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IRAs: PRE-MORTEM AND POST-MORTEM PLANNING IDEAS

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The popularity of IRAs has been fueled by their favorable tax treatment. Along with the tax breaks, however, come complications such as distribution requirements and tax penalties. That creates a need for planning by both account owners and their beneficiaries. Below are a dozen of those areas where such planning can pay off.

Planning consideration #1
Community property interests are disregarded with IRAs for federal income tax purposes.

In Ltr. Rul. 201623001, the IRS refused to allow a surviving spouse to roll over a portion of the deceased spouse's IRAs that had been "assigned" to her by the couple's son who was the sole beneficiary named on the beneficiary designation forms. This family lived in a "community property" state. Thus the surviving spouse claimed that she had a "community property" interest in her deceased spouse's three IRAs. The son, the decedent's estate, and the local state court accepted the claim. The IRS denied the request to have the assigned funds treated as a spousal rollover based on the community property claim. The IRS based its decision on Section 408(g) which states: "This section shall be applied without regard to any community property laws."

Background. A married IRA owner, who resided in a community property state, named his child as the sole beneficiary of his three IRAs. After the owner passed away, the IRAs were retitled as an inherited IRA for the child beneficiary. The surviving spouse then filed a claim against the decedent's estate for a one-half interest in the community property that the deceased spouse and the surviving spouse owned.

The surviving spouse and the decedent's estate negotiated a settlement under which the surviving spouse's community property interest in the estate was valued at "Amount 1." Importantly, the settlement was with respect to the community property interest in the total of the decedent's estate, not just in the decedent's IRAs. A state court in the community property state approved the settlement and ordered that the custodian of the IRAs assign Amount 1 of the inherited IRA for the child to the surviving spouse as a spousal rollover IRA.

The surviving spouse requested a private letter ruling from the IRS asking that:

1. The negotiated amount (i.e., Amount 1) of the child's inherited IRA should be classified as the surviving spouse's community property interest.

2. The surviving spouse may be treated as a payee of the child's inherited IRA.

3. The custodian of the child's inherited IRA can distribute the Amount 1 to the surviving spouse in the form of a surviving spouse rollover IRA.

4. The distribution of Amount 1 from the child's inherited IRA to the surviving spouse will not be considered a taxable event.

IRS denies request. The IRS first references Section 408(d)(1), which provides that "any amount paid or distributed out of any individual retirement plan shall be included in the gross income of the payee or distributee." Section 408(d)(3) is then referenced; it permits rollovers by the "individual for whose benefit the [IRA] is maintained." But, the IRS notes, rollovers are not permitted from inherited IRAs.[1] Inherited IRAs are defined as IRAs where (1) the individual for whose benefit the IRA is maintained acquired the IRA by reason of the death of another individual, and (2) such individual was not the surviving spouse of such other individual.[2] Section 408(g) is then referenced; that provision states that Section 408 "shall be applied without regard to any community property laws."

Regarding the first ruling request, whether an amount of the inherited IRA for the child should be classified as the surviving spouse's community property, the IRS declined to make a ruling because the IRS deemed that this is a matter of state property law and not a matter of federal tax law.

In regard to the second, third, and fourth ruling requests, the IRS noted that the child was the named beneficiary of the IRA of the deceased spouse and that the IRA had been retitled as an inherited IRA for the child. The IRS then denied all of these requests mainly due to Section 408(g) (i.e., Section 408 is applied without regard to any community property laws). Therefore, the IRS ruled, Section 408(d)'s distribution rules must be applied without regard to any community property laws.

Consequently, because the surviving spouse was not the named beneficiary of the decedent's IRA and the surviving spouse's community property interest is to be disregarded, the surviving spouse may not be treated as a payee of the inherited IRA for the child. In addition, the surviving spouse may not roll over any amounts from the inherited IRA for the child. Moreover, since the child was the named beneficiary of the decedent's IRA and because the IRS disregarded the surviving spouse's community property interest, any "assignment" of any interest in the inherited IRA for the child to the surviving spouse would be treated as a taxable distribution to the child.

In conclusion, the IRS states: "[T]he order of the state court cannot be accomplished under federal tax law." Thus, the IRS may be implicitly saying that the state court was wrong in trying to address federal tax law issues regarding this IRA.

As a result, the spouse's community property interest is disregarded under federal tax law and the child beneficiary would continue to be viewed by the IRS as the payee of the inherited IRA. Consequently, if the court order were to be carried out with the IRA funds being assigned to the spouse, the withdrawal would be a "double whammy" for the child. Not only would the child lose the inheritance (with the potential for tax-deferred growth), but the assignment of the inherited IRA assets from the child to the spouse would be taxable to the child beneficiary and ineligible for rollover to the spouse's IRA.

Conclusion. IRA owners who live in community property states, such as California, have wrestled with the question of how to recognize the alleged nonparticipant spouse's community property interest in the participant's IRA. Unfortunately, very few cases or rulings address this issue. However, one such case was *Bunney*[3] which held that when the participant withdrew funds from his IRA and paid them to his wife in satisfaction of her community property interest, that this was a taxable distribution to the participant and not a nontaxable spousal rollover. Thus, this letter ruling can be viewed as confirming *Bunney* in a post-death situation.

Consequently, there is really only one solution to this issue in community property states. A married couple residing in a community property state and wanting to formalize each spouse's community property interest in the other spouse's IRA will need to name each other as beneficiary of their respective IRAs at least to the extent of the nonparticipant's spouse's community property interest in the IRA.

Planning consideration #2
Knowing the difference between rollover IRAs and contributory IRAs is important.

Knowing the differences between a "rollover IRA" and a "contributory IRA," and keeping them separate, can provide important benefits and preserve options for the IRA owner. This section explains the differences and why the IRA owner should keep them separate.

The term "rollover IRA" refers to an IRA that was established to receive funds from a qualified employer retirement plan like a 401(k) plan ("qualified plan"). That is, the funds from the qualified plan were transferred (i.e., rolled over) from the qualified plan into the newly created IRA. (This transfer should be made by a "trustee-to-trustee" transfer.) In contrast, a "contributory IRA" is funded solely by annual contributions directly by the IRA owner.

When an individual intends to roll funds over from a qualified plan to an IRA, the financial institution that will serve as the custodian for the IRA may recommend that a new IRA be created to receive the funds from the qualified plan. Importantly, creating a new IRA to receive the funds to be transferred from the qualified plan is not required. One can transfer those funds into any other IRA that may already exist because there is no legal requirement that the distribution from the qualified plan be kept in a separate IRA from any other IRAs that the individual may own. But even though a separate IRA is not legally required when transferring funds from a qualified plan, there are at least three reasons to consider for keeping the distribution from a qualified plan separate from other IRAs, especially a contributory IRA, which, as referenced above, was funded solely by annual contributions by the IRA owner.

Bankruptcy protection. The first reason to create a separate rollover IRA is derived from federal bankruptcy law.[4] An IRA is protected from one's creditors under federal bankruptcy law if the IRA owner declares bankruptcy. But this protection is currently limited to $1 million for all of one's IRAs. Very importantly, however, the $1 million limit does not apply to amounts that are rolled over to any IRA from a qualified plan, or any earnings on the funds in the rollover IRA (i.e., "(T)he aggregate value of such assets exempted under this section, *without regard to amounts attributable to rollover contributions under section 402(c), 402(e)(6) ... of the Internal Revenue Code of 1986, and earnings thereon*, shall not exceed $1,000,000 in case filed by a debtor who is an individual"). The funds in this rollover IRA are protected in full if the IRA owner declares bankruptcy, just as they would have been if the funds had remained in a qualified plan.

Clearly it is easier to track, and maintain the records for, the amount of funds rolled over, and any future earnings on such funds, if those funds are in a separate IRA rather than an IRA that is funded with both annual contributions and rollover funds.

Creditor protection. The second reason for rolling over funds from a qualified plan into a separate IRA relates to the protection of assets from the creditors of the owner of that IRA funded with rollover funds outside of bankruptcy. For instance, under California law, assets held in "private retirement plans" are fully exempt from execution, both before and after distribution to the judgment debtor.[5] IRAs, however, are exempt only to the extent "necessary to provide for the support of the judgment debtor when the judgment debtor retires and for the support of the spouse and dependents of the judgment debtor, taking into account all resources that are likely to be available for the support of the judgment debtor when the judgment debtor retires."[6]

But this limited exemption for IRAs does not apply in California if the funds in the IRA can be traced back to a private retirement plan in which the funds would be fully exempt as described above.

