Version 8: 5/31/06

Life and Death Planning for Retirement Benefits, 5th edition, 2003:

Post-Publication Updates and Corrections

This document contains post-publication updates and corrections to the 5th edition of *Life and Death Planning for Retirement Benefits* by Natalie B. Choate, Esq. (Ataxplan Publications, 2003). Each item in this document is dated to show when it was posted at this website. You can search this document by Chapter, section number (if applicable), page number, word, or date posted. Thanks to Deborah Willard, Susan Hartman, Jerry Horn, Lisa Labno, Brenda Sherbine, John Steinkamp, and others who wrote to point out needed corrections.

Note to owners of earlier editions: If you own the 4th edition (2002), you need the updates to the 4th edition (posted at www.ataxplan.com) in addition to the following updates. If you own an earlier edition (pre-2002), you need to buy the 5th edition.

LIST OF UPDATES BY CHAPTER

This contents page provides a quick alert to let you know which chapters have corrections or updates in this document. There are no changes in Chapters 4, 7, 10, or 11, or in any Appendix other than Appendix B.

Chapter 1: ¶ 1.3.02, p. 27: Typo corrected.
¶ 1.5.03, p. 42: Typo corrected.
¶ 1.1.10, p. 80: New IRS rules on IRA providers' MRD reporting obligations.

Chapter 2: ¶ 2.5.02: Clarification added regarding rollover of inherited benefits.
¶ 2.5.03A: IRS's hardship waivers of the 60-day rollover deadline.

Chapter 3: ¶ 3.2.02: PLR 2004-50057 allows spouse to roll benefits to decedent's IRA.
¶ 3.2.06, p. 150. Citation corrected.
¶ 3.3.06, p. 159: Rev. Rul. 2006-26 explains what "income" means.

Chapter 5: New subsection ¶ 5.1.10 added regarding "Abusive Roth IRA transactions."

Chapter 6: Numerous important post-publication updates:
¶ 6.1.06: Additional PLRs blessing transfer of plan from trust to trust beneficiaries.
¶ 6.1.07, p. 272: Rev. Rul. 2006-26: IRS rejects the UPIA 1997 "10 percent rule."
¶ 6.2.04: "See-through trust" definition
¶ 6.2.08: PLR 2004-38044 supports use of disclaimer to cure "unidentifiable beneficiaries" problem.
¶ 6.2.13: PLRs 2004-32027–32029 approve trust as a see-through despite use of benefits to pay taxes and expenses to participant's estate.
¶ 6.3.10: PLR 2004-38044: contingent remainder beneficiary disregarded.
¶ 6.3.13: Separate accounts may not be used for beneficiaries taking through trust.

Chapter 8: ¶ 8.1.03: Substantive error corrected on page 342.
¶ 8.1.09: Rev. Rul. 2005-36 provides guidance on disclaimers of retirement benefits.

¶ 8.3.05 (p. 371), ¶ 8.4.04(E) (p. 381): SIGNIFICANT CHANGES: IRS issues new rules on valuation of life insurance policy distributed or sold to employee by the plan.

Chapter 9: ¶ 9.2.05: PLRs permit annual recalculation in annuity, amortization, SOSEPPs.
¶ 9.2.14, p. 411, second paragraph has a typo: "Form 4329" should be "Form 5329."
¶ 9.3.06, p. 417: PLR 2005-03036: Missed payment due to IRA provider error is not "modification."

Appendix B (Forms): Form 7.3, p. 518: changed to correct typo.

LIST OF UPDATES BY DATE POSTED

Here is a list of updates, by date posted (so if you check the website periodically you can tell which updates you already have and which are new):

June, 2006

¶ 3.3.06, p. 159: Rev. Rul. 2006-26 explains what "income" means.
¶ 6.1.07, p. 272: Rev. Rul. 2006-26: IRS rejects the UPIA 1997 "10 percent rule."

December, 2005

¶ 8.1.09: In June, 2005, the IRS issued Rev. Rul. 2005-36, providing substantial information about partial disclaimers of retirement benefits.

¶ 8.3, ¶ 8.4: Since publication of the 5th edition, the IRS has significantly changed the rules for valuation of a life insurance policy that is distributed (or sold) by a qualified plan to the participant or beneficiaries. These changes affect the following sections of the 5th edition: ¶ 8.3.04–¶ 8.3.06, ¶ 8.4. The changes have gone through several stages; the most recent are represented by (final) Reg. § 1.402(a)-1(a)(1)(iii) and Rev. Proc. 2005-25, discussed below.

April 13, 2005

¶ 2.5.03A (added 2/24/04), *further updated* regarding PLRs waiving 60-day rollover deadline; see PLR 2005-02050, page 8 of this update.
¶ 3.2.02: PLR 2004-50057 allows spouse to roll benefits to decedent's IRA.
¶ 3.2.06, p. 150: PLR citation corrected.
¶ 6.1.06, p. 269: Additional PLRs blessing transfer of retirement plan, intact, from trust to trust beneficiaries.
¶ 6.2.04: "See-through trust" definition
¶ 6.2.08: PLR 2004-38044 supports use of disclaimer to cure "unidentifiable beneficiaries" problem.
¶ 6.2.13: PLRs 2004-32027–32029 approve trust as a see-through despite use of benefits to pay taxes and expenses to participant's estate.
¶ 6.3.13 (added 7/1/2003), updated to add complete citation for article referred to in the update.
¶ 9.2.05: PLRs permit annual recalculation in annuity, amortization, SOSEPPs.
¶ 9.3.06, p. 417: PLR 2005-03036: Missed payment due to IRA provider error is not "modification."

February 24, 2004

¶ 1.3.00, p. 27: typos corrected.
¶ 1.5.03, p. 42: citation corrected.
¶ 1.1.10, p. 80: New IRS rules on IRA providers' MRD reporting obligations.
¶ 2.5.02: Clarification added regarding rollover of inherited benefits.
¶ 2.5.03: New material added regarding hardship waivers of the 60-day rollover deadline.
¶ 5.1.10: New subsection: Abusive Roth IRA transactions.
¶ 8.1.03, p. 342: Disclaimers: Error corrected regarding need to comply with state law.
¶ 8.3.05, p. 371; ¶ 8.4.04(E), p. 381: SIGNIFICANT CHANGES: IRS issues new rules on valuation of life insurance policy distributed or sold to employee by the plan.

July 7, 2003

¶ 8.4.04(E), p. 382: Complete citation provided for article.
¶ 9.2.14, p. 411: Second paragraph has a typo: "Form 4329" should be "Form 5329."

July 1, 2003

¶ 6.3.13 (pages 302-303): IMPORTANT UPDATE based on post-publication PLRs!!! The IRS has changed the rules regarding separate accounts treatment for benefits payable to trusts. This is a very significant update.
Form 7.3, p. 518: Typo corrected in form.

Supplement to Life and Death Planning for Retirement Benefits, 5th Edition 2003: Post-Publication Updates and Corrections

Chapter 1: The Minimum Distribution Rules:

¶ 1.3.00, last paragraph, page 27: The second sentence of this paragraph contains typographical errors. The birthday at the beginning of the sentence should be "December 31, 1932" (not 1933), and the age at the end of the sentence should be "71" (not 70).

¶ 1.5.03, page 42, typo: 3rd and 4th line from the bottom of the page: Citation should read "Reg. § 1.401(a)(9)-5, A-4(a)" (not Reg. § 1.401(a)(9)-5, A-4(a)(1)).

¶ 1.10.01, page 81: POST-PUBLICATION UPDATE: Add at end of this subsection (on page 82):

The IRS instructions to IRA providers regarding their MRD reporting obligations are contained in IRS Notice 2002-27, 2002-16 IRB 0, as clarified by IRS Notice 2003-3, 2003-2 IRB 258. The IRA provider must provide certain notices regarding an IRA "if a minimum distribution is required with respect to" such IRA for the "calendar year, and the IRA owner is alive at the beginning of the year," and the IRA provider held the account on December 31 of the preceding year. The IRA provider must notify both the IRA owner (Participant) and the IRS.

These notice requirements do NOT apply "at this time" to 403(b) contracts, Roth IRAs, or inherited IRAs. So, for now, there is no obligation to annually notify IRA beneficiaries or 403(b) contract owners of their MRD obligations. Also, obviously, the notice requirements do not apply to the account of an IRA owner who is below the age at which he must start taking MRDs.

