Life and Death Planning for Retirement Benefits, 6th edition, 2006:

Post-Publication Updates and Corrections

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This document contains post-publication updates and corrections to the 6th edition of *Life and Death Planning for Retirement Benefits* by Natalie B. Choate, Esq. (Ataxplan Publications, 2006).

My thanks to Carl T. Baker, Susan Hartman, Stephen Koster, and others mentioned in the text who wrote to point out needed corrections and clarifications. Natalie B. Choate.

"★" indicates a NEW ADDITION—something added to this update in Version 2 (9/1/07) that was not in the first update (Version 1, 4/23/07).

Note to owners of earlier editions: If you own the 5th edition (2003), you need the updates to the 5th edition (posted at www.ataxplan.com) in addition to the following updates. If you own an earlier edition (pre-2003), you need to buy the 6th edition.

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Chapter 1: THE MINIMUM DISTRIBUTION RULES

★¶ 1.1.02 *Which plans are subject to the MRD rules*, p. 27:

Update reference: In the second paragraph, to reflect issuance of the final 403(b) regulations in July 2007, change "Reg. § 1.403(b)-3, A-1(a)" to "Reg. § 1.403(b)-6(e)" effective after 2008.

¶ 1.2.05 *Which "account balance" the divisor applies to*, p. 34:

Addition: Delete the last two sentences of the second paragraph of this section and substitute the following:

"Although nothing in the regulations authorizes such an adjustment (see Reg. § 1.401(a)(9)-5, A-3), Rev. Proc. 2006-27, discussed at ¶ 1.9.02 below, suggests that such an adjustment is appropriate."

★¶ 1.3.04 *Taking distributions from multiple plans*, p. 43:

Update citation: As a result of issuance of the final 403(b) regulations in July 2007, all citations in this section to Reg. § 1.403(b)-3, A-4, are changed to Reg. § 1.403(b)-6(e)(7), effective after 2008. The rules did NOT change, just the citation.

★¶ 1.4.06 *RBD, other grandfather rules, for 403(b) plan*, p. 48:

Update citation: As a result of issuance of the final 403(b) regulations in July 2007, the citation in this section to Reg. § 1.403(b)-3, A-1(c)(1), is changed to Reg. § 1.403(b)-6(e)(7), effective after 2008. The rules did NOT change, just the citation.

★¶ 1.5.12 *How MRD aggregation applies to inherited IRAs*, p. 73:

Update citation: As a result of issuance of the final 403(b) regulations in July 2007, the citation in this section to Reg. § 1.403(b)-3, A-4, is changed to Reg. § 1.403(b)-6(e)(3), effective after 2008. The rules did NOT change, just the citation.

¶ 1.5.13 *Who gets the benefits when the beneficiary dies?*, p. 74:

Clarification: Insert the following at the end of the second paragraph of this section:

"The following alternatives A–D are the same regardless of whether the participant died before or after his RBD."

¶ 1.5.14 *What is the ADP after the beneficiary's death?*, p. 75:

Clarification: Delete the second sentence of the first paragraph and substitute the following:

"This ¶ 1.5.14 explains the ADP that applies to the successor beneficiary when the ADP is based on the life expectancy of a Designated Beneficiary (see ¶ 1.5.03, ¶ 1.5.04) and that Designated Beneficiary later dies. The rule discussed here applies regardless of whether the participant died before or after his RBD. If the ADP after the participant's death was *not* based on the life expectancy of a Designated Beneficiary (for example, because there was no Designated Beneficiary (¶ 1.5.03(C), ¶ 1.5.04(C)) or because the participant died after his RBD leaving benefits to a Designated Beneficiary who was older than the participant—see ¶ 1.5.04(A), (B), (C), and (E)), then obviously the later death of a beneficiary does not affect the ADP."

¶ 1.6.05 ***Spouse treated as "participant" if both die young***, p. 80:

For an extremely unfair (and, the author believes, erroneous) example of how this rule was applied to an IRA payable to a conduit trust for the spouse, see PLR 2006-44022, discussed in Appendix 2 of this Update.

¶ 1.7.02 ***Who is the participant's beneficiary?***, p. 86:

See PLR 2006-34052 for an example of paying benefits to the wrong beneficiary. See PLR 2007-07158 for an example of judicial reformation (accepted by the IRS) of a beneficiary designation form, after the participant's death, changing the beneficiary from "Taxpayer D" to "Cousin C"; however, PLR 2007-07158 does not discuss the MRD consequences, just the income, gift, and estate tax consequences.

★¶ 1.7.04 ***Estate cannot be a Designated Beneficiary***, p. 89:

Last paragraph: See PLR 2006-50022, in which the beneficiary designation form for deceased participant's IRA stated that the beneficiary was to be determined "per my will." Apparently all parties, including the IRS, treated this beneficiary designation form as leaving the benefits to the participant's estate.