This issue was addressed in *McMullen v. Haycock.*[7] In the appeal, the California Court of Appeals stated that it must decide which exemption under Section 704.115 of the CA Code of Civil Procedure applied to assets that were rolled over from a fully exempt private retirement plan into an IRA-the full exemption for private retirement plans under CA Code of Civil Procedure Sections 704.115(b) and (d), or the limited exemption for IRAs under Section 704.115(e).

In this case, the appellant judgment debtor, Don H. Haycock, appealed from a post-judgment order that applied the limited exemption under Section 704.115(e) to the assets that were rolled over from his fully exempt private retirement plan into an IRA. Haycock contended that under the California tracing statute,[8] because all of the assets in his IRA can be traced to his fully exempt private retirement plan maintained by his former employer, the full exemption continues to apply to those funds. The judgment creditor, Hugh McMullen, contended, however, that the full exemption was lost when the exempt private retirement plan assets were rolled over into the IRA, because IRAs are given only a limited exemption under Section 704.115(e).

The Appellate Court concluded that because California law permits the tracing of exempt funds under the above referenced Section 703.080(a) ("[A] fund that is exempt remains exempt *to the extent that it can be traced into deposit accounts* or in the form of cash or its equivalent."), the mere transfer of the fully exempt private retirement plan assets to the IRA did not eliminate their full exemption under Sections 704.115(b) and (d).

Importantly, the debtor claiming this exemption has the burden of tracing the claimed exempt funds.[9] Consequently, complying with the "tracing" requirements will be easier if the funds from the fully exempt private retirement plan are rolled over into a completely separate and newly formed IRA.

Future rollover to employer plan. The third reason to create a separate rollover IRA is that the IRA owner might decide in the future to roll the funds in that rollover IRA into a qualified plan with a new employer. In the past, qualified plans could accept rollovers only from rollover IRAs. That is, rollovers from IRAs that were previously funded solely by annual contributions were not permitted. Now, however, qualified plans can accept rollovers from both contributory IRAs as well as rollover IRAs.

Despite this flexibility, the administrators of qualified plans, while permitted, are not required to accept rollovers. In addition, the administrators can limit the types of contributions they will accept. While it is becoming less common, some qualified plans will accept rollovers only from rollover IRAs. Consequently, an individual who is planning on rolling over funds from a qualified plan into an IRA might keep this in mind if there is a possibility of rolling the funds from an IRA into a qualified plan with a new employer in the future.

In summary, knowing the differences between a rollover IRA and a contributory IRA is important. As described above, keeping funds from a qualified plan solely in a separate rollover IRA (and not mixed with a contributory IRA) may provide significant benefits to the IRA owner in the form of creditor protection, whether in or outside of bankruptcy.

Planning consideration #3
The U.S. Supreme Court has held that inherited IRAs are not protected in bankruptcy.

In *Clark v. Rameker,*[10] the U.S. Supreme Court unanimously held that inherited IRAs do not qualify for a bankruptcy exemption (i.e., they are not protected from creditors in bankruptcy).

Background. Under Bankruptcy Code Section 522(b)(3)(C), a debtor may exempt amounts that are both (1) "retirement funds" and (2) exempt from income tax under one of several specified Internal Revenue Code sections, including Section 408, which provides a tax exemption for IRAs.

Facts of the case. In 2001, Heidi Heffron-Clark inherited her deceased mother's traditional IRA as sole beneficiary. The IRA was worth about $450,000. Heidi and her husband, Brandon Clark, elected to take monthly distributions from the IRA as the way for Heidi to comply with the required minimum distribution (RMD) rules.

In 2010, the Clarks filed a bankruptcy petition under Chapter 7 of the Bankruptcy Code. In their petition, the Clarks sought to exempt the inherited IRA, then worth about $300,000, from their bankruptcy estate, via Bankruptcy Code Section 522(b)(3)(C). The bankruptcy trustee and the Clarks' unsecured creditors objected, arguing that the funds held in the inherited IRA were not "retirement funds" within the meaning of Bankruptcy Code Section 522(b)(3)(C), and so could not be exempted from the bankruptcy estate under that provision. The bankruptcy court agreed, finding that inherited IRAs do not hold "anyone's" retirement funds because the funds are not set aside for retirement needs, nor are they distributed upon retirement.

The bankruptcy court's decision was appealed to a federal district court, which reversed the decision and held that the inherited IRA did qualify for the Bankruptcy Code Section 522(b)(3)(C) exemption. This decision was then appealed to the Seventh Circuit, which determined that the bankruptcy court had gotten it right and that Heidi Clark's inherited IRA did not qualify for the Bankruptcy Code Section 522(b)(3)(C) exemption.

The Seventh Circuit's decision was at odds with an earlier holding by the Fifth Circuit in its *In Re Chilton*[11] decision. The U.S. Supreme Court agreed to hear the case to resolve the split among the circuit courts.

Supreme Court says "no exemption." Justice Sotomayor delivered the opinion for a unanimous court, stating that "text and purpose" of the Bankruptcy Code provides that funds held in inherited IRAs are not "retirement funds" for purposes of the Bankruptcy Code Section 522(b)(3)(C) exemption.

The Court began its review by noting that the Bankruptcy Code does not provide a definition of "retirement funds." Using the ordinary meaning of the term, the Court stated that "retirement funds" refers to money that is set aside for the time that a person is no longer working. The determination of whether funds held in an account are "retirement funds" should be based on the legal characteristics of the account holding the funds and on whether the account is one that was set aside for when an individual is no longer working.

The Court identified three legal characteristics of inherited IRAs that made funds held in these accounts "not objectively set aside for the purpose of retirement":

1. IRC Section 219(d)(4) prevents holders of inherited IRAs from putting additional funds into the account. Thus, where traditional and Roth IRAs allow their account holders to add to their retirement savings over time, inherited IRAs prohibit contributions to the account.

2. Holders of inherited IRAs must withdraw money from such accounts, without regard to the number of years until the account holder reaches retirement. That the tax rules governing inherited IRAs require these accounts to be depleted over time, regardless of how close their holders are to retirement, is not a feature of an account set aside for retirement.

3. Inherited IRA owners may make penalty-free withdrawals from the account at any time, up to the entire balance of the account, without triggering the 10% early withdrawal penalty under IRC Section 72(t). In contrast, withdrawals from a traditional or Roth IRA before the account holder reaches age 59½ are subject to the early withdrawal penalty, unless one of several limited exceptions apply. Thus, funds held in inherited IRAs can be used for current consumption, while those in traditional and Roth IRAs cannot.

Fresh start vs. free pass. According to the Court, the exemptions provided by the

Bankruptcy Code create a balance between the rights of creditors and the needs of debtors. Allowing debtors to protect funds held in traditional and Roth IRAs aligns with this balance by helping to ensure that debtors will be able to meet their basic needs during retirement. At the same time, the limits on traditional and Roth IRAs help make sure that the debtors who hold these accounts (but who have not yet reached age 59½) do not enjoy a windfall due to the exemption.

By contrast, nothing about an inherited IRA's legal characteristics prevents or discourages an individual from using the entire balance immediately after bankruptcy for purposes of current consumption. Allowing the exemption for inherited IRAs, said the Court, would turn the Bankruptcy Code's "fresh start" into a "free pass."

Change in status from regular IRA to inherited IRA. The Clarks further argued that, because the funds in an inherited IRA were once set aside for retirement of the initial IRA owner, the funds continued to have the legal characteristics of funds set aside for retirement even after the original owner's death. That is, the death of the initial IRA holder would not in any way affect the funds in the account. In response, however, calling this a "backward-looking inquiry," the Court said that the ordinary use of the term "retirement funds" implied that the funds were currently in an account set aside for retirement, not that they were set aside for retirement at some point in the past.

Recommendation. In order to avoid the result that the Clarks had in this case, an IRA owner should consider establishing a trust for the beneficiary or beneficiaries. These trusts are sometimes referred to as IRA beneficiary trusts or IRA standalone trusts. Once the trust is established, the IRA owner, instead of listing the individuals personally on the beneficiary designation form, would list the IRA beneficiary trust. If the IRA beneficiary trust has more than one beneficiary, however, the separate subtrust for each beneficiary would be listed on the beneficiary designation form. In this way, each beneficiary would be able to use his or her own life expectancy in determining the required minimum distributions that would have to be taken each year.

Planning consideration #4
Consider establishing an IRA beneficiary trust.