Here is a summary of the requirements as they apply for 2004 and later years:

Notice to the IRA owner: Each year, no later than January 31, the IRA provider must notify each Participant for whose account a minimum distribution is required for such year, and who is living on January 1 of the year. In the notice, the IRA provider must inform the Participant that the IRA provider is telling the IRS that the Participant is required to take an MRD from the account for the year; must tell the Participant the deadline for taking the year's MRD; and must EITHER:

1. Furnish the Participant with a statement showing the amount of the MRD. Note however, this amount could be misleading, because the IRA provider is entitled to assume, for purposes of this notice, that the beneficiary of the account is NOT a more-than-10-years-younger spouse, and also is entitled to ignore rollover amounts received into the IRA after the prior year-end, even though they may have to be included in the account balance to calculate the "real" MRD. Thus, the MRD stated in the IRA provider's notice to the Participant could be overstated (if the Participant's sole beneficiary is his more-than-10-years-younger spouse; see ¶ 1.4.02), or understated (if there were rollover deposits in transit to this account as of the prior year-end; see ¶ 1.2.08); OR

2. Simply tell the Participant that an MRD is required, and offer to calculate it for him. If the Participant accepts the offer, the IRA provider must calculate the MRD for the Participant and report the resulting amount to the Participant. Regarding these calculations, the Notice does not say that the IRA provider can ignore the actual facts (such as a more-than-10-years-younger spouse beneficiary, or rollover-in-transit).

The IRA provider is not required to treat all its customers the same; it can send the estimated MRD calculation to some of its IRA holders and just the "offer to calculate" to others.

Notice to the IRS: The IRA provider must inform the IRS that an MRD is required with respect to the IRA. The notice must be filed by January 31 of the year in question, the same deadline that applies to the IRA provider's annual report to the IRS of the prior year-end balance of the IRA. Both reports are combined on Form 5498. So, e.g., the Form 5498 for a particular IRA for the year 2003 will be filed by January 31, 2004, and it will show the 12/31/2003 account balance and also indicate that an MRD is required for the year 2004 (but will not have to state the amount of that MRD).

What about the first year? The year the Participant reaches age 70½ is his first "distribution year." Technically a distribution is required "for" that year, even though the deadline for taking that distributions is not until April 1 of the following year. Is the IRA provider nevertheless supposed to check the "distribution required" box on Form 5498? If it does so, there

may be unnecessary audits as the IRS chases people who it thought were required to take MRDs but who were actually legally postponing them until the following year.

[end of new material added to ¶ 1.10.02]

Chapter 2: Income Tax Issues:

¶ 2.5.02, page 131: For clarification, add the following new item at the end of the numbered list (on page 132):

6. Distributions from an inherited plan cannot be rolled over except by the surviving spouse. See ¶ 2.5.05, ¶ 3.2.

¶ 2.5.03, pages132–133: POST-PUBLICATION UPDATE: Add the following new subsection after ¶ 2.5.03:

¶ 2.5.03A: Experience with the IRS's granting waivers of 60-day deadline

When the 5th edition of *Life and Death Planning for Retirement Benefits* went to press (early 2003), the IRS had just issued Rev. Proc. 2003-16, allowing taxpayers to submit requests for letter rulings waiving the 60-day rollover deadline on a case-by-case basis for reasons of hardship. Not until late 2003 did the IRS start granting case-by-case hardship waivers. The trickle of PLRs on this subject quickly turned into a flood. Here is a summary of the types of reasons the IRS is granting—or denying—waivers.

Through early 2004, all the rulings were positive (granting waivers) and involved requests by the participant him or herself. All the positive rulings granted to participants involved institutional errors and/or confusion, trauma or other difficulties experienced by the participant. See Item #1. By mid-2004, we also had some denials. The denials make it clear that the IRS does NOT approve of the use of an IRA as a short-term financing source; see Item #2. We also now are seeing requests for waivers, made after the participant's death, to roll over a distribution made to the participant. The IRS allows some and denies some, with rationales not very clear in either case. See Item #3.

1. PLRs that granted waivers to the participant (summarizing the circumstances):

A. Money withdrawn from IRA was placed in a regular (taxable) account when it should have been rolled into an IRA; error not discovered until after 60 days had elapsed; and the error or misunderstanding was due to:

IRA-provider's error and Participant's lack of experience. 2004-07023.

IRA-provider's error and Participant's mental confusion and hearing loss. 2004-07025.

IRA-provider which received the intended Roth IRA rollover didn't have Roth IRA accounts so put it in a taxable account without telling Participant. 2004-03098.

Bank failed to follow Participant's instructions to open an IRA and complete the rollover. Bank denied receiving such instructions, but IRS still granted the waiver. 2004-04056.

New investment advisor forgot that part of the money he received from Participant's former investment advisor was Roth IRA funds and needed to be rolled to another Roth IRA. 2004-03099.

New investment advisor or bank inadvertently established a regular taxable account instead of an IRA with funds transferred from prior investment advisor or bank. 2004-02028, 2004-04053, 2004-01023, 2004-20035.

Bank failed to follow Participant's instructions to open an IRA and complete the rollover. Taxpayer didn't find out until too late. 2004-20034.

B. The original withdrawal or distribution was unintentional, involuntary, and/or misunderstood, and its existence or true nature was not discovered after 60 days had elapsed; reason for this delay was:

Surviving spouse received IRA distribution, believed it was life insurance proceeds and so did not roll it over; her poor health contributed to the misunderstanding. 2004-06050.

Surviving spouse received IRA distribution, believed (due to erroneous professional advice) that it was not taxable, and so did not roll it over. 2004-06050.

Participant's plan account was cashed out involuntarily; he had no knowledge of the distribution (never received the check) until he received Form 1099 the next year. 2004-06051.

Participant undergoing radiation and chemotherapy was told by bank "your CD is maturing." He requested proceeds, which were sent to him; bank didn't tell him the CD was in an IRA, so he didn't realize he needed to roll it over. 2004-05014.

Participant's plan account was cashed out involuntarily; with no knowledge of the nature of the distribution, he deposited it, then couldn't attend to it because he was abroad in the military. 2004-05013.

Plan administrator issued check to surviving spouse "without advance notice or an application," spouse was suffering from emotional stress and was confused. 2004-05012.

Problems with custodian caused distribution and/or prevented completion of rollover. 2004-04054.

Participant (recently divorced) requested distribution from his taxable account to buy a house; bank erroneously took the money from the IRA instead of taxable account. 2004-01020.

Participant had serious hearing impairment and wasn't wearing hearing aid during the meeting at which the IRA distribution was discussed, was confused, found the experience stressful and embarrassing, and thought it was just an "investment change." Late rollover allowed because taxable distribution was not his intent. 2004-10027.

Elderly blind participant with a number of health problems miscalculated MRD and took too much. Son who helped with finances tried to arrange rollover of excess but was called away for military duty before he could complete it. 2004-21006.

Mutual fund went out of biz, sent IRA check to participant (instead of to the IRA custodian), and neither the fund nor the custodian ever gave her any explanation or advised her of the tax effects. She deposited check in a taxable account; error discovered when she received 1099-R. IRS noted "the funds remained deposited…and were not used for personal expenses." 2004-21009.

Participant requested partial distribution, IRA provider erroneously closed the account and transferred entire amount to P's taxable account. Error discovered when 1099-R received. 2004-21008.

Old IRA was cashed out because provider stopped handling SIMPLE IRAs, new custodian returned the rollover check because it erroneously believed a non-U.S. resident could not roll over, by then the 60 days were up. 2004-09039.

C. Participant mentally or medically impaired when he made the withdrawal:

Mental impairment of Participant; guardian unaware of withdrawal. 2004-06055, 2004-01025.

Due to depression, Participant unable to understand finances when he withdrew funds from IRA. 2004-06049.

Surviving spouse was confused and suffering due to surgery and lengthy hospitalization, "thus, she did not act reasonably nor with prudence" (to complete a rollover of deceased spouse's retirement plan). 2004-02029.

Medical condition caused participant to fail to remember or understand the importance of rolling over. 2004-18052.

D. Taxpayer took the withdrawal intentionally, but was prevented by hardship from completing the rollover on a timely basis; the hardship was:

Turmoil caused by spouse's injury and hospitalization. 2004-06056.

Stress caused by spouse's hospitalization and surgery. 2004-06052.

Turmoil caused by disability (stroke), relocating (due to the disability), and repairs to new home. 2004-04051.