¶ 1.7.06 ***The separate accounts rule***, pp. 91–94:

Add the following at the end of this section:

"D. Separate accounts for beneficiaries of an estate or trust. Although individual beneficiaries who acquire their interest through an estate or trust cannot use "separate accounts" treatment for purposes of determining the Applicable Distribution Period (¶ 6.3.02, ¶ 1.7.04), they can divide the inherited plan into separate accounts for purposes of determining each beneficiary's MRD. See PLR 2006-46027, in which the participant died after his RBD leaving an IRA to his estate. His three children were equal residuary beneficiaries of the estate. The IRS ruled that the estate could transfer the IRA in equal shares to the three beneficiaries (see ¶ 6.1.05), and that thereafter each of the three beneficiaries would take MRDs and other distributions from his/her separate account (based on the remaining life expectancy of the participant; see ¶ 1.5.04(C)), without regard to distributions taken by the other beneficiaries from their separate accounts."

¶ 1.9.02 ***What to do when faced with the 50% penalty***, p. 99:

Correction: The last two paragraphs of ¶ 1.9.02 on page 99 incorrectly state that in order to report a missed MRD for a prior year the individual must file an amended income tax return (Form 1040X) attaching Form 5329. That is not correct. The individual must file Form 5329 for each year for which an MRD was missed. If he hasn't yet filed his income tax return for the year the distribution was missed, and he is required to file a return for that year, the Form 5329 should be attached to the return. However, if he already has filed his tax return for the year the distribution was missed, or if he is not required to file a return for that year, he should file Form 5329 as a stand-alone form. See the instructions for IRS Form 5329. My thanks to Gary L. Miller, Esq., of Toledo, for pointing this out.

Addition: Insert the following at the end of ¶ 1.9.02:

How to "remedy the shortfall"

When an IRA has failed to distribute MRDs in compliance with § 401(a)(9), the penalty-waiver procedure discussed above is the only way to get the § 4974 excise tax waived. One requirement of that procedure is that reasonable steps be taken to remedy the shortfall. Presumably that means the taxpayer must take, now, the distributions that were missed in prior years, but nothing explains how to compute those missed distributions. Mike Jones, CPA, suggests taking a leaf from the correction procedure that exists for other types of retirement plans:

If the retirement plan that failed to pay the MRDs is a qualified plan or 403(b) plan, there is another avenue for correcting the mistake, which is to use the IRS's "Employee Plans Compliance Resolution System" (EPCRS) set forth in Rev. Proc. 2006-27, 2006-22 I.R.B. 1. This system provides procedures for voluntary and semi-voluntary "cleanups" of dozens of types of plan errors—including failure to comply with § 401(a)(9). According to Appendix A of this Rev. Proc. (and of its predecessor, Rev. Proc. 2003-44, 2003-1 C.B. 1051), here is how to compute MRDs when multiple years' MRDs have been missed or underpaid:

".06 FAILURE TO TIMELY PAY THE MINIMUM DISTRIBUTION REQUIRED UNDER SECTION 401(a)(9). In a defined contribution plan, the permitted correction method is to distribute the required minimum distributions. The amount to be distributed for each year in which the failure occurred should be determined by dividing the adjusted account balance on the applicable valuation date by the applicable distribution period. For this purpose, adjusted account balance means the actual account balance, determined in accordance with section 1.401(a)(9)-5 Q&A-3 of the regulations, *reduced by the amount of the total missed minimum distributions for prior years….*" Emphasis added.

As a reminder, the above quote from Rev. Proc. 2006-27 does not apply directly to IRAs (other than, possibly, SEP-IRAs and SIMPLEs); presumably, by analogy, it does indicate the correct method of computing MRDs when there were missed MRDs in prior years. Also, if using Rev. Proc. 2006-27 to correct missed MRDs for a qualified plan or 403(b) plan, you need to comply with *all* the requirements of the entire Rev. Proc., not just the one paragraph quoted above, which is reproduced solely for the light it sheds on how to compute MRDs in certain situations.

★1.9.04 ***Calculating MRDs for pre-2003 years***, p. 100:

Correct and update citation: In the first paragraph, change the citation "§ 403(b)-3, A-1(b)" to "§ 1.403(b)-3, A-1(b) [Reg. § 1.403(b)-6(e)(2), after 2008]."

Chapter 2: INCOME TAX ISSUES

¶ 2.1.06 ***List of no-tax and low-tax distributions***, pp. 109–110:

Add the following at the end of this section:

"M. **Qualified health savings account funding distributions (QHSAFDs).** As a result of the Tax Relief and Health Care Act of 2006, effective January 1, 2007, certain individuals can make a one-time tax-free transfer of funds from an IRA to a health savings account (HSA). Specifically, a person who is eligible to contribute to an HSA can, for one year (any year he chooses, but only once), fund his HSA by means of a direct transfer from his IRA instead of by writing a check from his taxable checking account. Since the new type of permitted transfer does not increase the amount that can be contributed to the HSA; and since HSA contributions are *already* deductible in determining adjusted gross income; this new type of IRA distribution will provide a benefit to very few people. The bottom line: HSAs are great, and you should have one if you're eligible; however, almost everyone should fund the HSA from a taxable account, NOT by transferring funds from an IRA. For more information on HSAs and QHSAFDs, see IRC §223, § 408(d)(9); IRS Notice 2004-2, 2004-2 I.R.B. 269 ("Health Savings Accounts"); IRS Notice 2004-50, 2004-33 I.R.B. 196 ("Health Savings Accounts: Additional Qs&As"); and Rev. Proc. 2006-53, 2006-48 I.R.B. 996; or see the "Special Report: Health Savings Accounts" available through the web site www.ataxplan.com."