As the value of IRAs have increased over the years, the owners of the IRAs have to consider the "pros and cons" of naming the individual beneficiaries directly or creating a trust ("IRA trust") that will be named as the beneficiary of the IRA. The beneficiaries of the IRA trust are typically the children of the IRA owner. The primary objective of creating the IRA trust is to protect the IRA assets from the creditors and divorced spouses of the beneficiaries.

Importantly, under Section 401(a)(9)(E), only individuals qualify as "designated beneficiaries" for purposes of determining the "required minimum distributions" (RMDs) under Section 401(a)(9). Reg. 1.401(a)(9)-4 further amplifies this point:

> Q-1. Who is a designated beneficiary under section 401(a)(9)(E)?
>
> A-1. A designated beneficiary is an *individual who is designated as a beneficiary under the plan….* A beneficiary designated as such under the plan is an *individual* who is entitled to a portion of an employee's benefit, contingent on the employee's death or another specified event…. A designated beneficiary need not be specified by name in the plan or by the employee to the plan in order to be a designated beneficiary so long as the individual who is to be the beneficiary is *identifiable* under the plan. The members of a class of beneficiaries capable of expansion or contraction will be treated as being *identifiable if it is possible to identify the class member with the shortest life expectancy.* 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 unless *the individual is designated as a beneficiary under the plan.*
>
> Q-3. May a person other than an individual be considered to be a designated beneficiary for purposes of section 401(a)(9)?
>
> A-3. No, only individuals may be designated beneficiaries for purposes of Section 401(a)(9). A person that is not an individual, such as the employee's estate, may not be a designated beneficiary. *If a person other than an individual is designated as beneficiary of an employee's benefit, the employee will be treated as having no designated beneficiary for purposes of section 401(a)(9), even if there are also individuals designated as beneficiaries.* However, see A-5 of this section for special rules that apply to trusts.... [Emphasis added.]

Thus, a trust generally will not qualify as a "designated beneficiary," resulting in faster-than-desired RMDs. But if a trust satisfies certain requirements, then the beneficiaries of the trust (and not the trust itself) will be treated as having been designated as beneficiaries of the IRA for purposes of determining the RMDs:

> Q-5. If a trust is named as a beneficiary of an employee, will the beneficiaries of the trust with respect to the trust's interest in the employee's benefit be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9)?
>
> A-5. (a) If the requirements of paragraph (b) of this A-5 are met with respect to a trust that is named as the beneficiary of an employee under the plan, *the beneficiaries of the trust (and not the trust itself) will be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9).*[12]

To qualify, the trust must meet the following requirements:

1. The trust is valid under state law or would be but for the fact that there is no corpus (which is often the case because typically no assets go into the trust until the death of the IRA owner). The regulations specifically approve the use of testamentary trusts.

2. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the IRA owner (this is usually the case because by allowing the trust to be "revocable" or amended, the IRA owner reserves the right to change its provisions if circumstances change over time).

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. Documentation regarding the trust is timely submitted to the IRA custodian.

Probably the biggest challenge in drafting the trust document is having provisions that make it easy to "identify" the beneficiary or beneficiaries of the IRA trust so that the required minimum distributions (RMDs) can be readily determined. While there may be more than one beneficiary of the IRA trust, under the Treasury Regulations, the life expectancy of the oldest beneficiary will be used to determine the RMDs for all of the beneficiaries.

But without careful drafting, it can be very difficult to determine which of the beneficiaries have to be considered. For example, the regulations state that a "contingent beneficiary" has to be considered in determining which designated beneficiary has the shortest life expectancy. But, in contrast, a "successor beneficiary" will not have to be considered.

A "successor beneficiary" is a person who merely could become the successor to the interest of one of the IRA owner's beneficiaries after that beneficiary's death. However, the regulations state a beneficiary will not be excluded as a "successor beneficiary" if that person has any right (including a contingent right) to an IRA owner's benefits beyond being a mere potential successor to the interest of one of the IRA owner's beneficiaries upon that beneficiary's death. Thus, for example, if the first beneficiary has a right to all income with respect to an IRA owner's 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, both beneficiaries must be taken into account in determining the beneficiary with the shortest life expectancy and indeed, whether only individuals are beneficiaries (i.e., not an estate or a charity).

Planning consideration #5
Should an IRA beneficiary trust be structured as a conduit trust or accumulation trust?

As more individuals roll significant funds from their pension and retirement plans, the IRAs created with these rollovers are often quite large and constitute a substantial portion of these individuals' estates. As a result, IRA owners have become more aware of the estate planning issues revolving around the IRAs. For one, IRAs are typically not an asset that is transferred into the family revocable trust like most other assets. Instead, IRAs stand apart and require their own planning strategies.

But large IRAs do present some similar issues for the IRA owner trying to determine how best to pass down substantial wealth and assets to his or her children or grandchildren. Most parents want to avoid undercutting a child's motivation for being industrious by transferring a large financial sum to the child all at once or over a short period of time. Parents will often restrict distributions of the assets to a child until certain ages are reached. Sometimes the final distribution is not made until the child is in his or her 40s or even 50s. These restrictions are placed in the family revocable trust.

How is this done with an IRA? Normally, the IRA owner would simply list the surviving spouse as the primary beneficiary and the children as the contingent beneficiaries if the spouse predeceases the IRA owner. For example, if there were three children and the spouse died before the IRA owner, then the three children could either take only the required minimum distributions each year or pull out all of the funds in a single withdrawal. This second option is what many parents want to prevent, not only because of the adverse tax consequences but also because of the motivation concern noted above. Instead, because of the benefits of tax-deferred growth, they want the distributions stretched out over the life expectancies of the three children.

The mechanism to achieve this result is a form of trust, an irrevocable trust. And this trust is named as the beneficiary of the IRA in lieu of naming the children personally. Not all trusts, however, qualify as a "designated beneficiary" which will allow for the deferral of payments over the life expectancy of a child. But when certain requirements are satisfied, the IRS will "look through" the trust and find the children as the beneficiaries of the trust.

After deciding to use a trust in the above manner, the IRA owner must select between two basic structures for the trust:

1. A "conduit" trust.

2. An "accumulation" trust.

The choice will ultimately depend either on how restrictive the IRA owner wants to be or how concerned the IRA owner is about the child who is to benefit from the IRA.

With a conduit trust, the trustee is obligated to receive the required distributions from the IRA and then to immediately pass such distributions (and any other withdrawals from the IRA) on through the trust to the child. Thus the descriptive term "conduit trust" to denote this type of trust. The child/beneficiary has no power to demand any more from the trust than the required distributions (which distributions are based on the remaining life expectancy of the child). The IRA owner could give the trustee the power to make additional distributions if the trustee, in its discretion, determines that the child needs additional financial resources.

Because, potentially, only the required distributions are taken from the IRA, the payments from the IRA may well be stretched out over a long period, thus realizing the benefits of tax-deferred growth. Very importantly, if the trust is a "conduit trust" only the primary beneficiary will be considered in determining if there is a "designated beneficiary," and if so, what is the life expectancy of that primary beneficiary.

An IRA owner may, however, determine that the child cannot be relied on to use appropriately even the required distributions. In this situation, the IRA owner wants to insert the oversight of the trustee. Under the terms of this trust, the trustee is given the discretion to either make distributions to the child, the beneficiary of the trust, or to accumulate the required distributions, and any other withdrawals from the IRA, and other income of the trust. Thus this type of trust is called an "accumulation trust."

In considering whether to use an "accumulation trust," these factors need to be considered:

1. The federal income tax rates for trusts are compressed as compared to those for an individual. For example, in 2018, the maximum tax rate of 37% applies to taxable income of a nongrantor trust over $12,500. In comparison, the 37% tax rate applies to taxable income over $600,000 for married individuals filing jointly.

2. The 3.8% surtax on net investment income kicks in at this same "top" level.

3. State income tax may also be relevant. The California trust income tax rate, for instance, could range from 1% to 13.3%. This results in higher income taxes for income retained in the trust versus income distributed out to the beneficiary.

4. Potentially more important is the need to be very clear as to whom the primary and successor beneficiaries are. For example, suppose the IRA owner names his child as the primary beneficiary of the trust, but the IRA owner then names his brother or sister to be the beneficiary of the trust in the event the child dies before receiving all of the funds from the IRA. In this instance, the much shorter life expectancy of the IRA owner's brother or sister might have to be used to determine the required distributions rather than the longer life expectancy of the child. Thus, special caution is needed in drafting an "accumulation trust."

In summary, trusts as beneficiaries of an IRA are being used more frequently now in order to better assure the IRA owner that his or her wealth transmission goals for the IRA will be achieved.

Planning consideration #6
When using an accumulation trust, possibly limit the potential contingent beneficiaries.

IRS Private Letter Ruling 201320021 helps to emphasize this required process of "looking into" the trust with the hope of being able to identify the beneficiaries and determining which beneficiary's life expectancy has to be used in calculating the annual RMDs. When reaching its holding, the IRS assumed that Trust A was a valid see-through trust.

Facts of the ruling. The IRA owner was the mother of one child. The mother had a Will that provided for the terms of a trust ("Trust A") upon her death. Trust A was named as the beneficiary of the IRA. The child was the sole beneficiary of Trust A. The IRA owner was survived by her mother and brother, but neither was listed as a beneficiary of Trust A.

Trust A provided for staggered distributions over certain ages with all the remaining principal to be distributed once the child reached the age of 35. The Will then states that if a child (as noted above, there was actually only one child) dies before reaching the age of 35, the interest of the child would pass to the child's surviving issue. If the child died without issue, then that child's interest in Trust A would cease.

The IRS then points out that except for beneficiaries listed above (essentially the child and any issue of that child), the Will did not provide for any additional contingent beneficiaries. Consequently, the possibility existed that at the death of the IRA owner there would not be any named beneficiaries if the child (and any children of that child) had predeceased her.

Thus, because of the possibility of "running out of" beneficiaries, the question became whether one would have to look "outside" the trust as part of the process of "identifying" the beneficiaries of Trust A.

Because of this uncertainty, a ruling was requested that the child, as the beneficiary of Trust A, is the only designated beneficiary of the IRA. As such, the child's life expectancy would then be used to determine the applicable distribution period under Section 401(a)(9) .

The IRS agreed. The IRS noted that while the IRA owner was survived not only by her only child but also by her mother and her brother, the Will did not provide for additional contingent beneficiaries for Trust A. It then concluded that because the child was the only child of the IRA owner, such child was the only beneficiary of Trust A's beneficial interest in the IRA. As a result, the IRS ruled that the child was the designated beneficiary with respect to the IRA and that the child's life expectancy would be used to determine the applicable distribution period for the RMDs.

IRA owners forming IRA trusts to serve as the beneficiary of the IRA must make sure to avoid naming contingent beneficiaries who are older than the beneficiary whose life expectancy they want used in determining the RMDs. Interestingly, this letter ruling demonstrates that having a "short list" of beneficiaries will make it easier to determine who is the oldest beneficiary and will not inadvertently cause a problem.

Planning consideration #7
Are family revocable trusts and IRAs symbiotic or toxic for each other?

Naming the family revocable trust as the beneficiary of one's IRA often seems the most practicable and logical alternative. The client may well have spent significant time and effort (not to mention fees) in deciding on the various alternatives for transferring family assets to the children in the most tax efficient way. Ltr. Rul. 201021038 provides an excellent example of the various traps when a family revocable trust (or one of the subtrusts formed on the first death) is indeed listed as the IRA beneficiary. This letter ruling underscores the differences between "conduit" provisions and "accumulation" provisions, and between "contingent beneficiary" and "successor beneficiary." It demonstrates how the commonly used "power of appointment" results in having to consider a broader swath of beneficiaries for IRA distribution purposes than might have been intended, especially if one such beneficiary does not qualify as a "designated beneficiary."

The letter ruling strongly expresses the view of the IRS that the procedure in the regulations dictating that a "designated beneficiary" be so listed on the beneficiary form as of the date of death of the IRA owner cannot be altered.

Finally, the letter ruling points out the case law precedence that the IRS relied on to ignore and disregard a state court order that attempted to retroactively name a "designated beneficiary" (and remove all "undesirable" beneficiaries) effective as of the date of death.

Facts of the ruling. Dad and Mom created a revocable trust as part of their estate plan and restated it at some later date ("restated trust"). The restated trust had fairly typical provisions in that on the first death, the trust would divide into the traditional survivor's trust, bypass trust, marital deduction trust, and a disclaimed property trust.

The key subtrust of this letter ruling was the bypass trust. Under its terms, the trustee was required to distribute income from the bypass trust in installments, at least quarterly, for the health care, maintenance, support, and welfare of the beneficiary of the bypass trust but only if other resources are clearly inadequate. The primary beneficiary of the bypass trust (i.e., the surviving spouse) possessed the power to allocate principal from the bypass trust to the "secondary beneficiaries" of the bypass trust and their descendants as long as the surviving spouse remained competent. The balance of the bypass trust not so appointed or allocated would be disposed of under Article X of the restated trust upon the death of the surviving spouse/grantor.

Article X first provided for specific bequests and an amount, determined by a formula, to be distributed outright to the grandchildren of Mom and Dad. In addition, Article X created and provided for the administration of two separate "protective trusts," one for each of the two children of Mom and Dad. The provisions of these protective trusts became the focus of the ruling.

Under the restated trust, the trustee of each protective trust was to distribute "appropriate amounts of income and principal for the health care, maintenance, support and education" to the beneficiary of each such protective trust. Neither the distribution of the income nor the principal was mandatory; thus the income as well as the principal (and distributions from the IRA to the protective trust) could be retained and thus "accumulated" within the protective trust potentially for the benefit of a beneficiary other than one of the children of Mom and Dad.

As a result, the protective trusts were not "conduit" trusts" because the trustee was not obligated to distribute to the primary beneficiary the required distribution received each year from the IRA. Consequently, the "investigation" of whether there was a "designated beneficiary" could not stop after determining that a child was the "primary beneficiary" of each protective trust.

In addition, each of the beneficiaries of the protective trusts who attained a "designated age" had a lifetime power of appointment over the assets in her protective trust and such power extended to charities. Each child had attained the "designated age."

Moreover, each beneficiary of a protective trust, upon attaining the designated age, also had a testamentary power of appointment and thus could select who would receive the assets of the protective trust after such child's death. The potential "appointees" included certain persons and entities, including charities, with certain specified exceptions.

Article XI of the restated trust provided for the distribution of assets not disposed of under Article X. This Article XI provided for specific bequests to persons named in Schedule H. In addition, this article provided that any residue would be divided among the persons named or described in Schedule I. While a charity or other non-natural person was eligible to be a contingent beneficiary, none was listed on Schedule I.

At some later date, Dad and Mom apparently discussed with their advisor the possibility of naming either the restated trust or one of the subtrusts formed upon the first death as the designated beneficiary of his or her IRA. The advisor apparently drafted an amendment to the restated trust that was approved by Dad and Mom. Because of its importance to the ruling, it is fully quoted below:

> With respect to any IRA, 401K or other retirement plan payable to the trust on the death of either Trust Creator, it is the Trust Creators' desire that the Trustee utilize the minimum distribution rules described in the Internal Revenue Code ("IRC") and applicable regulations when making withdrawals from said retirement account.... In particular, the trustee should be guided by the following: (a) The Trustee should first determine whether the custodian allows for long-term deferral of income taxes by the Trustee;... (c) The Trustee should determine what requirements exist, if any, in order to elect the longest tax-deferral period; (d) Having made the appropriate election in order to elect the longest tax-deferral period of time, the Trustee should withdraw funds from the retirement plan in the minimum amounts required under IRC and applicable regulations without penalty; additional amounts should be withdrawn only if the Trustee determines that a need exists;... (f) ... The provisions of this instrument are intended to inform the Trustee of the Trust Creators' desire that the rules commonly known as the "stretch IRA"

> rules should be applied to all retirement plans. It is the Trust Creators' hope that the Trustee will use his or her best efforts to minimize income taxes on these assets for the maximum duration permitted by law.... For purposes of qualifying as a Designated Beneficiary under IRC and applicable regulations, each Beneficiary may amend the terms of the trust which govern the distribution of his or her trust at death in the absence of a complete and effective exercise of any applicable power of appointment;...

This amendment seems to reflect a sense that a trustee, once instructed by the trust grantors, had the power and authority to interpret and apply the rules affecting RMDs from the IRA in such a way as to exploit and maximize the "stretch IRA" rules to the extent desired.

But such an objective cannot be realized without also understanding the significance of the other very relevant provisions of the restated trust (i.e., the powers of appointment and the potential "appointees") in determining who (or what) would be the beneficiary whose life expectancy (if any) would determine the required distributions, i.e., who are (1) the "primary beneficiaries," (2) the "contingent beneficiaries," or (3) the "successor beneficiaries."

