UPIA Amendment
Saves Marital Deduction for Retirement Plans

by Steven B. Gorin[1]

In the summer of 2008, the Uniform Law Commission amended Section 409 of the Uniform Principal & Income Act (the "UPIA"). See the Appendix to this article. This amendment responds to the Internal Revenue Service's criticism of how the UPIA treats IRAs and certain qualified retirement plans held by marital trusts. This article addresses when benefits should be payable to a marital trust, describes the concerns underlying this amendment, explains the changes, and discusses their planning implications of these changes and related issues.

An IRA or defined contribution qualified retirement plan (either a "Fund") that is payable to a marital trust does not qualify for the Internal Revenue Service's safe harbor under Revenue Ruling 2006-26 (the "Ruling") under UPIA Section 409 as it existed before this change if the drafter of the trust did not take the precautions described in the Ruling. "Marital trust" refers to a general power of appointment trust under section 2056(b)(5) of the Internal Revenue Code of 1986, as amended (the "Code"), or a trust for which a QTIP election is made under Code Section 2056(b)(7).

Outright vs. Using Marital Trust

Before discussing the Ruling's requirements and the changes, let's consider when a Fund should or should not be payable to a marital trust. From an income tax perspective, ideally a Fund should be payable outright to the surviving spouse, so that the surviving spouse can roll over the distribution into the surviving spouse's own IRA. Code sections 402(c)(4), 402(c)(9),

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408(d)(3)(A), and 408(d)(3)(C)(ii)(II). This enables the surviving spouse to maximize income tax deferral, by allowing the surviving spouse to use the Uniform Lifetime Table found in Section 1.401(a)(9)-9(A-2) of the United States Treasury Regulations (the "Regulations"). The only time a surviving spouse might want to roll over less than all of the Fund is when the surviving spouse has not attained age 59½ and might need distributions before attained that age. Distributions before that age generally would be subject to a 10% penalty if they come from the surviving spouse's own IRA, Code section 72(t)(2)(A)(i), but not if they come from the decedent's account, Code section 72(t)(2)(A)(ii). In that case, the surviving spouse would estimate what might be needed before age 59½, leave that in the decedent's account if possible, and roll over the rest into the surviving spouse's IRA.

A Fund should be payable to a marital trust only if the estate planning objectives outweigh the benefit of the income tax deferral. For example, suppose the client had children and is no longer married to the other parent. The client remarries and wants to provide for the new spouse. Ideally, the client would give part of the Fund to the new spouse and part to the children, so that all of the beneficiaries could maximize income tax deferral. However, that might not be possible if the surviving spouse needs all of the Fund's income for living expenses and the client is willing to make the client's children wait until the new spouse dies. In that case, the client would likely use a marital trust, so that any principal not required for the new spouse's living expenses would be accumulated and pass to the children upon the new spouse's death. If the client had made the surviving spouse the outright beneficiary, the client would have no assurance that the surviving spouse would not use the entire Fund for a use other than what the client intended.

Another good candidate for a marital trust is a client who does not trust the surviving spouse to manage the Fund wisely. The client might not trust the spouse's ability to make good investment decisions or to hire appropriate investment advisors. The client might not be comfortable with the spouse's spending habits and therefore might want a third party to determine distributions to make sure the spouse lives under an appropriate budget.

Concerns Underlying the Amendment

The Ruling requires that the Fund itself qualify for the marital deduction under the same rules as any marital trust. Thus, a brief review of marital trusts is order before further describing the Ruling's safe harbor.

In a marital trust, the surviving spouse must be entitled to all of the trust's income for life. Although a very common drafting approach is to require that all income is paid to the surviving spouse no less frequently than annually, relevant regulations require only that the surviving spouse have the right to withdraw the income no less frequently than annually. Regulations Sections 20.2056(b)-5(f)(1), (8) and 20.2056(b)-7(d)(2).

The Ruling's safe harbor has two basic requirements:

1. The Fund's income must be determined as if the Fund itself were a marital trust.

2. The surviving spouse must have the right to receive this income without regard to the income of any trust to which the Fund is payable.

Before these amendments, UPIA Section 409 generally allocated 90% of any receipt from a Fund to principal and 10% to income. This allocation did not necessarily correspond to the Fund's internal income. Although it also provided that receipts would be reallocated to income to the extent necessary to qualify for the marital deduction, the Ruling expressly states that this approach does not satisfy the Internal Revenue Service's safe harbor. Furthermore, UPIA Section 409 did not address the safe harbor's requirement that the surviving spouse have the right to receive the Fund's income if the Fund did not distribute all of its income to the trust. It also did not address the safe harbor's requirement that this income be computed independently of the trust's other income.

The safe harbor is not necessarily the only way to qualify for the estate tax marital deduction in such circumstances. However, in light of the importance the Internal Revenue Service placed on these issues by going to the trouble of issuing a Revenue Ruling, the concern arose that many attorneys might draft estate plans that do not comply with the safe harbor. The general public's estate plans should not be subjected to Internal Revenue Service audit in such situations. As described further below, the Internal Revenue Service's safe harbor has broader policy implications. Therefore, additional UPIA Section 409 changes try to prevent an Internal Revenue Service attack in certain other situations that the Internal Revenue Service's safe harbor does not address. Based on certain informal discussions with relevant persons, the author believes that the Internal Revenue Service will eventually modify the Ruling to approve these changes with respect to Funds but will not address these other situations.

Explanation of the Amendment

Distributions from a Fund are allocated to income to the extent of the Fund's income, determined as if the Fund were a separate trust. If and to the extent that the trustee does not withdraw and distribute the Fund's income to the surviving spouse, the surviving spouse may require the trustee to distribute the Fund's income. However, the surviving spouse might prefer leaving part of the Fund's income inside the Fund to accumulate on a tax-deferred basis. If the surviving spouse chooses to do that, the UPIA Section 409 changes provide that the surviving spouse may require the trustee to distribute other assets equal to that year's accumulated income. Nevertheless, the trustee can decide the extent to which these distributions are made from the Fund or other assets. Therefore, the surviving spouse should discuss the trustee's plans before making a formal demand.

Under existing UPIA Section 409, annuities, defined benefit plans, and other assets payable to a marital trust might become subject to attack. The policy behind the Internal Revenue Service's safe harbor – that income must be determined based on what the asset generates rather than the 90/10 rule – might be used by the Internal Revenue Service with respect to these assets. The changes to UPIA Section 409 set up a mechanism for determining such assets' income. If the trustee cannot calculate the income, the trustee should try to find out the asset's value and then make unitrust payments. Unitrust payments would be a fixed percentage of the trust's assets. The fixed percentage would be set by the enacting state somewhere between 3% and 5%, which is based on an entirely separate safe harbor under Regulations section 1.643(b)-1, which is incorporated by reference into Regulations section 20.2056(b)-5(f)(1). If the trustee cannot re-determine the value, each year the trustee would determine the present value of the expected payments, using present value factors that apply to annuities under Code Section 7520. The trustee would multiply the present value by the Code Section 7520 interest rate then in effect, and the resulting product would be the income subject to the general requirements for a Fund.

Hopefully, in an audit the Internal Revenue Service would accept this process as a reasonable approach for determining income in light of uncertainty. However, if the Internal Revenue Service updates the Ruling to reflect the changes to UPIA Section 409, the Internal Revenue Service is not likely to express an opinion on whether this process for determining income in light of uncertainty satisfies the Internal Revenue Service's safe harbor.

Retroactivity of the Amendment

Key representatives of the Internal Revenue Service and US Treasury informally urged that these changes be adopted retroactively. It was suggested that the author write a letter asking that the Internal Revenue Service formally approve these changes as retroactively saving the estate tax marital deduction. The author has done so and, as of the date this was submitted for publication, awaits a reply.

In addition to estate tax implications, retroactivity affects trust administration generally and income tax issues specifically. Two key issues in implementing these changes retroactively are determining how to account for distributions already made and determining the effect on income tax returns.