¶ 2.3.03 ***Tax on transfer of right-to-receive IRD***, p. 123:

See also ¶ 6.4.08 and Appendix 3 of this Update regarding CCM 2006-44020 and the transfer of an IRA or other "right-to-receive IRD" in fulfilment of a pecuniary bequest.

¶ 2.3.06 ***§ 691(c) deduction: Deferred payouts, multiple plans***, pp. 125–127:

Add the following to the first full paragraph on p. 126:

"One method that is not justified is the "front-loaded approach" described in the article "A Sly Deduction" by Eric Reiner (*Wealth Manager* March 2007, p. 26 at p. 28), under which every dollar of distribution is offset by a dollar of deduction until the deduction has been used up. § 691 allows only a proportionate deduction: For each $1 of IRD included in income, the maximum deduction is the federal estate tax attributable to that amount. Since the federal estate tax is not 100 percent, there is no statutory justification for applying a dollar of deduction to a dollar of income. The uncertainly about the timing of the IRD deduction arises from the question of whether a post-death distribution represents IRD, post-death earnings, or some of each. Once the amount of IRD included in the distribution is determined, however, there is no uncertainty about the amount of deduction allowable against that IRD, contrary to the alleged statements of an estate planner cited in that article."

¶ 2.4.03 ***Second hurdle: "Reason" for distribution***, pp. 129–130:

(a) Landmine: separation from service

Update: Add the following at the end of this subsection:

"An employee ("A") separated from service in 2001, and took a partial distribution of his 401(k) account balance at that time, then was rehired in 2002. He was going to separate from service *again* in 2006. This "second separation from service would be considered a separate triggering event for purposes of" determining whether distributions subsequent to such second separation from service constituted an LSD, according to PLR 2006-34059.

NOTE: This letter ruling can be found at the IRS website at http://www.irs.gov/pub/irs-wd/0634059.pdf. Or you can search for it yourself among letter rulings at the IRS web site www.irs.gov by using the Uniform Issue List (UIL) number 402.07-00. My Kleinrock's tax service for some reason has a completely different letter ruling with this number.

¶ 2.4.04 ***Third hurdle: Distribution all in one taxable year***, pp. 130–134

Update: Add the following at the end of the first paragraph of this section:

"However, the LSD status of a distribution to an alternate payee under a QDRO is determined without regard to any amounts payable to the employee. PLR 2006-34059." See note at ¶ 2.4.03(a) above regarding how to find this ruling.

Update: Add the following at the end of the paragraph that carries over from p. 131 to p. 132:

PLR 2006-34059 [see Note at ¶ 2.4.03(a) above regarding how to find this ruling] confirms that this requirement is still alive and well. An employee ("C") separated from service in 2001, at which time a loan she had taken from the plan became payable, and her benefits "were reduced to repay the loan." C then wanted to take a lump sum distribution in 2006, though she had not been rehired (contrast "employee A" discussed at ¶ 2.4.03(a) above). The "plan loan offset" that occurred in 2001 "is considered an actual distribution for purposes of the Code," and thus precludes C from having an LSD from this plan after 2001 since there is no new triggering event.

¶ 2.5.02 *Determining the amount of NUA*, p. 139:

Add the following at the end of this section:

"When the stock is distributed to the employee, the amount included in the employee's income is the LESSER OF the plan's "cost or other basis" and the fair market value of the stock at the time of distribution. Thus, if the value of the stock has dropped below the plan's basis, only the lower amount is includible in the employee's income—and of course in that case there is no NUA. See Reg. § 1.402(a)-1(a)(1)(iii)."

¶ 2.5.04 *NUA: Expert Tips*, p. 141:

Clarification: I worded the last sentence of the description of Frank Duke's "expert tip" in a confusing manner. It should read as follows: "Using the basis allocation method endorsed by the IRS in PLR 8538062 (¶ 2.5.07(B)) maximizes the tax benefits to the employee: He can continue to defer income taxes on the ordinary income portion that was rolled over, while enjoying long-term capital gain treatment upon the eventual sale of the NUA portion that was not rolled over."

¶ 2.6.03 *Rollovers of inherited benefits*

Update: See Appendix 1 at the end of this Update for expanded coverage of nonspouse beneficiary rollovers under the Pension Protection Act of 2006, as modified by the IRS in Notice 2007-7 (January 2007) and by the IRS's subsequent "clarification" of Notice 2007-7 (February 2007).

Clarification: Insert the following at the beginning of the second full paragraph on p. 149:

"It is not required that a nonspouse beneficiary transfer the entire inherited benefit to an inherited IRA in order to take advantage of § 402(c)(11). The beneficiary could take part of the inherited benefit as a distribution (or several distributions), and still have a direct rollover of the rest of the benefit to an inherited IRA. