of the actual entitlement of the employee and provides that a surviving spouse's annuity under tier II railroad retirement benefits pursuant to a divorce decree can *not* be terminated because of the death of the participant unless the divorce order so provides.¹⁶

3. QJSA.

- a. Old Law: Pension plans must provide benefits in the form of a QJSA, that is, a qualified joint and survivor annuity in which the monthly survivor benefit must be at least 50% of the joint benefit.
- b. New Law: For plan years beginning *after* 2007, the Act requires that plans offer a joint and survivor benefit that provides at least a 75% survivor benefit.¹⁷

E. <u>Increased IRA Contributions for Victims.</u>

The Act permits victims of employer bankruptcies to make additional IRA contributions of up to \$3,000 per year for the years 2006-2009. A taxpayer is eligible if: (1) he or she was a participant in a Code § 401(k) plan in which the employer matched at least 50% of employee contributions to the plan with employer stock; (2) in a tax year preceding the tax year of an additional contribution, the individual's employer (or any controlling corporation of the employer) was in bankruptcy and the individual's employer or any other person was subject to an indictment or conviction resulting from business transactions related to the bankruptcy; and (3) he or she was a participant in a Code § 401(k) plan on the date that is six months before the bankruptcy case was filed. If the applicable individual elects to make these additional IRA

Act § 1002 and 1003.

¹⁵ Act § 1001.

Act § 1004 amending Code § 417(a)(1)(A).

contributions, the catch-up contributions that apply to individuals age 50 and older are *not* available. ¹⁸

F. <u>Distributions for a Beneficiary's Hardship or Unforeseen Financial Emergency.</u>

- 1. Old Law: Distributions from a Code § 401(k) plan, tax-sheltered annuity, Code § 457 plan, or nonqualified deferred compensation plan subject to Code § 409A can not be made before the occurrence of one or more specified events. For 401(k) plans or tax-sheltered annuities, one of these events is hardship. For Code § 457 plans and nonqualified deferred compensation plans subject to Code § 409A, one of these events is an unforeseeable emergency. Under old law, a hardship or unforeseeable emergency includes a hardship or unforeseeable emergency *only* if it involves participant's spouse or dependent.
- 2. New Law: The Act directs that the IRS revise the regs within 180 days after the enactment date to provide that an event that would be a hardship or unforeseeable emergency under the plan if it occurred with respect to the participant's spouse or dependent will also be treated as a hardship or unforeseeable emergency if it occurs with respect to any *beneficiary* under the plan if the plan so provides.¹⁹
- 3. Significance. This change will greatly expand the persons to whom a hardship distribution may be made.

G. IRA Income Limits for IRA Contribution Indexed After 2006.

1. Old Law: An individual who is not an active participant in certain employer-sponsored retirement plans, and whose spouse is not an active participant, may make an annual deductible cash contribution to an IRA up to the lesser of: (1) a statutory dollar limit (for 2006, \$4,000, increased to \$5,000 for those 50 or older), or (2) 100% of the compensation that's includible in his gross income for that year. If the individual (or his spouse) is an active plan participant, the deduction phases out over a specified dollar range of AGI.

Under old law, the phase-out for joint return filers begins at AGI of \$75,000 for 2006, and \$80,000 for 2007 and thereafter; for taxpayers who are single or heads of households, the phase-out begins at AGI of \$50,000. However, for an individual who is not an active participant, but whose spouse is, the IRA deduction phase-out begins at AGI of \$150,000. Married taxpayers can each make deductible contributions to separate IRAs, subject to the deduction phase-out rules that apply if either or both are active participants in an employer retirement plan for any part of the tax year.

Act § 831(a) adding a new Code § 219(b)(5)(C) and redesignating old subparagraph (C) as (D).

¹⁹ Act § 826.

2. New Law: For tax years beginning after 2006, the Act indexes the income limits for deductible contributions for active participants in an employer-sponsored plan (i.e., the \$80,000 figure for joint filers and the \$50,000 figure for singles and heads of households), and the \$150,000 income limit for deductible contributions if the individual is not an active participant but the individual's spouse is.²⁰

H. Limits for Roth IRA Contributions Indexed after 2006.

- 1. Old Law: Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA, subject to the overall limit on IRA contributions. Under old law, the maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI over certain levels for the taxable year. The adjusted gross income phase-out ranges are: (1) for single taxpayers, \$95,000 to \$110,000; (2) for married taxpayers filing joint returns, \$150,000 to \$160,000; and (3) for married taxpayers filing separate returns, \$0 to \$10,000.
- 2. New Law: For tax years beginning after 2006, the Act indexes the \$95,000 and \$150,000 AGI figures. Indexed amounts will be rounded to the nearest multiple of \$1,000.²¹

I. Direct Deposits of Tax Refunds to IRAs.

- 1. Old Law: Under old law, taxpayers may direct that their federal income tax refunds be deposited into a checking or savings account with a bank or other financial institution (such as a mutual fund, brokerage firm, or credit union) rather than being sent to the taxpayer in the form of a check.
- 2. New Law: The Act directs the IRS to develop forms allowing all or a portion of a taxpayer's refund to be deposited in his IRA (or his spouse's IRA, in the case of a joint return). The form is to be available for tax years beginning after 2006.²²

J. Payouts to Called-up Reservists not subject to 10% Additional Income Tax.

1. Old Law: Pre-age 59-1/2 distributions from a Qualified Plan are subject to a 10% additional income tax on the amount includible in income, unless one of several exceptions applies, such as disability or separation from service after age 55. Generally, amounts in a Code § 401(k) plan or in a Code § 403(b) annuity can not be distributed before severance from employment, age 59-1/2, death, disability, or financial hardship of the

22 Act § 830(a).

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Act § 833(b) amending Code § 219(g) by adding new paragraph 8.

Act § 833(c) amending Code § 408A(c)(3) by adding a new subparagraph C.

employee. Under old law, there was no exception for distributions to reservists called up for duty.

2. New Law: The Act provides that the 10% additional income tax does *not* apply to a qualified reservist distribution. This is a distribution: (1) from an IRA or attributable to elective deferrals under a Code §§ 401(k) plan, 403(b) annuity, or certain similar arrangement; (2) made to individuals who (because of their being members of a reserve unit) are ordered or called to active duty after Sept. 11, 2001, and before Dec. 31, 2007, for a period of more than 179 days or for an indefinite period; and (3) made during the period beginning on the date of the order or call to duty and ending at the close of the active duty period.

A qualified reservist who receives a distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions to an IRAs in an aggregate amount not to exceed the amount of the distribution. The two-year period does not end before the date that is two years after the enactment date. The regular IRA dollar contribution limits do not apply to "pay back" contributions, but a deduction can not be claimed for these contributions.²³

K. <u>Early Pension Plan Distributions to Public Safety Employees Not Subject to 10%</u> Additional Income Tax.

- 1. Old Law: A taxpayer who receives a distribution from a qualified plan before age 59-1/2 generally is subject to a 10% additional income tax on the amount includible in income, unless an exception to the tax applies, such as distributions made to an employee who separates from service after age 55. Under old law there was no exception for early distributions to public safety employees.
- 2. New Law: The Act provides that the 10% additional income tax does not apply to post-enactment-date distributions from a governmental plan to a qualified public safety employee who separates from service after age 50. A qualified public safety employee is an employee of a State (or political subdivision) who provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of the State or political subdivision.²⁴

L. RMDs for Governmental Plans.

- 1. Old Law: Detailed RMD rules apply to governmental plans.
- 2. New Law: The Act directs the IRS to issue regs under which a governmental plan is treated as complying with the RMD rules, for all

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Act § 827(a) adding a new subparagraph (G) to Code § 72(t)(2).

Act § 828(a) adding a new paragraph 10 to Code § 72(t).

years to which the rules apply, if the plan complies with a reasonable, good faith interpretation of the statutory requirements.²⁵

M. <u>Many EGTRRA pension and IRA Changes Made Permanent.</u>

- 1. Old Law: The EGTRRA (Economic Growth and Tax Relief Reconciliation Act of 2001) made changes to pensions and IRAs. However, under pre-Act law, all of the changes were to sunset at the end of 2010.
- 2. New Law: The Act repeals the sunset provisions of EGTRRA as they relate to pension and IRA provisions. Thirty-eight (38) pension and IRA changes made by EGTRRA are now made permanent. These changes include the following provisions:
 - Increases in the IRA contribution limits, including the ability to make catch-up contributions.
 - Rules relating to deemed IRAs under employer plans.
 - Increases in the limits on contributions, benefits, and compensation under qualified retirement plans, tax-sheltered annuities, and eligible deferred compensation plans.
 - Modification of the top-heavy rules.
 - Elective deferrals not taken into account for purposes of deduction limits.
 - Option to treat elective deferrals as after-tax Roth contributions.
 - Catch-up Code § 401(k), SEP and SIMPLE IRA contributions for individuals age 50 and older. Act § 811.