The differences in consequences depending on whether the protective trust contains "conduit' provisions (i.e., mandatory distribution to the beneficiary of the required distributions and all other withdrawals from the IRA) versus "accumulation" provisions (i.e., trustee has discretion as to whether to make the distributions of the funds from the IRA or retain and accumulate them), must also be understood. Finally, the need to be aware of, and to satisfy, the four requirements that will allow the beneficiaries of a trust to be treated as the beneficiaries of the IRA even though it was the trust that is named as the beneficiary on the beneficiary designation statement appears lacking in the terms of the amendment.

Subsequent to the adoption of the above amendment, Mom died. Dad then became the sole trustee of the various subtrusts referenced above. Dad decided to name his two adult daughters (hereafter Taxpayer C and Taxpayer D) as the Co-Trustees of the Bypass Trust. At some point before his death, Dad had named the Trustees of the Bypass Trust (i.e. his two daughters) as the beneficiary of his IRA.

After Dad's death, pursuant to Article X of the restated trust, all the subtrusts that had been created on the death of Mom were consolidated and equally divided into the above-described two protective trusts, one for each daughter. In addition, each became the trustee of her respective protective trust.

At this point, the two daughters apparently sought the advice of a different advisor. The daughters, acting as trustees of the bypass trust, filed for a declaratory judgment in the local state court. The daughters asked the state court to modify the restated trust in order to comply with certain requirements under Treasury Regulation 1.401(a)(9). The court issued an order modifying the restated trust retroactively to the date of Dad's death, apparently as requested.

The court order modified the restated trust, in relevant part, as follows:

1. All amounts received from the custodian of the IRA are to be distributed to the beneficiaries of the Protective Trusts.

2. The trustee is authorized to arrange direct distributions to the beneficiary.

3. If a special independent trustee is selected, distributions to descendants of beneficiaries born before 1955 are prohibited.

4. Descendants of beneficiaries born before 1955, contingent beneficiaries, and charities are removed as potential appointees of a beneficiary's lifetime power of appointment.

5. Any individual born before 1955 is removed as a potential appointee of a beneficiary's testamentary power of appointment.

6. Taxpayer C (the oldest lineal descendant of Dad) is named as the designated beneficiary under Section 1.401(a)(9)-4, Q&A-4, and the restated trust is to be administered so that all beneficiaries following the two daughters are "successor beneficiaries," as defined in Section 1.401(a)(9)-5, Q&A-7(c)(1).

7. The trustee is directed to use IRA proceeds to pay debts, administration expenses, or taxes of Dad's estate only after other assets are exhausted, and is prohibited from using any IRA proceeds to make such payments after a specified date.

Based on the above, the daughters requested the following letter rulings from the IRS:

1. That the IRA be distributed as though the beneficiaries of the bypass trust administered under the restated trust, as amended by the court order, were named beneficiaries of IRA thereby satisfying the guidance set forth in Reg. 1.401(a)(9)-4 , Q&As-4 and 5.

2. That Taxpayer C, the oldest daughter, was the "designated beneficiary," as that term is used in Section 401(a)(9)(A)(ii), of Dad's IRA based on the judicial modification of the restated trust retroactively to Dad's date of death, which modification is valid under State S's Revised Code.

3. Alternatively, that Taxpayer C, the oldest daughter, was the "designated beneficiary" of the IRA as a result of removing certain discretionary distributees and potential objects of appointment before a specified date in 2009 through the judicial modification of the restated trust under State S's Revised Code.

4. That the applicable distribution period as used in Reg. 1.401(a)(9)-5 , Q&A-5(c)(1) for the applicable calendar year (2009) was 30.5 years (reduced yearly), which was Taxpayer C's life expectancy based upon her current year (2009) birthday.

IRS analysis. The IRS starts its analysis by citing and summarizing several Treasury Regulations sections that address the definitions of a "designated beneficiary," "contingent beneficiary," and "successor beneficiary." It is instructive to see how the IRS analyzed the issues and which IRC sections and Treasury Regulations it emphasized in its analysis. Thus the following highlights those provisions referenced by the IRS in the ruling with respect to the different issues and concepts.

Designated beneficiary. Section 401(a)(9)(E) states that the term "designated beneficiary" means any individual designated as a beneficiary by the employee.

Reg. 1.401(a)(9)-4, Q&A-1 provides, in part, that a "designated beneficiary" is an individual who is designated as a beneficiary under the plan. Thus an individual may be designated as a beneficiary under the plan either by (1) the terms of the plan or, (2) if the plan so provides, by an affirmative election by the employee (or the employee's surviving spouse) specifying the beneficiary. Under this regulation, a designated beneficiary need not be specified in the name of the plan in order to be a "designated beneficiary" so long as the individual is identifiable under the plan. In addition, even a member of a class of beneficiaries capable of contraction or expansion is treated as being identifiable if it is possible to identify the class member with the shortest life expectancy. It is also noted that under these regulations, the passing of an employee's interest to an individual under a Will or otherwise under applicable state law will not make that individual a designated beneficiary unless that individual is designated as a beneficiary under the plan.

Reg. 1.401(a)(9)-4 , Q&A-3 emphasizes again that only individuals may be "designated beneficiaries." A person who is not an individual, such as an estate or a charitable organization may not be a designated beneficiary. Indeed, if a person other than an individual is designated as a beneficiary, the employee is treated as not having a beneficiary for purposes of Section 401(a)(9), even if individuals are also designated as beneficiaries.

Reg. 1.401(a)(9)-4, Q&A-4 provides, in relevant part, that in order to be a designated beneficiary, an individual must be a beneficiary as of the date of the employee's death. Thus, generally, a designated beneficiary is determined based on the beneficiaries designated as of the date of death and remain beneficiaries as of September 30 of the year following the calendar year of the date of death.

Contingent beneficiary vs. successor beneficiary. The IRS then references the regulations that define a "contingent beneficiary" and a "successor beneficiary" and the very important significance of distinguishing between the two.

Reg. 1.401(a)(9)-5, Q&A-7(b) provides, in essence, that if a beneficiary's entitlement to an employee's benefit after the employee's death is a "contingent right," then such "contingent beneficiary" is nevertheless considered to be a beneficiary for purposes of determining who, if anyone, is the designated beneficiary.

In contrast to a "contingent beneficiary," a "successor beneficiary" will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy. A "successor beneficiary" is defined as a person who could become the successor to the interest of one of the employee's beneficiaries only after that beneficiary's death.[13] (In other words, this interest arises after the death of the employee's (designated) beneficiary, not after the death of the employee him or herself.)

Trust reformation and potential tax consequences. The IRS then states that a reformation of a trust instrument is not effective to change the tax consequences of a completed transaction. The IRS references *Estate of La Meres*,[14] where the trustees retroactively reformed a governing instrument solely for the purpose of qualifying the bequest for the estate tax charitable deduction. The Tax Court held that the retroactive reformation, undertaken solely for tax consequences, was not effective for federal tax purposes:

> This and other courts have generally disregarded the retroactive effect of State Court decrees for Federal tax purposes. [Citations omitted.]

The IRS then states that while it will look to local law in order to determine the nature of the interests provided under the trust document, it does not feel bound to give effect to a local court order which modifies the dispositive provisions of the document after the respondent has acquired rights to tax revenues under its terms.

The IRS further states that it will treat a state court order as controlling with respect to a reformation if the reformation is specifically authorized by the Code, such as under Section 2055(e)(3), which allows for the reformation of a split-interest charitable trust in order for the charitable interest to qualify for the charitable deduction as authorized under that statute.

But the IRS then concludes that there is no applicable federal statute which authorizes, in this instance, the daughters' retroactive reformation of the restated trust. As a result, the IRS concludes, the subject modification of the restated trust will not be recognized for federal tax purposes:

> In this instance, the efforts undertaken to modify the terms of the Restated Trust will not be given retroactive effect for federal tax purposes and the designated beneficiary of IRA X must be determined under the terms of the Restated Trust as it existed at the time of Taxpayer B [Dad's] death.

Bypass trust as beneficiary of the IRA. The analysis then turns to the bypass trust created under the restated trust because it was named as the beneficiary of Dad's IRA.

The IRS states that, provided the restated trust meets the requirements for a "see through" trust as set forth in Reg. 1.401(a)(9)-4, Q&A-5, it is then permissible to "look through" the trust in order to determine who, if anyone, is the designated beneficiary. But after doing the "look through," the IRS concludes that there was no identifiable beneficiary of the IRA at the time of Dad's death.

How did the IRS reach this conclusion? First, the IRS points out that the relevant terms of the restated trust, and specifically the terms of the bypass and the protective trusts, do not require or authorize either of the daughters under their respective protective trusts to receive all amounts that are distributed from the IRA. Rather the terms of the restated trust makes all distributions of either income or principal subject to a standard, essentially the typical "ascertainable standard."

Moreover, the relevant restated trust terms do not require that amounts distributed from the IRA, even if based on Taxpayer C's life expectancy, be paid either to Taxpayer C or Taxpayer D "or any other natural person (human being)." In essence the IRS is pointing out that there were no "conduit provisions" mandating that all IRA distributions be, in turn, distributed from the respective "protective trusts" to the daughters. The result? Such distributions from the IRA could be "accumulated" by the trustee.

This, in turn, means that such accumulated IRA distributions could be the subject of the powers of appointment granted to the daughters. But these powers of appointment could be exercised not only in favor of individuals but also charities:

> Because the terms of the Restated Trust allow for the accumulation of amounts distributed from the IRA X, the remainder beneficiaries must be considered beneficiaries of IRA X. Charitable organizations are clearly authorized to be potential/contingent beneficiaries under the relevant provisions of the Restated Trust. However, only individuals may be designated beneficiaries for purposes of satisfying the requirements of Code section 401(a)(9) and related Income Tax Regulations. *As a result, Taxpayer B (i.e. Dad) is treated as having no beneficiary of his IRA for purposes of section 401(a)(9) of the Code .* [Emphasis added.]

The IRS then repeats the rules for the proper timing for designating a beneficiary. First it is noted, as above, that "potential beneficiaries" may be eliminated after the death of an IRA owner and prior to September 30 of the year following the IRA owner's death for purposes of determining who is the "designated beneficiary." But, in contrast, while "beneficiaries" may be eliminated, "beneficiaries" cannot be added during this period. Furthermore, a "designated beneficiary" must be in existence as of the IRA owner's death:

> A designated beneficiary cannot be created after the date of death by means of a State Court Order even if said Order is valid under State Law.

The IRS concludes by emphasizing the importance of the terms of the restated trust:

> In this case, due to the language of relevant terms of the controlling Restated Trust document *there is no designated beneficiary* for purposes of section 401(a)(9) analysis. Subsequent efforts to obtain a post-mortem judicial modification had the effect of creating a designated beneficiary after the death of the taxpayer. Said efforts will not be given effect for purposes of Code section 401(a)(9). [Emphasis added.]

The IRS then provides its specific response to each of the ruling requests.

As to the first requested ruling, as noted above, the IRA will have to be distributed as if the IRA had no designated beneficiary. Why? Since entities ineligible to be treated as "designated beneficiaries" were, in fact, eligible to receive amounts from the IRA, then such entities (the charities) had to be considered as "contingent beneficiaries." Thus, the IRA has to be treated as having no "designated beneficiary."

As to the second ruling request, the IRS stated that no response could be provided because of the response to the first ruling request.

As to the third ruling request, Taxpayer C cannot be treated as the "designated beneficiary" of the IRA simply because of the above described court order since said order created a "designated beneficiary" of the IRA where none existed prior to the entry of the court order. Such "creation of a designated beneficiary after the death of the IRA owner" does not comply with the requirements of Section 401(a)(9) .

As to the fourth ruling request, it was noted that Dad had attained the "required beginning date" prior to his death. Consequently, the applicable required distribution period is the remaining life expectancy of Dad in accordance with the relevant regulations.

Conclusion. This ruling presents an excellent list of typical provisions of a family revocable trust that must be considered, and potentially revised, before such a trust (or any of its subtrusts) is designated as a beneficiary of an IRA. Moreover, the ruling underscores how powers of appointment, typically inserted intentionally to provide flexibility, may well eviscerate all the benefits that could have been realized by the proper designation of beneficiaries. Indeed, the ruling may appropriately guide advisors away from naming the family revocable trust as the IRA beneficiary and toward using what is often referred to as the IRA standalone trust or IRA beneficiary trust, a trust where certainty over flexibility is the desired objective.

Planning consideration #8
Separate accounts can be an achievable goal even with a single trust.

The "separate account" rule provides a significant benefit and opportunity to those individuals listed as the beneficiaries on an IRA's beneficiary designation form. Under this rule, if the named individuals create separate "inherited IRAs" by December 31 of the year after the death of the IRA owner, each individual will be able to use his or her own life expectancy in determining the required distributions. If the "separate accounts" are not created by this deadline, the individual beneficiaries have to use the life expectancy of the oldest beneficiary in calculating the required distributions.

The "separate account" rule would not be available, however, if the individuals were "simply" the beneficiaries of a trust which, in turn, was the beneficiary named on the beneficiary designation form. A solution to this problem though, does exist. But it must be done at the time the IRA owner creates the trust and is filling out the beneficiary designation form. The solution is to list each of the subtrusts being created under the trust for each individual beneficiary on the beneficiary designation form not just the single trust itself.

IRS Private Letter Ruling 201210045, underscores the importance of the "separate account" rule in conjunction with the naming of the beneficiaries of an IRA.

Overview. Often an IRA owner is very concerned with achieving the maximum "stretch-out" of the IRA distributions during his or her remaining life expectancy. Then the IRA owner considers who should be named as the beneficiaries of the IRA in order to receive the IRA balance remaining after the account owner's demise. Several recent letter rulings reflect how trusts, in their various forms, very often serve as a key component of an individual's estate plan, whether that individual is single, married, re-married, or the surviving spouse. Finalizing the terms of such trusts can take a great deal of time, thought, and emotional energy. Thus, it is understandable why such a trust is simply listed as the primary beneficiary of that individual's IRA.

Unfortunately, many recent rulings show the adverse consequences when the "planning" stops there. For example, Ltr. Rul. 201021038 provides a "good" example of how the "traditional" provisions of a family revocable trust, inserted to obtain maximum flexibility, can undercut what should be a primary goal of the IRA owner (i.e., allowing each of the individuals who are beneficiaries of the trust to realize his or her maximum stretch-out of his or her share of the IRA).

Another ruling, Ltr. Rul. 201203033 , also points out the structural issues to be addressed to enable a family trust to qualify as a "see-through" trust so that a surviving spouse can do a "spousal rollover" and the children can transfer their shares to "inherited IRAs." It also shows how a disclaimer can be used to preserve to some, and maybe significant, extent the benefits of being able to "stretch-out" the minimum required distributions over at least one individual beneficiary's life expectancy.

The above two rulings demonstrate how the "see-through" trust rules can be very challenging to adhere to when drafting a family trust and certainly very challenging when applying these rules after the death of the IRA owner. These "see-through" trust rules focus on the requirement that the beneficiaries of a trust may be treated as the "designated beneficiaries" if four requirements are met. The most challenging requirement is that the beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the IRA must be "identifiable." [15]

Even if the beneficiaries are "identifiable," however, each individual beneficiary is not able to use his or her own life expectancy in determining the RMDs. Reg. 1.401(a)(9)-4, Q&A-5(c) provides that if the trust has more than one beneficiary, the rules under Reg. 1.401(a)(9)-5, Q&A-7 determine which beneficiary's life expectancy is used to determine the distribution period.

Reg. 1.401(a)(9)-5, Q&A-7(a), states that if more than one individual is a designated beneficiary, the beneficiary with the shortest life expectancy will be the designated beneficiary for purposes of determining the applicable distribution period.

Separate account rule. The separate account rule generally applies when the IRA owner has listed two or more individuals as the primary beneficiaries of the IRA:

> If the employee's benefit in a defined contribution plan is divided into separate accounts and the beneficiaries with respect to one separate account differ from the beneficiaries with respect to the other separate accounts of the employee under the plan, for years subsequent to the calendar year containing the date as of which the separate accounts were established, or date of death if later, such separate account under the plan is not aggregated with the other separate accounts under the plan in order to determine whether the distributions from such separate account under the plan satisfy section 401(a)(9). *Instead, the rules in section 401(a)(9) separately apply to such separate account under the plan.* However, the applicable distribution period for each such separate account is determined disregarding the other beneficiaries of the employee's benefit *only if the separate account is established on a date no later than the last day of the year following the calendar year of the employee's death.* [Emphasis added.] [16]

With the establishment of the separate account for each individual beneficiary of an IRA, each such individual will be able to use his or her own life expectancy, as set forth in the "Single Life Table" at Reg. 1.401(a)(9)-9, Q&A-1, in calculating the required distributions. Importantly, as indicated, the separate account for each beneficiary must be created by December 31 of the year following the year of the IRA owner's death.

Separate account rule not available to beneficiaries of a trust. What happens when the IRA owner forms a trust and lists the trust as the "beneficiary" on the custodian's beneficiary designation form and the individuals are now named as beneficiaries of the trust? The regulations are clear. Even if the trust satisfies the "see-through" trust rules, the "separate account rules" are not available to these beneficiaries.[17]

Ltr. Rul. 201210045. This ruling provides a good example of where the IRS confirmed that the "see-through" trust rules could be applied so that the individual beneficiaries of the trust could be treated as the "designated beneficiaries" of the decedent's IRA. In addition, the surviving spouse was able to roll over her share of the IRA into her own IRA so that she could use the "Uniform Lifetime Table."[18] The two children were allowed to transfer their respective shares into his or her own "inherited IRA." But the children could not use their own life expectancies under the Single Life Table. Nor could the children use the life expectancy of the oldest sibling. Unfortunately, each child had to use the life expectancy of the surviving spouse. As usual, the ruling does not state the ages of the surviving spouse nor of the children. But it might be reasonable to assume that the surviving spouse was around 20 years older than the oldest child.[19]

Facts of the ruling*.* Bob, the IRA owner, died at age 74 and was survived by his spouse, Amelia, and his two children, Charles and David. Bob had an IRA. Trust T was the designated beneficiary of the IRA.

Under the terms of Trust T, at Bob's death, Amelia would receive one-third of all of Bob's interest in all of the assets of Trust. Charles and David would receive equal shares of the remaining two-thirds interests.

In order to have Trust T treated as a "see-through trust," Amelia represented to the IRS that (1) Trust T was valid under state law, (2) Trust T became irrevocable upon Bob's death, and (3) a copy of Trust T was delivered to the IRA custodian by October 31 of the calendar year following the year of Bob's death.

Amelia requested the following rulings:

1. That the IRA may be divided by means of trustee-to-trustee transfers into an IRA for Amelia in her own name (i.e., Amelia could do a "spousal rollover" of her one-third interest into her own IRA), and into separate IRAs for Charles and David, with each such account in the name of "Bob (the decedent) for the benefit of Trust T," all without resulting in taxable distributions or payments under Section 408(d)(1).

2. That the minimum distribution requirements under Section 401(a)(9) would be met by (a) for the IRA in Amelia's name, applying the Uniform Lifetime Table (referenced above), and (b) for the IRAs set up to benefit Charles and David "(in the name of 'Bob' for the benefit of Trust T)," applying the Single Life Table (referenced above) *using the life expectancy of Amelia* (not the life expectancy of the oldest of Charles or David).

Comment. The remaining discussion will stay primarily focused on Charles and David and their interests in the IRA resulting from them being beneficiaries of Trust T.

The ruling points to the various provisions dealing with "inherited IRAs." Section 408(d)(3)(C) provides, generally, that amounts from an "inherited" IRA cannot be "rolled over" into another IRA. In general, an "inherited" IRA is an IRA maintained by an individual who acquired said IRA by reason of the death of another and such individual is not the surviving spouse of said decedent.

But Revenue Rule 78-406[20] states that the direct transfer of funds from one IRA trustee to another IRA trustee (i.e., a "trustee-to-trustee transfer"), even if at the behest of the IRA holder, is not a payment or distribution to a participant, payee, or distributee, as those terms are used in Section 408(d). Furthermore, such a transfer is not a "rollover distribution." Very importantly, 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. For example, the "transferee IRA" would be titled "Bob Smith (deceased) FBO Charles Smith."

Based on the above, the IRS ruled that the requested division of the interests in the IRA could be done. That is, the IRA could be divided by means of trustee-to-trustee transfers into (1) an IRA for Amelia, in her own name, and (2) "inherited" IRAs for Charles and David, but in the name of "Bob for the benefit of Trust T," with these divisions and transfers not resulting in taxable distributions or payments under Section 408(d)(1).

Inherited IRAs: Whose life expectancy will apply? As indicated above, if two or more individuals are listed as the "designated beneficiaries," each individual can "separate" out his or her specified interest in the decedent's IRA and do a trustee-to-trustee transfer into a newly created "inherited IRA." Thus, each would be able to use his or her own life expectancy under the Single Life Table to determine distributions from the "inherited IRA."

As noted above, however, if the IRA owner simply lists a trust as the designated beneficiary and then has those individuals named as the beneficiaries of the trust, those individuals may well have the ability to do a trustee-to-trustee transfer to newly created "inherited IRAs." But, despite the creation of the separate "inherited IRAs," these individuals must use the life expectancy of the oldest beneficiary of the trust in determining the required distributions.

As a result, with Amelia being the oldest of the named beneficiaries of Trust T and thus having the shortest life expectancy, Charles and David will have to use Amelia's life expectancy under the Single Life Table. With an assumption that Amelia is 20 years older than the oldest of Charles and David, the distributions to Charles and David will be dramatically accelerated and the benefits of tax-deferral, in turn, will be dramatically reduced.

Example. If Amelia was 70 years old in the year after the death of Bob, the "divisor" under the Single Life Table would be 17.0. Assuming Charles and David's share of the IRA was $1 million, the required distribution in the first year (i.e., the year after the year of Bob's death) would be $58,823.

In contrast, assuming Charles was the oldest sibling at age 50, then the divisor would be 34.2. This would result in a required distribution of $29,239. This is about half as much as with having to use Amelia's life expectancy.

Consequently, if tax-deferred growth was a goal of Charles and David (or their father, Bob), the differences in the required distributions over time would be very significant.

Possible solution. An alternative to the above scenario does exist. The alternative involves naming the individual subtrusts that will be created for each individual beneficiary under the main trust when the IRA owner dies directly on the beneficiary designation form that is filed with the IRA custodian. Thus, under the above facts, Bob would have listed the three separate subtrusts that would be created under Trust T at his death rather than simply listing Trust T as the beneficiary. The listing on the beneficiary designation form might be as follows:

Trustee of the Charles Subtrust established under Article XX of the Trust T, dated ______________.

The subtrusts for Amelia and David would be similarly described and listed on the beneficiary designation form.

With the naming of each of the subtrusts under Trust T, the "see-through" trust rules will then be applied to each subtrust. Assuming that Charles is identified as the primary beneficiary of the Charles Subtrust of Trust T, then Charles would be able to use his own life expectancy to determine the required distributions rather than that of Amelia's.

Conclusion. Having trusts serve as the beneficiary of the IRA can provide significant benefits both from the perspective of the IRA owner and the individual IRA beneficiary. But if one of those desired benefits is to provide the maximum "stretch-out" opportunity for each individual beneficiary of a trust, then naming each individual's subtrust as a separate beneficiary on the custodian's beneficiary designation form should be considered.

Planning consideration #9
Key dates need to be considered on the death of the IRA owner.

Treasury Regulation 1.401(a)(9)-4 discusses timing issues for IRAs.

Date of death of the IRA owner. In order to be a designated beneficiary, an individual must be named on the beneficiary designation form that is effective as of the date of death of the IRA owner.[21] Beneficiaries cannot be added after this date. In fact, the IRS has rejected amendments to trusts that have been approved by the local state court after the death of the IRA owner on the basis that the amendment added beneficiaries after the death of the IRA owner and that is not permitted.

September 30 of year after year of IRA owner's death. The IRA owner's designated beneficiary will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the IRA owner's death.[22] Consequently, any person who was a beneficiary as of the date of the IRA owner's death, but is not a beneficiary as of that September 30 (e.g., because the person receives the entire benefit to which the person is entitled before that September 30) is not taken into account in determining the IRA owner's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the IRA owner's death.

This can be very important if the IRA owner listed a charity as one of the beneficiaries. A charity is not a "designated beneficiary," so having the charity remain as a beneficiary until that September 30 would likely eliminate any stretch-out of the RMDs for the other beneficiaries. Therefore it would be very appropriate to pay to the charity its full share of the IRA before that September 30.

In another scenario, the IRA owner listed not only his children but also his older brother (e.g., the older brother is 90 years old in the year of the IRA owner's death). This older brother could disclaim his interest in the IRA in compliance with Section 2518 by that September 30, thereby allowing the much younger children of the IRA owner to receive the benefit in lieu of that brother. By disclaiming, the older brother is not taken into account in determining the IRA owner's designated beneficiary.