Company soliciting the rollover failed to mention the 60-day limit; and during the 60 days taxpayer endured cancer surgery and treatments, anguish from this and recent family deaths, which "rendered her unable to consummate the rollover" on time. 2004-12002.

Taxpayer did the rollover on the internet, intended to roll over to an IRA but clicked the wrong button, money went to a taxable account. The choice of buttons "were not obviously identifiable" as IRA or non-IRA, and there were no warning or other "obvious indications" that he was moving $$ to a taxable account. Taxpayer has made no withdrawals from the erroneously opened account. Error discovered the following year. 2004-19032.

Extensive home damage from Tropical Storm Gabriel and resulting illness (caused by mold caused by storm). It is not entirely clear in this PLR whether the withdrawal occurred before or after the storm. 2004-22054.

Illnesses of taxpayer's two children, who "fell into depression" 16 and four days (respectively) before the 60-day deadline; taxpayer's concern and involvement with the treatment caused him to miss the deadline. 2004-22057.

E. "Dog ate my homework" (waivers granted despite a not-very-heartrending excuse)

Taxpayer intended to roll over on the 60th day, but was prevented from leaving her house on that day by a blizzard. 2004-06054.

On day 58, taxpayer attempt to complete the rollover, but custodian closed early due to Labor Day weekend, and by the time they opened (Tuesday) it was day 62! 2004-11052.

Taxpayer believed he had 90 days to roll over, error discovered on day 75. 2004-21007.

2. Waivers requested by Participant, denied by IRS

A. Taxpayer used plan as source of financing

Unemployed taxpayer lost his car to repossession, turned down for loans at several places, took money from IRA to stave off home foreclosure. Eventually received funds from mother, tried to roll those back into the IRA (102 days after the distribution). Waiver denied. "…you used [your IRA distribution] as a personal loan to pay off a personal debt…you did not have the intent to rollover the distribution…" This was not Congress's intent regarding rollovers (which was to improve portability between retirement plans). 2002-22053.

B. Other denials (requests for rollover during P's life)

Taxpayer withdrew from IRA in erroneous belief that the taxable income generated by those distributions could be offset against his capital losses (in his non-IRA accounts), and thus the distributions would be essentially tax-free. When he discovered that the capital losses could not be used to offset IRA distribution income, he sought to roll the distributions back into the IRA, late. The IRS refused to waive the 60-day deadline, saying "you did not intend to roll over your distribution…you withdrew…in order to minimize your investment losses…." IRS also noted taxpayer had been advised to consult a tax specialist and had not done so (until too late). 2004-22058.

3. Waivers requested by survivors, after Participant's death

A. Waiver allowed

Surviving spouse, as sole beneficiary of decedent's estate, received a distribution of his IRA annuity that was payable to the estate. Her investment advisor "incorrectly advised" her that the distribution was not taxable, so she did not roll it over. She did not discover error until she received the 1099-R. IRS found "substantial hardship," and that spouse "could not reasonably satisfy" the 60-day rollover requirement in view of this erroneous advice. 2004-05017.

Decedent was hospitalized after receiving total distribution of an IRA of which spouse had been the beneficiary, and died (apparently within the 60-day period, though that's not 100% clear). Spouse opened a "rollover IRA" in her name as surviving spouse. IRS granted waiver, since decedent's failure to complete the rollover was due to his "illness and subsequent death." Strange aspects of this ruling: the IRS does NOT recite that decedent had intended to roll over the distribution, and it does NOT recite who were the executors and beneficiaries of decedent's estate. Since the executor would have control of the funds not rolled over, and the estate beneficiaries would have beneficial ownership of those funds, allowing a rollover by the spouse with no mention of the other parties who had an interest in the funds is…odd. 2004-20037.

B. Waiver denied

Surviving spouse-beneficiary signed election form for decedent's IRA, requesting distribution. IRA provider gave her no explanation or information regarding distribution options.

She deposited distribution in a savings account. Only when she received 1099-R did she learn tax effects and that she could have rolled over. IRS denied waiver saying "you relied solely on the custodian information regarding the IRA C distribution" (so what?), and "Using an IRA distribution as a deposit to a savings account is not consistent" with Congress's intent "to allow portability between retirement plans" (HUH?????). This lady should have cited mental stress from loss of spouse, but seems to have been treated very unfairly if you compare PLRs 2004-05017. 2004-21003.

[The following was added to this update in April 2005]:

C. PLR 2005-02050: First PLR allowing post-death rollover of a pre-death distribution granted to someone **other than** the surviving spouse.

In PLR 2005-02050, for the first time, the IRS allowed an executor who was not the decedent's surviving spouse to complete a rollover that was initiated, but not completed, by the decedent prior to her death. Until this PLR came out, the IRS had denied all requests for post-death rollovers of pre-death distributions unless the request came from the decedent's surviving spouse. What was different this time, causing the IRS to allow a post-death rollover by a nonspouse? In this PLR, the pre-death distribution was the result of an IRA provider error; the decedent had not even requested the distribution and she had been trying to get the error corrected when death intervened.

Until now, when a waiver was requested by someone other than the surviving spouse, the IRS said no. See, e.g., PLR 2004-15011, where the decedent's executor (his son) attempted to return, to the decedent's IRA, funds the decedent had withdrawn prior to death. The IRS pointed out that, under § 408(d)(3), a distribution to the account owner can only be rolled into a plan "for the benefit of" the same individual (or his surviving spouse). Rolling over to an account for the benefit of the IRA owner was impossible because he was now dead, and the executor was not the surviving spouse, therefore there could be no rollover.

Practitioners speculated that this rigid attitude might change *if* the IRS were presented with the right facts, namely, a case in which a participant was actively attempting to roll over a distribution and was prevented from completing the rollover by death. PLRs up to this point did not mention that the decedent had been attempting to roll the distribution over, just that the participant had received a distribution and the survivors wanted to roll it over.

Finally, PLR 2005-02050 has presented the right facts. "Taxpayer A" had requested the direct plan-to-plan transfer of "Amount E" from certain IRAs (maintained with Company C) to IRA Z (at Company D). The transferor-IRA provider (Company C) by mistake withheld income taxes from Amount E, so only a part of the funds ("Amount H") was sent directly to the transferee IRA at Company D; Company C sent the balance ("Amount I") directly to the IRS as withheld income taxes.

The withheld income taxes clearly constituted a distribution from the transferor IRA, but Taxpayer A apparently did not notice this error until preparing her income tax. "At no time did Taxpayer A have control of any" of the funds involved. "Prior to her death, Taxpayer A had contacted Company D on more than one occasion in attempts to reverse Company C's error," but the error had still not been fixed when Taxpayer A died on August 31. Her executor deposited "Amount I" into the IRA it was supposed to have been sent to originally, and sought a hardship waiver blessing this deposit as a tax-free rollover of Amount I. The IRS granted the request.

Significantly, the IRS notes that Taxpayer A "had the intent" to transfer the entire amount by trustee-to-trustee transfer, and would have done so but for an error on the part of one of the IRA providers "which was beyond the control of Taxpayer A." She died "in the process of, but prior to, rectifying the error made by" the IRA provider. In addition to the decedent's clear intent, this ruling involved a distribution that the decedent had not even requested in the first place—the distribution was made in error by the IRA provider. The now history of hardship waivers (2003–2005) shows that the IRS has strong sympathy for taxpayers whose problems are caused by the errors of IRA providers or professional advisors.

Nevertheless, the result in this PLR is incompatible with the IRS's pronouncements in prior PLRs denying rollovers by nonspouse survivors. Just as in PLR 2004-15011, rolling over to an account for the benefit of the IRA owner was impossible (because she was now dead), and the executor requesting the ruling was not the surviving spouse, so according to § 408(d)(3) (as interpreted in PLR 2004-15011) there could be no rollover here…and yet the IRS allowed it!

Implications for practitioners: The result in this PLR is good new and bad news for executors. The good news is that the door is open, post-death, for survivors to fix the type of error that confronted Taxpayer A, which is certainly a fair and desirable result. However, the larger implications are mixed.

For one thing, could the executor have completed the rollover *without* getting an IRS waiver, if he had been able to do so within 60 days after the original distribution? If not, why not? Is the IRS in this ruling really just granting a waiver of the 60-day deadline, or are they also granting permission for a transaction that could not occur absent their blessing, namely, a rollover by someone other than the participant or surviving spouse? If this ruling is (as it purports to be) merely a hardship-based deadline waiver, then why can't any executor complete a rollover of any distribution received by his decedent, so long as the rollover is completed within 60 days after the original distribution—regardless of whether the decedent intended to roll over that distribution?