N. Low-income Saver's Credit make Permanent.

1. Old Law: Under EGTRRA, effective for tax years beginning before 2007, an eligible lower-income taxpayer can claim a nonrefundable tax credit for the applicable percentage of up to \$2,000 of his qualified retirement savings contributions to "the saver's credit." The applicable percentage (50%, 20%, or 10%) depends on filing status and AGI.

Only an individual who is 18 or over (other than a full-time student, or an individual allowed as a dependent on another taxpayer's return for a tax year beginning in the calendar year in which the individual's tax year begins) is eligible for the credit.²⁶

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Act § 823.

²⁶ Code § 258(c).

2. New Law: The Act makes the saver's credit permanent. It also indexes the income limits applicable to the saver's credit, beginning in 2007, with indexed amounts rounded to the nearest multiple of \$500.²⁷

O. <u>Tax-free IRA Distributions for Charitable Purposes.</u>

- 1. Old Law: Under old law, if an amount withdrawn from an IRA or Roth IRA is donated to a charitable organization, the amount withdrawn is subject to the income tax rules and the charitable contribution is subject to the normally applicable limitations on deductibility of contributions.
- 2. New Law: For distributions in tax years beginning after 2005 and before 2008, the Act provides an exclusion from gross income for otherwise taxable IRA distributions from an IRA or Roth IRA that are qualified charitable distributions. To constitute a qualified charitable distribution, the distribution must be made (1) directly by the IRA trustee to a Code § 170(b)(1)(A) charitable organization (*other than* an organization described in Code § 509(a)(3) or a donor advised fund (as defined in Code § 4966(d)(2)) and (2) on or after the date the IRA owner attains age 70-1/2.

If the IRA owner has any IRA with nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income and is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of *income first*, up to the aggregate amount that would be includible in gross income if the aggregate balance of all IRAs having the same owner were distributed during the same year.

To be excludible from gross income, a distribution to a qualifying charitable organization must otherwise be *entirely deductible* as a charitable contribution deduction under Code § 170, without regard to the Code § 170(b) charitable deduction percentage limits. ²⁸ If the deductible amount is reduced because of a benefit received in exchange, or a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is *not* available for any part of the IRA distribution.

Distributions that are excluded under the new provision are not taken into account in determining the individual's deduction, if any, for charitable contributions.²⁹

3. Significance: The distribution to the qualifying charitable organization counts as an RMD. For purposes of the RMD rules as they apply to

Act § 1201 amending § 408(d) by adding new paragraph 8.

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²⁷ Act §§ 811 and 833(a).

Code Sec. 408(d)(8)(C).

traditional IRAs, qualified charitable distributions may be taken into account to the same extent the distribution *would* have taken into account under the RMD rules had the distribution *not* been directly distributed under the IRA qualified charitable distribution rules. Consequently, an IRA owner who makes an IRA qualified charitable distribution in an amount equal to his RMD for that tax year is considered to have satisfied his RMD for that year, even though a charitable entity (and not the IRA owner) is the recipient of the distribution.

IV. Trusts as Beneficiaries: Some Basic Principles

- A. Trusts as Beneficiaries: Basic Rules and Practical Advice.
 - 1. The Designated Beneficiary as a Measuring Life. The life expectancy of the Designated Beneficiary can determine RMDs after the death of the owner of the Qualified Plan Account or IRA.
 - 2. When is the Designated Beneficiary Determined? A Designated Beneficiary is determined as of September 30 of the calendar year following the calendar year of the participant's or IRA owner's death (the "Designation Date"). For example, if a participant or IRA owner died January 1, 2005 the Designation Date is September 30, 2006 which is 21 months after date of death. If the death occurred December 31, 2005, the Designation Date is September 30, 2006 which is 9 months after date of death. Reg § 1.401(a)(9)-4, A-4. This period between 9 and 21 months is sometimes referred to as the "Shake-Out Period."

Planning Pointer: The Designation Date rule does not affect the identity of the beneficiary entitled to the plan benefit. This is an unusual concept for estate planners. The Designation Date only affects the identity of the person whose life is a measuring period for purposes of RMD's. As noted above, there could be a shake-out period between determining the beneficiary and the Designated Beneficiary for as long as 21 months after the date of the employee's death. The shake-out period gives some time for postmortem estate planning.

- 3. Who Can Be Designated Beneficiaries?
 - a. Individuals Only. Only individuals can be Designated Beneficiaries. However, beneficiaries of certain types of trusts can be treated as Designated Beneficiaries. Reg § 1.401(a)(9)-4, A-5.
 - b. Not an Estate nor Charity. An estate or a charitable organization may not be a Designated Beneficiary. Reg § 1.401(a)(9)-4, A-3.

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- c. Beneficiaries of a Trust. The beneficiaries of a trust will be treated as Designated Beneficiaries if the trust meets all of the following requirements during any period during which RMDs are being determined by treating the beneficiaries of the trust as Designated Beneficiaries:
 - (1) Valid. The trust must be a valid trust under state law, or would be but for the fact there is no corpus.
 - (2) Irrevocable. The trust must be irrevocable or will, by its terms, become irrevocable upon the death of the employee.
 - (3) Identifiable. The beneficiaries of the trust must be identifiable from the trust instrument. Identifiable beneficiaries:
 - (a) Include: Include an individual designated as beneficiary by the terms of the Qualified Plan or IRA or, if the plan so provides, by an affirmative election of the participant or IRA owner or his or her surviving spouse. The beneficiary need not be specified by name. Members of a class are identifiable if as of the date the beneficiary is determined, it is possible to identify the class member with the shortest life expectancy.
 - (b) Exclude: Exclude an individual to whom the benefit passes under applicable in testate state law unless such individual is designated under paragraph 1 above.

Reg § 1.401(a)(9)-4, A-1.

- (4) Documentation. The following documentation requirement in must be satisfied. By October 31 of the calendar year immediately following the calendar year in which the employee died (that is one month after the September 30 Designation Date), the trustee of the trust must either—
 - (a) List. Provide the plan administrator with a final list of all beneficiaries of the trust (including contingent and remainderman beneficiaries with a description of the conditions on their entitlement) as of September 30 of the calendar year following the calendar year of the employee's death; certify that, to the best of the trustee's knowledge, this list is correct and complete and that the requirements of § 1.401(a)(9)-4, A-5, (b)(1), (2) and (3) are satisfied;

- and agree to provide a copy of the trust instrument to the plan administrator upon demand; or
- (b) Copy. Provide the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee's date of death.
- 4. Change Beneficiaries. If the plan allows the participant or IRA owner to specify that after his or her death any person can change the beneficiaries, the participant or IRA owner will be treated as having no Designated Beneficiary. However, the surviving spouse may have the right to change a minor beneficiary if he or she is the only other beneficiary. IRC § 401(a)(9)(F).
- 5. Oldest Beneficiary. If there are multiple beneficiaries, the Designated Beneficiary with the shortest life expectancy (that is, the oldest beneficiary) is used to calculate the distribution period. Reg § 1.401(a)(9)-5, A-7(a)(1). This is important in connection with a trust which has multiple beneficiaries.
- 6. Multiple Beneficiaries. If there are multiple beneficiaries and at least one does not qualify as a Designated Beneficiary and no separate accounts have been established, the participant or IRA owner will be deemed not to have selected a Designated Beneficiary. Reg § 1.401(a)(9)-4, A-3. The Final Regulations change the treatment of Contingent Beneficiaries and Successor Beneficiaries.
- 7. Death of Designated Beneficiary. If the individual beneficiary whose life expectancy is being used to calculate the distribution period dies after September 30 of the calendar year following the calendar year of the employee's death, such beneficiary's remaining life expectancy will be used to determine the distribution period without regard to the life expectancy of the subsequent beneficiary. Reg § 1.401(a)(9)-5, A-7(c)(2).
- 8. Contingent Beneficiary. Except as provided in paragraph 9 below, if a beneficiary's entitlement to an employee's benefit after the employee's death is a contingent right, such contingent beneficiary is nevertheless considered to be a beneficiary for purposes of determining whether a person other than an individual is designated as a beneficiary (resulting in the employee being treated as having no designated beneficiary) and which Designated Beneficiary has the shortest life expectancy. Reg § 1.401(a)(9)-5, A-7(b).
- 9. Successor Beneficiary. A person will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy, or whether a person who is not an individual is a beneficiary,

merely because the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death. However, the preceding sentence does not apply to a person who has any right (including a contingent right) to an employee's benefit beyond being a mere potential successor to the interest of one of the employee's beneficiaries upon that beneficiary's death. Thus, for example, if 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. Reg § 1.401(a)(9)-5, A-7(c)(1).

B. A Conduit Trust: Contingent Beneficiaries Don't Count.

- 1. What is it? A conduit trust is a trust that provides that all amounts distributed from the decedent's account in a Qualified Plan or any other plans subject to Code § 401(a)(9), or IRA (the "Retirement Account") to the trustee while the beneficiary is alive will be paid directly to the beneficiary upon receipt by the trustee. In other words, no amounts distributed from the Retirement Account to the trust may be accumulated in the trust during the beneficiary's lifetime for the benefit of any other beneficiary. See Reg § 1.401(a)(9)-5, A-7(c)(3), Example 2 and Rev Rul 2000-2, 2000-1 C.B. 305.
- 2. More Than One Beneficiary. A conduit trust can have more than one beneficiary, that is, the trustee can have discretion over distributions from the Retirement Account. The key is that all distributions from the Retirement Accounts must be distributed to the beneficiaries. No amounts may be accumulated for others. See PLR 200226015 (Mar 21, 2002).
- 3. When Would You Use a Conduit Trust?
 - a. QTIP Trust.
 - (1) Longer. The QTIP Trust will last longer and the RMDs will be smaller if the QTIP Trust is a conduit trust because the spouse will be the sole beneficiary. If the spouse is the sole beneficiary, the spouse's life expectancy is recalculated for RMD purposes. Reg § 1.401(a)(9), A-5, (c)(1).
 - (2) Deferral. RMDs can be deferred until the year in which the decedent would have reached age 70½.
 - b. Charity. You can name a charity as remainder beneficiary of a conduit trust and still have a Designated Beneficiary.

- c. Older Beneficiaries. You can name an older beneficiary as remainder beneficiary of a conduit trust and still have a younger Designated Beneficiary.
- d. Control. You can satisfy a participant who wants only RMDs distributed to the beneficiary. The trustee can prevent access to any larger distributions.

4. When Would You Not Use a Conduit Trust?

- a. Accumulate. You want to accumulate some of the Retirement Account distributions for later distribution to remainder beneficiaries.
- b. Incapacity. You want to preserve the distributions for an incapacitated beneficiary during life. E.g. A special needs trust.

C. <u>Discretionary Trusts: Contingent Beneficiaries Do Count.</u>

- 1. Which Trust Beneficiaries Count in Determining the Designated Beneficiary? Recent Private Letter Rulings ("PLRs") have helped to clarify what trust beneficiaries must be taken into account in determining the Designated Beneficiary for purposes RMDs under Code § 401(a)(9)). Remember that a PLR has no presidential value except for the taxpayer who received it.
 - a. The Facts. In PLR 200228025 (April 18, 2002), the decedent named a trust as beneficiary of her IRA accounts. She named two minor grandchildren as beneficiaries of the trust. In each case, the grandchild was entitled to distributions of income and principal in the trustee's discretion until age 30. At age 30, the grandchild was entitled to his entire share of the trust. If the grandchild did not survive to age 30, his share would pass to the other grandchild. If neither grandchild survived to age 30, the balance would pass to their aunt who was 67 years old.
 - b. IRS Ruling. The IRS noted that distributions from the IRA could be accumulated in the trust. The IRS disregarded the likelihood that both grandchildren or at least one of them would live to age 30 and would receive the entire trust including all accumulations. The IRS ruled that since distributions from the IRA could be accumulated in the trust, all beneficiaries including the contingent beneficiaries must be taken into account in determining the Designated Beneficiary. Since the aunt was the oldest of all the beneficiaries, she was the Designated Beneficiary and her life expectancy was used for purposes of RMDs.