An individual who is a beneficiary on the date of death of the IRA owner and dies prior to September 30 of the calendar year following the calendar year of the IRA owner's death without disclaiming continues to be treated as a beneficiary as of that September 30 for purposes of determining the distribution period for required minimum distributions after the IRA owner's death, without regard to the identity of the successor beneficiary who is entitled to distributions as the beneficiary of the deceased beneficiary.

October 15 of year after year of IRA owner's death. If the IRA owner converted a traditional IRA to a Roth IRA in the year of death, it may be appropriate to exercise the right to recharacterize that conversion by the October 15 deadline in the year after death in order to avoid the significant income tax consequences of that conversion.

October 31 of year after year of IRA owner's death. If a trust was named as a beneficiary of the IRA, then a copy of the trust document must be provided to the custodian by October 31 of the year after the year of death of the IRA owner's death. [23]

December 31 of year after year of IRA owner's death ("December 31 date"). If the IRA owner named two or more beneficiaries (e.g., the three children) of the IRA, then each child has the ability to create a "separate account" (i.e., a separate inherited IRA) and then be able to determine his or her own RMD based on his or her own life expectancy and not have the RMD based on the life expectancy of the oldest child. However, the applicable distribution period of each such separate account is determined by disregarding the other beneficiaries only if the separate account is established no later than December 31 of the year after the year of the IRA owner's death.[24] Thus, in order to obtain maximum "stretch-out" of RMDs, the first RMD must be made by the December 31 date if the designated beneficiary is not the spouse of the IRA owner. If the spouse is the sole designated beneficiary, RMDs must commence on or before the later of: (1) the end of the calendar year immediately following the calendar year in which the IRA owner died, and (2) the end of the calendar year in which the IRA owner would have attained age 70½.[25]

Planning consideration #10
Determine the required minimum distribution in the year of the IRA's owner's death.

If the RMD in the year of the IRA owner's death is not fully taken, the balance of the RMD must be distributed to the beneficiary.[26] Failure to take the remaining balance of RMD can result in a 50% penalty. If the remaining RMD is not distributed by December 31 of the year of the IRA owner's death, then IRS Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, will need to be filed. This form does allow for an explanation for why the 50% penalty should be waived.

Planning consideration #11
Options are available when the surviving spouse is the designated beneficiary.

One option available to the surviving spouse of the deceased IRA owner is to roll over the funds from the deceased spouse's IRA into the surviving spouse's own IRA. The advantage for the surviving spouse in being able to do a rollover is that when the surviving spouse reaches the age of 70½, the RMDs can be determined under the Uniform Lifetime Table. As it does for all IRA owners, the Uniform Lifetime Table allows for the distribution period to be based on the age of the surviving spouse in each year and an assumed beneficiary who is ten years younger. This allows for a longer "stretch out" of the RMDs as compared to determining the distribution period solely on the life expectancy of the surviving spouse in any given year, as is done under the Single Life Table.

The alternative for the surviving spouse is to remain as beneficiary of the deceased spouse's IRA. This can be very advantageous to a surviving spouse who is under the age of 59½ and may need to make withdrawals from the inherited IRA because such distributions from the inherited IRA will not be subject to the 10% penalty imposed on distributions from IRAs before the IRA owner reaches 59½. Moreover, the surviving spouse may at any time in the future do a rollover into his or her own IRA, or by certain actions, have the original account become his or her own IRA.

In addition, a special rule applies when a surviving spouse is the only beneficiary of the IRA. In this situation, the RMDs must begin by December 31 of the year after the decedent's death or, if later, December 31 of the year when the decedent would have attained age 70½. [27] This provides the surviving spouse with great flexibility in choosing how much to withdraw, or not withdraw, from the inherited IRA during this period.

Planning consideration #12
Take appropriate steps when a non-spouse is the designated beneficiary and receives an inherited IRA.

A designated beneficiary who is not the deceased IRA owner's spouse must coordinate his or her efforts with the custodian of the IRA in order to create and fund the inherited IRA for this beneficiary from the funds in the deceased's IRA. An IRA is treated as an "inherited IRA" if: (1) the individual for whose benefit the account is maintained acquired such account by reason of the death of another individual, and (2) such individual is not the surviving spouse of such other individual.

Importantly, the name of the deceased IRA owner needs to be included in the title for the inherited IRA. As an example, if John Jones was the owner of the IRA and Susan Jones is the designated beneficiary of that IRA, the inherited IRA ought to be titled as "John Jones (deceased) FBO Susan Jones IRA" or something similar.

Once this inherited IRA is created and funded with this custodian, the beneficiary does have the ability to open an inherited IRA with another custodian. However, the funds from the original inherited IRA can be transferred only by a "trustee-to-trustee" transfer to the inherited IRA with the new custodian because rollovers are not permitted with inherited IRAs.

As described above, if there is more than one designated beneficiary, each designated beneficiary needs to create his or her respective inherited IRA with the custodian by the December 31 date. In addition, each designated beneficiary needs to take the first RMD from the newly created inherited IRA by the December 31 date in order to qualify under the "separate account" rule and thus be able to use his or her own life expectancy to determine the RMD for that year and all subsequent years.

A couple of restrictive provisions apply to an inherited IRA:

1. No contributions can be made into an inherited IRA by the owner of that inherited IRA.

2. The inherited IRA owner may not roll over funds from the inherited IRA into such person's own IRA, and no funds from another IRA of such person can be rolled into that inherited IRA.

Finally, as mentioned above, the designated beneficiary needs to receive the first RMD from his or her inherited IRA by the December 31 date. The RMD for this year and each year thereafter is determined by a fraction. The numerator is the account value on December 31 of the immediately preceding year. The divisor is determined by the life expectancy of the designated beneficiary under the Single Life Table in the Treasury Regulations in the year after the death of the IRA owner. In each year thereafter, the divisor is reduced by one. For example, if the designated beneficiary reaches the age of 50 in the year following the year of death of the IRA owner, then the divisor for that year is 34.2. In each succeeding year, this divisor is reduced by one.

Conclusion

Although IRAs are intended to provide support for the account owner to use during his or her retirement years, funds often remain in these accounts at the time of the owner's death. IRA balances that are not distributed during the owner's lifetime can be significant inheritances for IRA beneficiaries. This increases the complexity of planning for IRAs, presenting opportunities for both pre-mortem and post-mortem planning to transfer the wealth to the intended parties at the lowest tax cost.

[1] Section 408(d)(3)(C).
[2] Section 408(d)(3)(C)(ii).
[3] 114 TC 259 (2000).
[4] 11 USC section 522(n) 11 USC section 522(n).
[5] CA Code of Civ. Proc. §§704.115(b) and (d).
[6] CA Code of Civ. Proc. §704.115(e).
[7] 147 Cal. App. 4th 753 (2007).
[8] CA Code of Civ. Proc. §703.080(a).
[9] CA Code of Civ. Proc. §703.080(b).
[10] 113 AFTR2d 2014-2308.
[11] 674 F.3d 486 109 AFTR2d 2012-1375 (CA-5, 2012).
[12] Reg. 1.401(a)(9)-4 , Q&A-5. Emphasis added.
[13] Reg. 1.401(a)(9)-5 , Q&A-7(c).
[14] 98 TC 294(1992).
[15] The other three requirements are: (1) the trust is valid under state law; (2) the trust is irrevocable, or will, by its terms, become irrevocable upon the death of the IRA owner; and (3) the documentation described in Reg. 1.401(a)(9)-4 , Q&A-6 has been provided to the IRA custodian.
[16] Reg. 1.401(a)(9)-8 , Q&A-2(a)(2).
[17] Reg. 1.401(a)(9)-4 , Q&A-5(c): "However, the separate account rules under A-2 of sec. 1.401(a)(9)-8 are not available to beneficiaries of a trust with respect to the trust's interest in the employee's benefit."
[18] Reg. 1.401(a)(9)-9 , Q&A-2.
[19] This "20-year" age differential is definitely just an assumption because from the structure of the trust, one might assume that the surviving spouse was not the mother of the two children.
[20] 1978-2 CB 157.
[21] Reg. 1.401(a)(9)-4 , Q&A-4.
[22] *Id.*
[23] Reg. 1.401(a)(9)-4 , Q&A-6(b).
[24] Reg. 1.401(a)(9)-8 , Q&A-2(a)(2).
[25] Reg. 1.401(a)(9)-3 , Q&A-3.
[26] Reg. 1.401(a)(9)-5 Q&A-4(a).
[27] Reg. 1.401(a)(9)-3 , Q&A-3.

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