Another thing: In PLR 2005-02050, it was clear which IRA was supposed to receive "Amount I," and the decedent had already designated a beneficiary for that IRA prior to her death. But in other cases there may be more than one IRA which potentially could receive the distribution and they may have different beneficiaries; which IRA would the executor choose? Even if there is only one possible IRA to receive the rollover, what if the IRA beneficiaries and the estate beneficiaries are not the same people? How can the executor diminish the estate to benefit the IRA beneficiaries?

Perhaps the IRS is doing us a favor if it limits these post-death rollovers to cases in which the decedent was clearly attempting to roll the distribution over to a particular IRA prior to death.

If the decedent was attempting to roll over the distribution at the time of death, but had not yet created the recipient IRA account, the executor might be able to open the IRA but could not name a beneficiary. The IRS in PLR 2005-02050 says that the IRA that receives the distribution will have a "designated beneficiary" for minimum distribution purposes only if the decedent had designated individual beneficiaries for it prior to her death. "You, as personal representative of Taxpayer A's estate, cannot 'designate' a Code section 401(a)(9) beneficiary of IRA Z."

Conclusion: Consistent with the legislative history of EGTRRA and with the IRS's policy pronouncements in Rev. Proc. 2003-16, PLR 2005-02050 produced a fair result when the decedent

was the victim of an IRA provider error that she was unable to get corrected prior to her death. If this apparent expansion of the post-death rollover possibilities is limited to that situation, it will be a blessing.

Chapter 3: Marital Matters

¶ 3.2.02: PLR 2004-50057 allows spouse to roll benefits to decedent's IRA.

Insert the following at the end of the second full paragraph on page 147 (which begins "Finally, she could…):

Or, she could roll the funds into an IRA in the decedent's name, thus preserving their penalty-free character as death benefits, according to PLR 2004-50057. In that ruling the spouse did not want to roll over to her own IRA because she was under age 59½ and wanted to continue to have penalty-free access to the funds, which were in a qualified plan that required her to take a lump sum distribution. She opened an IRA in the name of the deceased participant and rolled the lump sum distribution over to that newly-opened IRA.

¶ 3.2.06, p. 150, last line: Typo: PLR 2001-01018 should be PLR 2001-01038.

¶ 3.3.06, p. 159: Rev. Rul. 2006-26 explains what "income" means.

In Revenue Ruling 2006-26, 2006-22 I.R.B.____(5/4/2006), the IRS added an important detail to its long-standing rule (explained in ¶ 3.3.05) that, when an IRA or other retirement plan is payable to a marital deduction trust, both the plan and the trust must qualify for the marital deduction, because the IRS considers the plan to be a separate item of "qualified terminable interest property" (QTIP). The new addition is the definition of what is the "income" the spouse is entitled to with respect to that IRA or plan payable to the marital trust.

Rev. Rul. 2006-26 says that the income the spouse is entitled to, with respect to an IRA or other retirement plan payable to a marital trust (the "IRA"), is either the IRA's internal investment income (i.e., its traditional trust accounting income, as if the IRA were a "trust-within-a-trust") or (if, pursuant to state law, the trust is using an IRS-acceptable "unitrust" accounting method for the IRA) it is the "unitrust" percentage of the IRA. An IRS-acceptable unitrust provision under state law is one which calls for distribution of an annual percentage of the trust's value, where the percentage is not less than three nor more than five percent. See Reg. § 1.643(b)-1.

As explained at ¶ 6.1.07 (see pp. 272–273), some states have adopted the Uniform Principal and Income Act of 1997 (UPIA 1997), which provides its own trust accounting rule for retirement benefits payable to a trust. The UPIA 1997 rule is that 10 percent of any required plan distribution (MRD) is allocated to income; all other distributions (i.e., 90% of any MRD and 100% of other distributions) are allocated to principal. In Rev. Rul. 2006-26, the IRS announced that the 10 percent rule does NOT meet the standards for an acceptable definition of income under the IRS's final regulations on this subject (Reg. § 1.643(b)-1) which was issued in 2004. I predicted this result in my article "Trustees' Dilemma with Section 643," *Trusts & Estates*, Vol. 143, No. 7, July 2004, p. 26.

Even though UPIA 1997 contains a marital deduction savings clause, and even though UPIA 1997 permits the trustee to make some adjustments between income and principal (of which the IRS speaks approvingly), the IRS did not find that these provisions overcame the defect of the 10 percent rule, namely, that the 10 percent rule does not provide a suitable allocation of total return between the income and remainder beneficiaries. **Thus a trust that uses the 10 percent rule to determine the spouse's income with respect to the IRA does not qualify for the marital deduction.**

However, the Rev. Rul. 2006-26 holds that a trust DOES qualify for the marital deduction, even in a state that has adopted UPIA 1997 with the 10 percent rule, **if the trust instrument specifies that the spouse is entitled to "the income of the IRA"** in addition to "the income of the trust."

The IRS logic is as follows: The IRA is a separate item of QTIP. The IRS considers it self-evident that "the income of the IRA" means either the IRA's internal trust accounting income (trust-within-a-trust approach) or the unitrust percentage of the IRA's value (if a trust is using unitrust accounting). Therefore, says the IRS, if the trust specifically states that the spouse is entitled to the income of the IRA, then the trustee is obligated to distribute to her (either automatically or upon her request, depending on the particular trust terms) the IRA's internal income (or the unitrust percentage)…regardless of whether the 10 percent rule otherwise applies to the trust!

Accordingly, any marital trust that contains the magic words to the effect that the surviving spouse is entitled to the income of any retirement plan payable to the marital trust does NOT need to be amended on account of Rev. Rul. 2006-26. THIS LANGUAGE HAS BEEN PART OF THE SAMPLE FORMS IN APPENDIX B OF *Life and Death Planning for Retirement Benefits* THROUGH ALL EDITIONS, BEGINNING WITH THE FIRST (1996).

If a marital trust does not contain those magic words, it may *still* not need to be amended, if the UPIA 1997 10 percent rule does not apply. The 10 percent rule does not apply if: the trust has its own IRS-acceptable definition of trust accounting income with respect to retirement benefits payable to the trust; or the state whose law governs the trust either has not adopted UPIA 1997 at all, or has adopted UPIA 1997 but without the 10 percent rule. Each practitioner whose marital trust documents do not include the magic words will have to check his or her state's law on this point. A majority of the states have adopted UPIA 1997 with its 10 percent rule unchanged; practitioners in those states will have to check their documents (or perhaps get their legislatures to fix the law).

Chapter 5: Roth IRAs

POST-PUBLICATION UPDATE: Immediately following ¶ 5.1.09, on page 216, add the following new subsection (this material first appeared as an article in *Trusts & Estates* magazine):

¶ *5.1.10 Abusive Roth IRA transactions*

It's a shame when promoters turn a legitimate retirement savings vehicle into an "abusive" tax shelter, but that's what has happened with Roth IRAs. The IRS has now given notice that certain transactions involving Roth IRAs will be treated as "listed transactions" (also known as tax shelters) under § 6011, and that the IRS intends to attack them on several fronts.

Here is the abuse that caught the IRS's attention (perhaps due to the article "The Secret Life of a Retirement Account" by Lynnley Browning and David Cay Johnston in the *New York Times,*

Nov. 11, 2003). The taxpayer owns a "pre-existing business" (such as a corporation or proprietorship) and also owns a Roth IRA. The Roth IRA in turn owns "substantially all" the shares of another corporation (the "Roth-owned corporation"). The pre-existing business and the Roth-owned corporation do business with each other.

Strangely enough, even though the same hard-nosed businessman controls both sides of these deals, the Roth-owned corporation always gets the better end of the stick, and the pre-existing business always gets snookered. Specifically, according to the IRS, goods, services, and shares are "not fairly valued" in the transactions between the pre-existing business and the Roth-owned corporation, with the result that value is shifted into the Roth IRA. Since Roth IRA distributions are generally income tax-free, the taxpayer's prize for cheating himself in business deals is to decrease his taxable gains from the pre-existing business and increase his tax-free income from the Roth IRA.

In Notice 2004-8, 2004-4 IRB ____, the IRS declares that these maneuvers are "tax avoidance transactions," and will be treated as "listed transactions" under Reg. § 1.6011-4(b)(2) effective December 31, 2003. The notice covers any "similar transactions" involving multiple Roth IRAs and business entities controlled by related parties.

Treatment as a listed transaction entails, for openers, a host of disclosure, registration, and reporting requirements that are not daily fare for most estate planners. For example, the "organizers and managers" of the tax shelter must register the tax shelter with the IRS. Reg. § 1.301.6111-1T. That requirement may apply retroactively in the case of "confidential" tax arrangements that meet certain fee levels. Reg. § 1.301.6111-2(b)(2). The organizers must maintain a list of their customers for IRS inspection. Reg. § 1.301.6112-1. The individual taxpayer must attach a disclosure statement to his tax return. Reg. § 1.6011-4.

The IRS named several Code provisions it will use to attack these transactions, including some that I had predicted in my article"Retirement Benefits: Unexpected Drama," Vol. 143 *Trusts & Estates* No. 1 (Jan. 2004), p. 40), such as prohibited transactions and IRA contributions in excess of statutory limits. They also will use some other attack lines I didn't think of, such as reallocation of income under § 482, disallowance of deductions, and constructive dividends. For example, the IRS might treat a payment from the pre-existing business to the Roth IRA not as a deductible business expense but rather as a distribution to the business owner (taxable dividend) followed by a contribution of the same amount to the Roth IRA (generating excise tax for excess IRA contribution).

Sadly, these abusive transactions have been promoted by some big-name firms and might encourage Congress to kill what was the best (legitimate) tax shelter ever for "the little guy."

Chapter 6: Trusts as Beneficiaries of Retirement Benefits:

Since publication of the 5th edition of *Life and Death Planning for Retirement Benefits*, the IRS has issued numerous PLRs on the subject of trusts as beneficiaries of retirement benefits, necessitating the following post-publication updates:

¶ 6.1.06: Additional PLRs blessing transfer of retirement plan, intact, from trust to trust beneficiaries. Since PLR 2001-31033 (discussed on page 269), there have been numerous other PLRs approving the transfer of a retirement plan, intact, from a trust to the beneficiaries of the trust. See, e.g., PLRs 2004-32027–32029.

¶ 6.1.07, p. 272: Rev. Rul. 2006-26: IRS rejects the UPIA 1997 "10 percent rule." See discussion above under the update for ¶ 3.3.06.

¶ 6.2.04: "See-through trust" definition. The IRS calls a trust that passes all these rules a "see-through trust," because the effect of passing the rules is that the IRS will look through, or see through, the trust entity and treat the trust beneficiaries as the Participant's "designated beneficiaries," as if they had been named directly as beneficiaries of the retirement plan.

¶ 6.2.08: PLR supports use of disclaimer to cure "unidentifiable beneficiaries" problem. In PLR 2004-38044, benefits were left to a trust that was to pay income to Spouse for life. On Spouse's death, the trust gave Spouse the power to appoint the trust principal on her death to Taxpayer A's lineal descendants "and their spouses." The existence of this power would cause the trust to violate the rule that it must be possible to identify who is the oldest trust beneficiary. The spouse disclaimed the power of appointment, thus causing the power to be disregarded in applying the trust rules, and the IRS approved the trust as a "see-through."

¶ 6.2.13: PLRs 2004-32027–32029 approve trust as a see-through despite use of benefits to pay taxes and expenses to participant's estate, where all amounts estimated to be needed for this purpose were withdrawn form the IRA prior to September 30 of year after year of death.

PLRs 2004-32027–32029 confirm that, even if the Participant's estate is considered a beneficiary of the trust by virtue of its right to receive funds from the trust for payment of debts, expenses, and taxes, it can be removed as a beneficiary by complete distribution of its share by September 30 of the year after the year of death. In this PLR, "as of" September 30 of the year after the year of the Participant's death, the trustee had withdrawn, from the IRA that was payable to the trust (the IRA was the trust's major asset), a sufficient amount to pay all anticipated debts, expenses and taxes of the Participant's estate (including a reserve for income taxes that would be due on the IRA distributions themselves). The IRS blessed the trust as a see-through. From the PLR:

"In this regard, we note that amounts sufficient to pay then known expenses and taxes associated with Taxpayer A's death and with his estate were withdrawn from IRA X *no later than* September 30, 2003.…After careful consideration of the facts in this case, we believe that it is appropriate to treat said fact pattern as coming within § 1.401(a)(9)-4 of the 'Final' regulations, Q&A-4(a).…on September 30, 2003, the only remaining beneficiaries of Trust T were [the three children]…." Emphasis added.

The IRS even conceded that the trust's contingent liability to pay additional estate taxes in the future (for example, if the tax bill went higher as a result of audit) did not disqualify the trust, despite the fact that such additional tax payments would have to come out of the IRA after the magic September 30th date:

"Additional amounts will be used to pay estate taxes [after 9/30] only if there is a determination that additional estate taxes are due and there are no remaining assets of the estate to pay the taxes.…[O]n September 30, 2003, the only remaining beneficiaries of Trust T were [the

three children]…. The use of Trust T assets to pay expenses associated with the administration of Trust T (in effect, expenses associated with the administration of the Trust T assets for the benefit of [the three children]…or the possibility, under these facts, that Trust T assets may be required to be used to pay any estate taxes due, in addition to the amount reported on Form 706, does not change this conclusion."

¶ 6.3.10: PLR 2004-38044 blesses "snapshot" approach to testing trust: contingent remainder beneficiary (who takes only if prior outright remainder beneficiary dies before the income beneficiary) is disregarded.

In ¶ 6.3.10, delete the last four lines on page 296, the first four lines at the top of page 297, and the first sentence of the first full paragraph on page 297, and substitute the following:

Many practitioners assume that in this example we are entitled to disregard Charity X, because Peter receives his interest outright at Anita's death, so Charity X is a "mere potential successor" to Peter. This theory has been called the "snapshot" approach, because in essence it takes a "snapshot" of all the beneficiaries as of the moment of the participant's death, and applies the test to that group, disregarding contingencies that may occur later. Any beneficiary who, viewed as of the time of the Participant's death, has a "limited" interest (such as a life income interest) counts as a beneficiary. Beneficiaries who would take the trust property outright if the limited-interest beneficiary's interest terminated immediately also count; but we do not have to look beyond the list of existing beneficiaries who would take the trust property outright upon the termination of the interests of the limited-interest beneficiaries.

PLR 2004-38044 blessed this snapshot approach. The IRS ruled that, where the surviving spouse was the life beneficiary of the trust, and the decedent's living children were to receive the trust principal outright upon the spouse's death, there was no need to consider any potential beneficiary beyond the children. Any beneficiary(ies) who would take the trust principal only if one or more of the children predeceased the spouse are disregarded. The "snapshot" is taken as of the date of death of the participant ("Taxpayer A").

From the ruling: "Since the right of each child to his/her remainder interest in the…[trust] was unrestricted at the death of Taxpayer A, it is necessary to consider only Taxpayers B through E [i.e., the spouse and the three children] to determine which of them shall be treated as the designated beneficiary of Taxpayer A's interest in" the IRA.

Two notes about this PLR:

1. The IRS's conclusion is a slight misstatement of its own rules. Under the IRS trust rules, the correct statement is that the spouse and the three children are *all* considered as the participant's "designated beneficiaries," with the spouse being the oldest of them, so her life expectancy is the Applicable Distribution Period.

2. The trust called for distribution of the children's shares outright to them when they reached age 30. They had already reached that age as of the date of Participant's death. If any of the children had been under age 30 at the time of the Participant's death, then it would have been necessary also to count, as trust beneficiaries, the person or persons who would inherit the

trust if a child died before reaching age 30, because in that case the children would be only "limited" beneficiaries.

The snapshot principle blessed in this private letter ruling will be of help in drafting see-through trusts. Unfortunately, a PLR cannot be relied on as precedent. The regulations provide no discussion of this point, no guiding principles, no definitions and no examples.

If preparing a typical trust (such as that in the Hunter Trust Example) with a charitable wipe-out beneficiary, your choices are to rely on PLR 2004-38044, apply for your own ruling, or restructure the trust to eliminate the charity.

¶ 6.3.13: Separate accounts cannot be used for beneficiaries who take through a trust.

The final paragraph in ¶ 6.3.13 predicted that the IRS might read Reg. § 1.401(a)(9)-4, A-5(c), as prohibiting separate account treatment for any benefits that are payable on death to a trust, even if the trust terminates immediately on the participant's death and is divided up into separate shares or subtrusts. That prediction has unfortunately come true. In three private letter rulings issued by the IRS after the book was published (2003-17041, 2003-17043, and 2003-17044) the IRS ruled that, under the final regulations, benefits payable to a trust can not be treated as "separate accounts" for the trust beneficiaries. Thus, PLR 2002-34074, issued in May 2002, which held directly to the contrary (see page 303) has been "revoked."

Accordingly, delete the last paragraph of ¶ 6.3.13 and substitute the following:

Unfortunately, it appears the IRS does not adopt this author's interpretation and has reversed its own position as stated in PLR 200234074. This radical change of position (which was not previewed to the practitioner community in any way) was not mentioned as one of the changes being made by the final regulations in the Preamble to the final regs, despite the statement in the Preamble that the 2001 proposed regulations were being adopted with no changes except changes stated in the Preamble, and was adopted without opportunity for comments or hearing; in other words, without observance of any of the procedural safeguards required for a major change in administrative rules.

PLRs 200317041, 200317043 and 200317044, issued after and under the final regulations, are almost identical in relevant facts to PLR 200234074. An IRA was payable to a trust that was required to terminate upon the Participant's death. The assets of the terminating trust passed outright to the Participant's three children; there was no trustee discretion involved in either the fact of the termination or the relative share of each beneficiary, and the trust qualified as a see-through trust. Thus, just as in PLR 200234074, the children were the Participant's designated beneficiaries, with their respective shares dictated by the deceased Participant through the terms of the trust that he had named as his beneficiary. Each of the children sought a ruling. In these rulings the IRS reached exactly the opposite result of PLR 200234074, issued less than a year before. The 2003 rulings provided that *each child would have to use the oldest child's life expectancy to measure his/her MRDs*, because the IRA had been payable to the trust as named beneficiary and separate accounts could not be established for the beneficiaries of a trust (citing the new sentence in the regulation).

The conclusion that separate accounts treatment does NOT apply to beneficiaries who take through a trust (because the trust is the named beneficiary of the retirement plan) was further confirmed in PLRs 2004-32027–2004-32029 (8/6/04).

In order for benefits payable to a trust to be treated as "separate accounts" for purposes of determining the Applicable Distribution Period, two requirements must be met:

1. There must be actual *separate trusts* that are created at or before the Participant's death (benefits payable to a single trust cannot be treated as "separate accounts" under any circumstances, according to the letter rulings cited above); and

2. The benefits must be divided, at the plan level, into separate accounts payable to those separate trusts by the December 31 deadline.

A Participant can, with a lot of extra bother, but with absolutely no difference in substantive effect, circumvent the rule—a result the IRA providers, the planners, and the clients surely would prefer to avoid, and that the IRS receives no benefit from. Thus, the rule enunciated in the these letter rulings is particularly unfortunate since it constitutes only to a trap for the unwary.

If it is desired to have the interests of multiple trust beneficiaries constitute separate accounts, it is necessary to establish *separate trusts* for them (this was always true) and (the new part) put the division of the IRA into *the beneficiary designation form* rather than *the trust*.

For example, consider the typical case of a Participant who wants to leave his entire estate including his IRA in trust for his spouse for life with remainder to his issue living on the death of the surviving spouse. The normal way to accomplish this is to name the trust as beneficiary of the retirement plan, and leave it up to the trustee to either hold the benefits in trust for the spouse or to distribute them outright to the issue if the spouse does not survive the participant. Under the new rule, this normal approach does not work. If Participant wants the shares passing to his issue to qualify as separate accounts, he should name them *directly* as contingent beneficiaries of his IRA rather than simply leaving the benefits to the trust in all events. For example:

Instead of this: "I name the Natalie B. Choate Trust as beneficiary of my IRA."

Use this: "If my spouse survives me, I name the Natalie B. Choate Trust as beneficiary of my IRA. If my spouse does not survive me, I name as beneficiary of my IRA my issue surviving me, by right of representation."

If the trust that Participant would like to name as beneficiary is to terminate upon Participant's death and be divided up into specified shares for different subtrusts, the Participant should name the subtrusts directly as beneficiaries of the IRA rather than naming the single, funding, trust as beneficiary. For example, typically a trust might be divided into subtrusts for the Participant's children at the Participant's death. If it is important for these subtrusts to be able to use the separate accounts treatment to measure required distributions, then:

Instead of this: The IRA beneficiary designation provides: "I name as beneficiary of my IRA the Natalie B. Choate Trust." The Natalie B. Choate Trust instrument then provides that "Upon

my death, the trustee shall divide the principal of the trust into as many equal shares as there are children of mine then living and children of mine then deceased leaving issue then living. Each such share shall constitute a separate trust to be held and administered for the benefit of the child or issue for whom it is established on the following terms and conditions:"

Use this: The IRA beneficiary designation provides: "Upon my death, this IRA shall be allocated into as many equal shares as there are children of mine then living and children of mine then deceased leaving issue then living. One such share shall be payable to XYZ Bank, as Trustee of the separate trust established for each living child of mine under Article ## of the Natalie B. Choate Trust dated mm/dd/yyyy (or its successors in trust). One such share shall be payable to XYZ Bank, as Trustee of the separate trust established for the living issue of each deceased child of mine under Article ### of the Natalie B. Choate Trust dated mm/dd/yyyy (or its successors in trust). Each such share shall constitute a separate account (within the meaning of section 401(a)(9) of the Internal Revenue Code and regulations thereunder) payable to a different beneficiary, namely, the separate trust for the primary benefit of the child or issue for whom such share is allocated."

The Natalie B. Choate Trust instrument then provides as follows: "Upon my death, the trustee shall establish as many separate trusts as there are children of mine then living and children of mine then deceased leaving issue then living. A trust so established for a living child of mine shall be administered as provided in Article ##. A trust so established for the issue of a deceased child of mine shall be administered as provided in Article ###. The separate trusts so established under this Article and administered as provided in Articles ## and ### shall be funded in either or both of the following ways:

"First, I intend to name such separate trusts as beneficiaries of one or more retirement plans. Each such separate trust shall receive directly, hold and administer property that is payable to it under any beneficiary designation form or other instrument. Any property thus paid or payable directly to a separate trust shall not be considered, treated as or accounted for as property of this trust, but rather shall be considered, treated as or accounted for solely as property of such separate trust.

"Second, any property that is held in this trust at my death, or that becomes payable to this trust (rather than to the separate trusts established under this article) upon my death, shall be divided into as many equal shares as there are children of mine then living and children of mine then deceased leaving issue then living, and each such share shall be allocated to one of the separate trusts established under this Article."

The preceding forms are offered as examples of a new approach to naming a beneficiary of retirement benefits suggested by the letter rulings discussed above. A more cautious practitioner could go further and create *separate complete trust instruments*, one for each child or other beneficiary for whom separate account treatment is sought, rather than trying to use the shortcut of creating separate trusts under one "master" trust instrument. This requires more drafting and paperwork at the planning stage, but the good result would be an even "cleaner" situation to present to an auditing plan administrator or IRS agent (two groups who have difficulty understanding trusts and other estate planning devices).

Needless to say, neither practitioners nor plan administrators will welcome the substantial additional paperwork necessitated by these suggested approaches, but there is no other way to assure “separate accounts” treatment in light of the private letter rulings cited above.

Conclusion: If separate accounts treatment is an important goal, it is IMPERATIVE to create the separate accounts IN THE BENEFICIARY DESIGNATION FORM, and leave the separate accounts thus created DIRECTLY TO THE DIFFERENT BENEFICIARIES. If the benefits are left to a single funding trust, required distributions will apparently be based on the life expectancy of the oldest beneficiary of that trust (assuming the trust qualifies as a look-through trust)—even if the trust is required to terminate immediately on the Participant’s death and pass out the retirement benefits in predetermined fixed shares to different individual beneficiaries or subtrusts.

For more on these rulings and how to avoid their impact, see my article in the July, 2003, issue of *Trusts & Estates* magazine, “MRD Rule Reversal” (Vol. 142, No. 7, p. 36).

Chapter 8: Disclaimers; Life Insurance; Grandfather Rules

Disclaimers:

¶ 8.1.03 (p. 342): Error in text: The last paragraph of this subsection erroneously cites two examples from the disclaimer regulations. Those examples *do not apply* to disclaimers occurring after 1981. As corrected, the last paragraph of ¶ 8.1.03 should read as follows:

“If the applicable state law does not permit disclaimers, the would-be disclaimant can transfer his or her interest to the “person or persons who would have received the property had the transferor made a qualified disclaimer,” and the Code will treat this as a qualified disclaimer if the other requirements of § 2518 (such as the deadline, and the absence of “acceptance”) are met. § 2518(c)(3). See also ¶ 8.2.08 regarding possible conflicts between ERISA and disclaimers that are valid under state law.”

¶ 8.1.09 (p. 347): Taking MRD does NOT constitute “acceptance” of the entire account for disclaimer purposes. In Rev. Rul. 2005-36, 2005-26 I.R.B. 1368, the IRS provided extensive discussion of partial disclaimers of inherited retirement benefits, including, most significantly:

A. A new “safe harbor” rule: although a beneficiary cannot disclaim an inherited retirement plan once he or she has “accepted” it, taking a minimum required distribution does not constitute “acceptance.” Thus, a beneficiary can take the MRD for the year of death (if applicable), and still disclaim all or part of the rest of the inheritance later.

B. Guidance on who takes the MRD for the year of death. At least in cases of disclaimer, the Ruling indicates that as long as some beneficiary took the MRD, the MRD rules are satisfied: it is not necessary for each beneficiary to take a pro rata share of that MRD.

¶ 8.3.05 (p. 371), **¶ 8.4.04(E)** (p. 381): POST-PUBLICATION UPDATE:

The following new development has made parts of ¶ 8.3 and ¶ 8.4 (especially ¶ 8.3.05 and ¶ 8.4.04(E)) of the 5th ed. of *Life and Death Planning for Retirement Benefits* out of date. **08/05: Final Reg. § 1.402(a)-1(a)(1)(iii), Rev. Proc. 2005-25: IRS issues rules for valuation of life insurance policies distributed (or sold) by a qualified retirement plan**

In this discussion, "Section" refers to a section of Rev. Proc. 2005-25.

In February, 2004, the IRS replaced the old rule regarding the valuation of a life insurance policy distributed by a qualified retirement plan ("value = cash surrender value or, sometimes, policy reserves") with a new rule: "Value = fair market value" (FMV). See Rev. Proc. 2004-16, 2004-10 I.R.B. 559. The IRS did not say, then, how FMV would be determined, other than by providing one crude "safe harbor" valuation method.

In Rev. Proc. 2005-25, 2205-17 I.R.B. 962 (April 2005), the IRS issued more detailed guidance (including a "semi-safe harbor" rule) regarding how life insurance policies are to be valued for purposes of § 402(a) (income taxation of distributions from qualified retirement plans). Final regulation § 1.402(a)-1(a)(1)(iii), adopted August 29, 2005, confirms that FMV must be used to determine the amount of gross income resulting from the distribution of a life insurance contract by a qualified retirement plan (QRP). The Preamble to the final regulation refers taxpayers to Rev. Proc. 2005-25 for guidance on how to determine FMV.

I. Overview of Rev. Proc. 2005-25

Rev. Proc. 2005-25 provides a "semi-safe harbor" rule for the valuation of life insurance policies for several compensation-related purposes: § 402(a) (distributions from qualified plans); § 83 (transfers of restricted property); § 79 (group permanent benefits); and § 402(b) (distributions from nonqualified plans). This paper deals *only* with distributions from qualified plans (§ 402(a)).

When a life insurance policy (including a retirement income or endowment contract) is distributed by a qualified plan to "any distributee," or "when such a contract is sold by the plan to a participant," on or after February 13, 2004, the value of the policy, for purposes of determining the amount of income taxable to the participant, is its fair market value, which is the same rule that applies to any other asset distributed by a plan (except an annuity contract). Section 2.01(1).

The Rev. Proc.'s safe harbor formula for determining the fair market value of a life insurance contract (Section 3.01) is not to be regarded as a rigid numerical test for clever advisors to dodge. The formula "must be interpreted in a reasonable manner, consistent with the purpose of identifying the fair market value of a contract." The IRS is determined to ban game-playing with these new valuation rules.

"Furthermore, at no time are these rules to be interpreted in a manner that allows the use of these formulas to understate the fair market value…For example, if the insurance contract has not been in force *for some time*, the value of the contract is best established through the sale of the particular insurance contract by the insurance company (i.e., as the premiums paid for that contract)." Section 3.05 (emphasis added). How long is "some time?" It is not defined. In other words, the sum of premiums paid since date of issue is the only REALLY safe harbor; the PERC formula is only a "semi-safe harbor."

II. The safe harbor "PERC" formula

There is one version of the formula for non-variable contracts and one for variable contracts (as defined in § 817(d)). A non-variable contract can only be valued using the non-variable formula, but a variable can apparently be valued using either. If income is credited on premium payments, "that amount must be included in item 3 of the formulas, even if the income can only be realized through an exchange right that gives rise to a springing cash value under another policy." Rev. Proc. 2005-25, § 3.05.

For both types of policies, the safe harbor value is "the greater of A or B."

"A" is the same for both types of contracts: it is the sum of the interpolated terminal reserve and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience.

"B" differs. Here is "B" for a *non-variable contract*:

B = the product of PERC times ASF, where, PERC (Premiums + Earnings - Reasonable Charges) is the aggregate of:

1. Premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums; plus
2. Dividends applied to purchase paid-up insurance prior to the valuation date; plus
3. Any amounts credited (or otherwise made available) to the policyholder with respect to premiums, including interest and similar income items (whether credited or made available under the contract or to some other account), but not including dividends used to offset premiums and dividends used to purchase paid up insurance; minus
4. Explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated, or otherwise reversed at a later date; minus
5. Any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

"B" for a *variable contract* is the same, except for items #2 and #3 in the formula, which are as follows (different wording is underlined):

2. Dividends applied to increase the value of the contract (including dividends used to purchase paid-up insurance) prior to the valuation date; plus or minus
3. All adjustments (whether credited or made available under the contract or to some other account) that reflect the investment return and the market value of segregated asset accounts; minus

"ASF" stands for Average Surrender Factor. ASF is the same for both types of policies: "…if the contract provides for explicit surrender charges,…the unweighted average of the applicable surrender factors over the 10 years beginning with the policy year of the distribution or sale. For this purpose, the applicable surrender factor for a policy year is equal to the greater of 0.70 and" a

fraction. The fraction is quite complicated; the point is that surrender charges will not be given their full nominal weight in valuing the policy. The formulas basically disallow excessive, waivable, or "disappearing" surrender charges as an offset against value.

However, the fact that *any* value offset for surrender charges is allowed is an improvement over the safe harbor valuation rule announced in February 2004, which allowed no reduction for surrender charges.

The IRS position on surrender charges appears reasonable in these days when there are several companies in the business of buying existing life insurance policies, so surrendering the policy to the insurance company (and incurring the surrender charge) is no longer the only way an insured can "sell" his policy.

III. Items to be included in income in addition to the fair market value

"Dividends held on deposit with respect to an insurance contract," though not included in the fair market value of the contract, "are taxable income to the employee…at the time the rights to those dividends are transferred to that individual." Section 4.01.

Also, if any loan made to the employee "in connection with the performance of services…is terminated upon distribution or transfer of the collateral, the terminated loan or debt amount constitutes an additional distribution to the employee…." Section 4.02.

IV. Effect on "rollout" sales of policies

A common strategy for dealing with a QRP-owned life insurance policy is for the participant (or his beneficiaries, through a "defective grantor trust" or family partnership) to buy the policy from the QRP when the participant retires. Under Prohibited Transaction Class Exemption (PTCE) 92-6 issued by the Department of Labor (DOL), such a purchase is exempted from the prohibited transaction rules provided the sale is for at least cash value and certain other requirements are met. Prior to the IRS rule changes on valuation of policies, the cash value was typically used for such sales.

Reg. § 1.402(a)-1(a)(1)(iii) states that, if such a sale is made on or after August 29, 2005, for less than the FMV of the policy, the excess value shall be treated as a distribution "to the distributee under the plan for all purposes of the Internal Revenue Code." A bargain sale could create a serious problem for the retirement plan. For example, if a pension plan sells the policy to a participant for less than its FMV, and the participant has not met the requirements for retirement or separation from service, the resulting deemed "in-service" distribution could disqualify the plan. Similarly, if the sale is to the beneficiary, and results in a deemed distribution to the beneficiary while the participant is still living, that could disqualify the plan.

Thus, it appears advisable, from now on, for a QRP to sell an insurance policy only to the participant himself, and only at a time when a distribution to the participant is permitted under the plan. If the participant, having purchased the policy from the plan, wants to get the policy out of his gross estate, he can give it the beneficiaries, or sell it to them if he wants to avoid the three-year rule of § 2035, or sell it to them via a defective grantor trust or family partnership if he wishes to avoid the transfer-for-value rule as well as the three-year rule.

V. Effective date; use of 2004 safe harbor ok until May 1, 2005

Rev. Proc. 2005-25 supersedes Rev. Proc. 2004-16; however, the safe harbor in Rev. Proc. 2004-16 can still be used to value contracts distributed between February 13, 2004, and May 1, 2005. The safe harbors in Rev. Proc. 2005-25 may be used for any distribution before May 1, 2005, as well as after.

VI. Remaining comments, issues, and questions.

Final Reg. § 1.402(a)-1(a)(1)(iii) and Rev. Proc. 2005-25 leave practitioners with the following questions and issues:

A. **Who is going to apply these complicated formulas to plan-owned insurance policies?** Realistically, the insurance company will probably get stuck with the job, but the plan trustees are responsible for correct reporting of the income tax value to the IRS and to the participant on form 1099-R. What types of indemnities will plans seek from the insurance companies on the valuation question? Will the insurance companies want compensation for carrying out these valuations and certifying them to the plan and the participant?

B. **Is this good news or bad news for life insurance sellers?** Some plans may be discouraged from buying life insurance by the complexity of the new valuation rules and the serious consequences of an incorrect valuation. On the other hand, some plans and insurance companies that stayed away from QRP-owned life insurance may find the greater certainty of the new rules attractive.

C. **Other valuation methods.** Plans are not required to use the safe harbor. If the formula seems to produce too high a value, some practitioners suggest soliciting bids from a company in the business of buying existing life insurance policies and using such bids to establish FMV. Another approach would be to get an appraisal of the policy from an independent company that is in the business of evaluating insurance policies, if such a company can be found.

D. **Waiting for the other shoe to fall.** Will the IRS apply these new rules to the valuation of insurance policies for gift tax purposes as well as income tax purposes?

On the bright side, the IRS apparently does not require that the participant's actual health be taken into account in valuing the policy. There is no suggestion that the value of a policy must reflect replacement cost if the participant is no longer insurable at the same rates that applied when the policy was purchased.

[End of update regarding insurance valuation]

¶ 8.4.04(E), p. 382: The cite for the Leimberg/McFadden article recommended at the end of (E) is: "Fully Insured 412(i) Pension Plans Offer Simplicity and Low Risk," by John J. McFadden and

Stephan R. Leimberg, *Estate Planning*, April 2003, Vol. 30, No. 4, Pg. 155. Single issues of *Estate Planning* magazine are available by contacting Wm. S. Hein & Co. at 800-828-7571, ext. 162.

Chapter 9: Distributions before age 59½

¶ 9.2.05, p. 400: PLRs permit annual recalculation in annuity, amortization, SOSEPPs.

Insert the following at the end of ¶ 9.2.05 on page 403:

A. Three 2004 PLRs Show Annual Recalculation Still Available

Although Rev. Rul. 2002-62 described amortization- and annuitization-method SOSEPPs as involving fixed payments, the IRS has since approved SOSEPPs using these methods with annual recalculation. In three 2004 PLRs issued to four individuals, the IRS has made clear that annual recalculation is alive and well, even after Rev. Rul. 2002-62.

In PLR 2004-32021, the IRS approved two SOSEPPs (one each for a husband and a wife; they obtained a joint ruling, thereby saving one “user fee”) using the amortization method. Each spouse’s SOSEPP used that spouse’s life expectancy (from the IRS single life table), an interest rate of 120 percent of the Federal mid-term rate (the highest rate allowed under Rev. Rul. 2002-62), and the prior year-end account balance. The spouses proposed to recalculate their “fixed” amortization payments annually, using each year’s then-current life expectancy, prior year-end account balance, and 120 percent-of-Federal-mid-term-rate interest rate. An identical SOSEPP design was approved for another taxpayer in PLR 2004-32024.

In PLR 2004-32023, the IRS approved an annuitization-method SOSEPP that provided for annual recalculation of the payments in the same manner. Each year’s payment would be calculated using the account balance and Federal mid-term rate as of December 31 of the year prior to the distribution year, and the annuitization factor would be based on the participant’s age in the distribution year.

The key to the IRS’s approval in these rulings is that, even though the sizes of the payments will vary, the payment is determined exactly the same way each year. Each year’s payment size is determined using the previous year’s year-end account balance, an interest rate of 120 percent of the Federal mid-term rate as of 12/31 of the prior year, and the life expectancy of the participant in that distribution year.

The flexibility offered by annual recalculation is a welcome addition to the SOSEPP menu. As a reminder, to qualify for the SOSEPP exception, all elements of the SOSEPP design must be fixed at the outset. Thus, someone who has already launched a fixed-payment SOSEPP using the amortization or annuitization method cannot now change over to the annual recalculation method of determining his payments. Annual recalculation is available only if it is part of the SOSEPP design from the outset.

Should people use annual-recalculation SOSEPPs modeled on these three PLRs without getting their own PLRs? That’s not clear. The IRS has stated as a matter of “general information” that any variation not explicitly blessed in Rev. Rul. 2002-62 would require an advance ruling. On the other hand, it is hard to see how the IRS could argue that a SOSEPP that follows a method explicitly blessed in one of these PLRs does not qualify for the penalty exception.

The next question is whether someone will now seek a PLR approving a SOSEPP with an annual cost-of-living adjustment, similar to those approved prior to Rev. Rul. 2002-62 in PLRs 9816028, 9747045, 9723035 and 9536031.

B. IRS Rejects Zero Coupon SOSEPP; Allows Rollover to Cure Defective SOSEPP

The IRS rejected another taxpayer's proposed SOSEPP design. Using his current account balance and his life expectancy from the applicable IRS table, the participant in PLR 2004-37038 proposed to determine the amount of his series payments by pretending that he was buying zero-coupon U.S. Treasury securities ("zeroes") maturing at regular intervals over his life expectancy. Based on then-current market values, his account balance was just sufficient to purchase sequentially-maturing zeroes that would provide him equal payments of $59,500 per year. The IRS denied approval on grounds that the interest rate used to determined the series payment amounts (i.e., the yield-to-maturity of the hypothetical zeroes) would be set by the bond market, and "may very well exceed 120 percent of the Federal mid-term rate," which is the maximum rate permitted under Rev. Rul. 2002-62.

What if this fellow had already started taking "series" payments under his clever SOSEPP design before the IRS rejected it? No problem; he should seek IRS permission to roll those payments back into an IRA tax-free, even if the 60-day deadline has passed. In PLR 2004-42033, the IRS granted a waiver of the 60-day rollover deadline to a taxpayer who had commenced a SOSEPP using an unapproved method, so he could unwind the defective SOSEPP and put the payments he had already taken back into his IRA, late, tax-free.

¶ 9.2.14, p. 411, second paragraph has a typo: "Form 4329" should be "Form 5329."

¶ 9.3.06: PLR 2005-03036: Missed payment due to IRA provider error is not "modification."

Insert the following at the end of ¶ 9.3.06, on page 419:

E. In PLR 2005-03036, the taxpayer was taking a SOSEPP from his IRA. He requested a distribution from the IRA provider in order to complete the distributions he was required to take in a particular calendar year. Due to the IRA provider's error, the distribution was not made until the following year. Because he did everything he reasonably could to comply with the SOSEPP requirements, and the failure to receive the required payment was due to someone else's error and was beyond his control, the IRS ruled that no modification had occurred.

Appendix B, Forms: Typographical error on p. 518:

There is an extra "the" in Form 7.3, p. 518 (Provision excluding older adopted issue from sharing in the trust). The form should read as follows (strike-out shows the correction that should be made):

Notwithstanding any other provision hereof or of state law, ~~the~~ a person's "issue" shall not include an individual who is my (or such person's) "issue" by virtue of legal adoption if such individual (i) was so adopted after my death and (ii) is older than the oldest other beneficiary of this trust who was a living member of said class at my death.