For example, if the trustee received a distribution that was classified as principal before the changes but is retroactively classified as income under the new rules, then the trustee must distribute that retroactively reclassified amount to the surviving spouse. It is possible that, because of discretionary distributions already paid to the surviving spouse, the reclassification of incomemight not require the trustee to make additional distributions.

Any required additional distribution might have income tax effects, under which the trust would receive an additional deduction and the surviving spouse would report additional income. Regulations Section 1.661(a)-2 deducts from a trust's taxable income the lesser of the trust's distributed net income or the sum of the amount required to be distributed to the beneficiary and any additional amounts properly paid or credited to the beneficiary. Regulations Section 1.662(a)-1 requires a beneficiary to include in income the amount a trust deducted with respect to that beneficiary under Regulations Section 1.661(a)-2.

If this affects years for which income tax returns were previously filed, the trustee would have to consider amending the prior returns, giving the surviving spouse an amended K1, which would then cause the surviving spouse to need to file an amended income tax return. The trustee would not be legally obligated to amend a prior return that was filed without fraudulent intent. If the trustee files such a return, however, the surviving spouse would need to file a return so that the income reported on the surviving spouse's income tax return matches the Schedule K1 income. If the trustee does not file an amended income tax return, then the trustee would have to consider whether an adjustment should be made if the surviving spouse later receives this additional amount without the trust receiving an income tax deduction. UPIA Section 506(a).

Additionally, suppose the surviving spouse had the right to withdraw the Fund's income but did not know it? The surviving spouse should be authorized to exercise the withdrawal right with respect to any period covered by the retroactivity within a reasonable time after the effective date of this change.

To avoid the income tax issues and to avoid the need for make-up distributions covering many years, the UPIA section 409 changes would be retroactive until January 1 of the year in which these changes are enacted if the marital trust has been funded for more than one taxable year. If the marital trust is not funded until the year of enactment, or will not be funded until a later year, these changes are retroactive to the date of death.

General Estate & Gift Tax Planning Implications of the Amendment

These changes are good rules that, like the rest of the UPIA, apply only if the person who writes the estate plan does not choose to override them. Before discussing the implications of drafting marital trusts, consider some background information.

Providing the surviving spouse with the ability to withdraw other assets is not required by the Internal Revenue Service's safe harbor. Rather, it facilitates income tax planning by allowing the surviving spouse to receive the same amount of money without being taxed on the accumulated retirement income. It also avoids an unintentional gift (described below), to the extent that the spouse receives a distribution to replace what was permitted to be accumulated.

To the extent that the surviving spouse permits income to be accumulated and added to principal and does not receive a make-up payment from other assets, the surviving spouse has permitted the lapse of a general power of appointment. Generally, to the extent that this lapse exceeds 5% of the trust's assets, including the Fund, the spouse has made a gift. Code Section 2514(b) provides that a lapse is considered to be a gift to the extent it exceeds the greater of $5,000 or 5% of the assets out of which it may be satisfied. The $5,000 figure is coordinated with other lapses, so it might or might not be available. Code Section 2702 provides that, generally, the value of the surviving spouse's right to income and any discretionary distributions are not subtracted from this gift because they are not in the form of an annuity or unitrust interest. Furthermore, because any gift to the remainder beneficiaries is not a present interest, the Code Section 2503(b) annual gift exclusion is not available.

To minimize or avoid the gift:

- Using Power of Appoint to Convert Taxable Gift To Incomplete Gift. If the surviving spouse has a power of appointment (even a limited power) over the trust's assets, the lapse constitutes an incomplete gift. Regulations Section 25.2511-2(b).

    - If the trust was created for protection from creditors, from the surviving spouse's potential future spouse's rights, or to prevent excess spending during the surviving spouse's life, the estate plan might already grant the surviving spouse a power of appointment over the remainder.

    - Another alternative is not to lapse the withdrawal right immediately. Instead, grant the spouse "hanging" *Crummey* powers that lapse each year only to the extent that the lapse is not a taxable gift.

    - If the natural objects of the surviving spouse's bounty are different than the remaindermen, the author tends to use "hanging" *Crummey* powers that never lapse. Instead, the surviving spouse has an inter vivos and a testamentary general power of appointment. This theory is based on the fact that the surviving spouse has every incentive to fully exercise withdrawal rights rather than let them lapse. Using nonlapsing hanging powers incentivizes the surviving spouse to leave the assets in the Fund to accumulate on a tax deferred basis, which presumably would benefit the surviving spouse and the remaindermen.

- Minimizing Taxable Gifts. If the surviving spouse is entitled to a unitrust distribution (Regulations section 25.2702-3(c)(1)(i)) out of the remaining assets, the value of that unitrust distribution is subtracted from the value of the gift.

    - If a power of appointment is not included, a lawyer drafting an estate plan might consider whether avoiding gift tax complexities is a significant enough factor that the trustee should be required to distribute enough to the surviving spouse to avoid a possible taxable gift.

    - Some attorneys view permitting the accumulation of the Fund's income to constitute over-lawyering, particularly when (a) it is obvious that the surviving spouse is going to need the income anyway, or (b) the attorney is drafting a conduit trust under Code Section 401(a)(9) and the required minimum distributions are expect to exceed the fund's income. They would simply require that all of the Fund's income be distributed to the surviving spouse.

Conclusion

The amendment to UPIA Section 409 helps save the unwary from losing the marital deduction. Therefore, all states should adopt the amendment. However, those who write estate planning documents should consider possible gift tax issues if the amendment is adopted and the surviving spouse does not withdraw all of the Fund's income.

Appendix

Below are the amendments to Uniform Principal and Income Act, which are incorporated into the UPIA at http://www.law.upenn.edu/bll/archives/ulc/upaia/2008_final.htm:

Section 409 is amended to read:

SECTION 409. DEFERRED COMPENSATION, ANNUITIES, AND SIMILAR PAYMENTS.

(a) In this section~~, "payment"~~:

(1) "Payment" means a payment that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer~~, including:~~. For purposes of subsections (d), (e), (f), and (g), the term also includes any payment from any separate fund, regardless of the reason for the payment.

(2) "Separate fund" includes a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

(b) To the extent that a payment is characterized as interest, ~~or~~ a dividend, or a payment made in lieu of interest or a dividend, a trustee shall allocate ~~it~~ the payment to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.

(c) If no part of a payment is characterized as interest, a dividend, or an equivalent

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payment, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to 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 shall allocate the entire payment to principal. For purposes of this subsection, a payment is not ~~“~~required to be made~~”~~ to the extent that it is made because the trustee exercises a right of withdrawal.

(d) ~~If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.~~ Except as otherwise provided in subsection (e), subsections (f) and (g) apply, and subsections (b) and (c) do not apply, in determining the allocation of a payment made from a separate fund to:

(1) a trust to which an election to qualify for a marital deduction under Section 2056(b)(7) of the Internal Revenue Code of 1986 [, as amended] [, 26 U.S.C. Section 2056(b)(7)] [, as amended], has been made; or

(2) a trust that qualifies for the marital deduction under Section 2056(b)(5) of the Internal Revenue Code of 1986 [, as amended] [, 26 U.S.C. Section 2056(b)(5)] [, as amended].

(e) Subsections (d), (f), and (g) do not apply if and to the extent that the series of payments would, without the application of subsection (d), qualify for the marital deduction under Section 2056(b)(7)(C) of the Internal Revenue Code of 1986 [, as amended] [, 26 U.S.C. Section 2056(b)(7)(C)] [, as amended].

(f) A trustee shall determine the internal income of each separate fund for the accounting period as if the separate fund were a trust subject to this [act]. Upon request of the surviving spouse, the trustee shall demand that the person administering the separate fund distribute the internal income to the trust. The trustee shall allocate a payment from the separate fund to income to the extent of the internal income of the separate fund and distribute that amount to the surviving spouse. The trustee shall allocate the balance of the payment to principal. Upon request of the surviving spouse, the trustee shall allocate principal to income to the extent the internal income of the separate fund exceeds payments made from the separate fund to the trust during the accounting period.