- c. What Difference Does It Make? The result is much larger RMDs than would have been required if the oldest grandchild were treated as the Designated Beneficiary. Assume that the prior 12/31 balance of an IRA were \$1 million. If the oldest beneficiary is 67 years old, the distribution period is 19.4 years and the RMD would be \$51,546. If the oldest beneficiary is 10 years old, the distribution period is 72.8 years and the RMD would be \$13,736 a difference of \$37,810.
- d. Practical Advice. Name contingent beneficiaries with care if you want to preserve a Designated Beneficiary. If you want a beneficiary of a trust to be treated as the Designated Beneficiary, you should name a contingent beneficiary who is younger than the Designated Beneficiary so that any accumulations will be for a younger person. In the alternative, draft a conduit trust (discussed below).
- 2. Creation of Separate Trusts by Trustee for RMD Purposes? No.
 - a. The Facts. In PLRs 200317041, 200317043 and 200317044 (December 19, 2002), the decedent named his Revocable Trust as beneficiary of his IRA. The beneficiary designation directed the trustee of the Revocable Trust to create three separate trusts. The IRA was distributed directly to each of the three separate trusts. The Rulings requested that the IRS recognize that three separate trusts had been created and that RMDs could be paid over the life expectancy of the oldest beneficiary of each of the three separate trusts.
 - b. IRS Ruling. The IRS ruled that separate accounts were not created for purposes of RMDs since the Final Regulations preclude "separate account" treatment for RMD purposes where amounts pass "through a trust." The Final Regulations provide that the separate account rules "are not available to beneficiaries of a trust with respect to the trust's interests in the employee's benefit." Reg § 1.401(a)(9)-4, A-5(c). The IRS ruled that even though the IRA had been divided into three IRAs for some purposes, the oldest beneficiary of all the IRAs was the Designated Beneficiary for purposes of RMDs.
 - c. Practical Advice. Do not name only one trust as beneficiary if you intend to create separate accounts and to treat the oldest beneficiary of each such account as the Designated Beneficiary for such account. Name each trust individually in the beneficiary designation. For example, assume that you want three separate accounts: one for an older child by a first marriage, one for a second spouse and one for a baby by the second spouse. Although there is no statutory or regulatory authority directly on point, you

should be able to create separate accounts by a beneficiary designation which names as beneficiaries "Trust A, Trust B and Trust C, in equal shares." However, the safer course is to create separate IRAs during life and to name a separate trust as beneficiary of each separate IRA.

D. Trustee-to-Trustee Transfers: A Very Important and Often Overlooked Tool

- 1. The Problem. Practitioners are increasingly frustrated in dealing with broker-dealers and others who hold assets as a Custodian or Trustee of an IRA. Many have developed their own rules and will not budge. Many insist that if a trust or estate is the beneficiary, distributions must be made in a lump sum and, consequently, be subject to immediate income tax.
- 2. An Example. An example helps illustrate the problem. Assume a participant dies without naming a beneficiary and under the terms of the IRA, the estate is the default beneficiary. Under the Final Regulations, the decedent's interest may be distributed to the beneficiary over five years if the decedent died before RBD or over the decedent's remaining life expectancy if the decedent died after RBD. Code § 401(a)(9)(B)(ii); Reg § 1.401(a)(9)-3, A-4(2); Reg § 1.401(a)(9)-5, A-5(c)(3). For example, if the participant were 65 years old, distributions could be made over five years and if the decedent were 75 years old, distributions could be made over 13.4 years. A peculiar result! See the Single Life Table at Reg § 1.401(a)(9)-9, A-1. However, many IRA Custodians and Trustees insist that they can only distribute to the personal representative of the estate or the trustee of the trust in a lump sum distribution. When asked for authority for this decision, none is forthcoming except it's "their policy," that is, stop asking questions because it's not going to get you anywhere.
- 3. Alternatives. There is authority that a lump sum distribution is not the only alternative available.
 - a. Rollover by Surviving Spouse. If a surviving spouse is either the personal representative of the estate or the trustee of the trust as well as a beneficiary of the estate or trust, perhaps the spouse can roll over the IRA to his or her rollover IRA. See PLRs 200236052 (June 18, 2002), 200305030 (Nov. 4, 2002), 200324059 (Mar 18, 2003) re distributions from estates and PLRs 199941050 (July 2, 1999), 200130056 (May 3, 2001) re distributions from trusts. No withdrawal followed by a rollover within 60 days is available for any amount received from an "inherited IRA" by a beneficiary who is not a surviving spouse. Code § 408(d)(3)(c); See also PLR 200228023 (April 15, 2003). However, after 2006 a nonspouse beneficiary can cause "a direct trustee-to-trustee transfer" or direct rollover from a Code § 401(a) Qualified Plan, Code § 403(a) or Code § 403(b) annuity or a governmental Code § 457 Plan to an

IRA. See the discussion above regarding the Pension Protection Act of 2006.

b. Trustee-to-Trustee Transfer. The estate or trust could create new IRAs to reflect the beneficiaries' shares without triggering income taxes. Each of the IRAs would be titled in the decedent's name for the benefit of the particular beneficiary and the beneficiary's social security number would apply. After the transfer took place, the beneficiaries could continue to take distributions in installments over the number of years remaining in the original term. The estate could be closed or the trust could be terminated according to its terms. There would be no taxable distribution.

c. What is a Trustee-To-Trustee Transfer?

- (1) No Income Tax. A trustee-to-trustee transfer is neither a taxable distribution nor a rollover although sometimes it is referred to as a "direct" rollover. In a trustee-to-trustee transfer, the Plan assets pass directly from one trust to another trust. There is neither actual nor constructive receipt of income by a plan participant and, hence, no income tax liability.
- (2) No Code Provision. There is no Code provision permitting such transfers between IRAs although the Final Regulations recognize trustee-to-trustee transfers between IRAs. Reg § 1.408-8, A-8. The concept of a trustee-to-trustee transfer was created by the IRS Administrative Revenue Ruling program. See Rev Rul 67-213, 1967-2 CB 149 wherein no income was recognized by participants in a Qualified Plan upon the transfer of their interests from a trust under one Qualified Plan to a trust under another Qualified Plan. The concept was expanded in later private letter rulings to individuals. See below for a number of those rulings.
- (3) A New Code Provision. The Pension Act of 2006 authorizes "a direct trustee-to-trustee transfer" between Qualified Plans and IRAs for nonspouse beneficiaries effective January 1, 2007. Code § 402(c)(11)(A).
- (4) What Kinds of Transfers? The IRS recognizes trustee-to-trustee transfers between Qualified Plans. The IRS also recognizes trustee-to-trustee transfers between IRAs. However, prior to 2007, the IRS does not recognize a trustee-to-trustee transfer from a Qualified Plan to an IRA. The only transfers recognized between a Qualified Plan and an IRA are rollovers by participants, by surviving spouses,

and by former spouses or pursuant to a QDRO. Code §§ 401(a)(13), 402(c) and (e), 414(p). But see paragraph (3) immediately above.

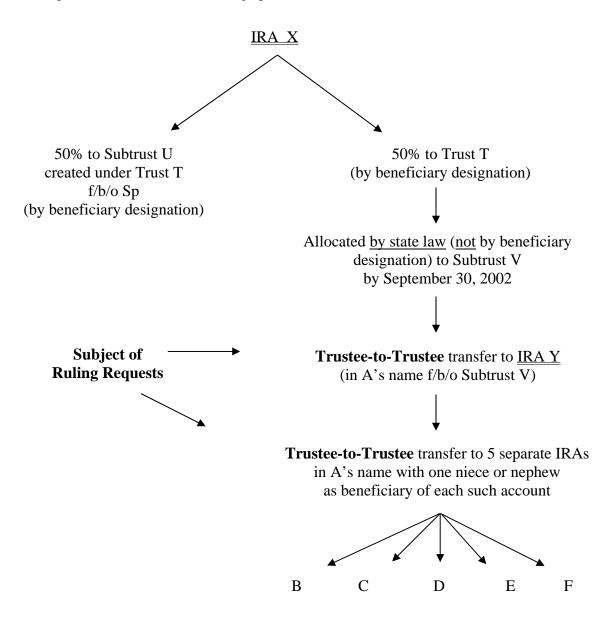
- 4. Authorities. Listed below are some authorities for the conclusion that a trustee or executor can assign the trust's or estate's beneficial interest in a retirement account and that such assignment does not result in a taxable distribution.
 - a. Rev Rul 78-406. Rev Rul 78-406, 1978-2 CB 157, provides that the direct transfer of funds from one IRA trustee to another IRA trustee does not result in such funds being paid or distributed to the participant and that such a payment is not a rollover contribution. The Ruling states that this conclusion would apply whether the bank trustee or the IRA participant initiates the transfer of funds. PLR 200228023 (Apr 15, 2002) broadens Rev Rul 78-406 to allow the IRA beneficiary to create the new IRA and states: "Rev Rul 78-406 is applicable if the trustee-to-trustee transfer is directed by the beneficiary of an IRA after the death of the IRA owner as long as the transferee IRA is set up and maintained in the name of the deceased IRA owner for the benefit of the beneficiary."
 - b. Super PLRs: PLRs 200528031-35 (Apr. 18, 2005): Trusts. Each of the five almost identical letter ruling is addressed to a different one of the decedent's five nieces and nephews. The IRS approved 12 trustee-to-trustee transfers in connection with the decedent's IRA and the decedent's interest in a Qualified Plan both of which were payable to trusts by beneficiary designation. A picture is worth a thousand (or at least a couple hundred) words:

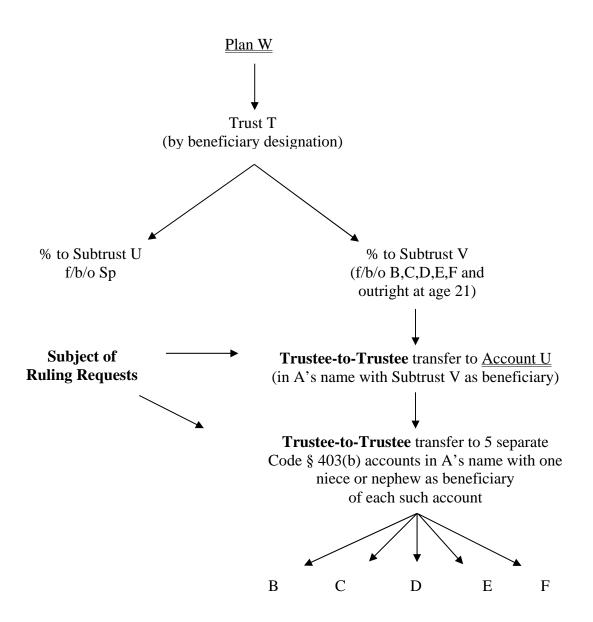
(1) Facts

A = Decedent died in 2001 at age 64. Decedent owned IRA X and an Account in Plan W

B-F = Nieces and nephews all over age 21

Sp = Decedent's surviving spouse





(2) Issues: Each Ruling requested that the IRS approve the trustee-to-trustee transfers by the nieces and nephews and approve the use of the life expectancy of the oldest beneficiary of Subtrust V for purposes of RMDs from IRA X and the life expectancy of the oldest beneficiary of Trust T for purposes of Plan W.

(3) Rulings:

(a) Transfer. The IRS ruled that a trustee-to-trustee transfer from one IRA to another, or from one 403(b) account to another, may be accomplished after the date of death of an IRA owner or Code § 403(b) annuitant by a beneficiary of such IRA owner or Code § 403(b) annuitant as long as the transferee IRA or Code § 403(b) account remained in the name

- of the decedent for the benefit of the beneficiary. Furthermore, a trustee-to-trustee transfer did not constitute a distribution and accordingly was not subject to income tax.
- (b) IRA X. The IRS also ruled that for purposes of Code § 401(a)(9), the life expectancy of the surviving spouse who was a beneficiary of Subtrust U but not of Subtrust V, must be considered with respect to the portion of IRA Y because the allocation to Subtrust V was made in accordance with state law and not in accordance with the beneficiary designation. Consequently, separate accounts for RMD purposes were not created pursuant to Regulation § 1.401(a)(9)-4, A-1. The surviving spouse was the eldest of such beneficiaries. Unfortunately, the nieces and nephews had to use the surviving spouse's life expectancy (and not their own) in determining their RMDs from IRA Y. Note that if the decedent in her beneficiary designation had specifically named Subtrust V as beneficiary, she would have created a separate account for Subtrust V and the designated beneficiary for RMD purposes would have been the oldest of the nieces and nephews. This would have resulted in a stretch-out of payments.
- (c) Plan W. As to Plan W, the IRS ruled that the surviving spouse was the eldest beneficiary of Trust T and that the nieces and nephews must use the surviving spouse's life expectancy in determining their RMDs from Account U. Again, separate accounts for RMD purposes had not been created since Trust T and not Subtrust V was the named beneficiary.
- (d) Computation. The surviving spouse's life expectancy was computed using the "Single Life Table" at Reg § 1.401(a)-9, A-1. Such life expectancy is reduced by one for each calendar year that elapses thereafter.

Planning Pointer: Note that in both cases, if the decedent in her beneficiary designation had specifically named each niece's and nephew's trust as a beneficiary, five separate accounts for RMD purposes would have been created and each nephew and niece could have used his or her own life expectancy for RMD purposes. This would have resulted in an even longer period of payments. What do you do when the IRA Custodian or Trustee still says no? You arrange to transfer the entire IRA to a new IRA with a new Custodian or Trustee who is willing to create the IRAs and make the transfers.