(g) If a trustee cannot determine the internal income of a separate fund but can determine the value of the separate fund, the internal income of the separate fund is deemed to equal [insert number at least three percent and not more than five percent] of the fund's value, according to the most recent statement of value preceding the beginning of the accounting period. If the trustee can determine neither the internal income of the separate fund nor the fund's value, the internal income of the fund is deemed to equal the product of the interest rate and the present value of the expected future payments, as determined under Section 7520 of the Internal Revenue Code of 1986 [, as amended] [, 26 U.S.C. Section 7520] [, as amended], for the month preceding the accounting period for which the computation is made.

~~(e)~~(h) This section does not apply to ~~payments~~ a payment to which Section 410 applies.

Comment

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~~**Marital deduction requirements.** When an IRA is payable to a QTIP marital deduction trust, the IRS treats the IRA as separate terminable interest property and requires that a QTIP election be made for it. In order to qualify for QTIP treatment, an IRS ruling states that all of the IRA's income must be distributed annually to the QTIP marital deduction trust and then must be allocated to trust income for distribution to the spouse. Rev. Rul. 89-89, 1989-2 C.B. 231. If an allocation to income under this Act of 10% of the required distribution from the IRA does not meet the requirement that all of the IRA's income be distributed from the trust to the spouse, the provision in subsection (d) requires the trustee to make a larger allocation to income to the extent necessary to qualify for the marital deduction. The requirement of Rev. Rul. 89-89 should also be satisfied if the IRA beneficiary designation permits the spouse to require the trustee to withdraw the necessary amount from the IRA and distribute it to her, even though the spouse~~

~~never actually requires the trustee to do so. If such a provision is in the beneficiary designation, a distribution under subsection (d) should not be necessary.~~

Marital deduction requirements. When an IRA or other retirement arrangement (a "plan") is payable to a marital deduction trust, the IRS treats the plan as a separate property interest that itself must qualify for the marital deduction. IRS Revenue Ruling 2006-26 said that, as written, Section 409 does not cause a trust to qualify for the IRS' safe harbors. Revenue Ruling 2006-26 was limited in scope to certain situations involving IRAs and defined contribution retirement plans. Without necessarily agreeing with the IRS' position in that ruling, the revision to this section is designed to satisfy the IRS' safe harbor and to address concerns that might be raised for similar assets. No IRS pronouncements have addressed the scope of Code § 2056(b)(7)(C).

Subsection (e) requires the trustee to demand certain distributions if the surviving spouse so requests. The safe harbor of Revenue Ruling 2006-26 requires that the surviving spouse be separately entitled to demand the fund's income (without regard to the income from the trust's other assets) and the income from the other assets (without regard to the fund's income). In any event, the surviving spouse is not required to demand that the trustee distribute all of the fund's income from the fund or from other trust assets. Treas. Reg. § 20.2056(b)-5(f)(8).

Subsection (e) also recognizes that the trustee might not control the payments that the trustee receives and provides a remedy to the surviving spouse if the distributions under subsection (d)(1) are insufficient.

Subsection (f) addresses situations where, due to lack of information provided by the fund's administrator, the trustee is unable to determine the fund's actual income. The bracketed language is the range approved for unitrust payments by Treas. Reg. § 1.643(b)-1. In determining the value for purposes of applying the unitrust percentage, the trustee would seek to obtain the value of the assets as of the most recent statement of value immediately preceding the beginning of the year. For example, suppose a trust's accounting period is January 1 through December 31. If a retirement plan administrator furnishes information annually each September 30 and declines to provide information as of December 31, then the trustee may rely on the September 30 value to determine the distribution for the following year. For funds whose values are not readily available, subsection (f) relies on Code section 7520 valuation methods because many funds described in Section 409 are annuities, and one consistent set of valuation principles should apply whether or not the fund is, in fact, an annuity.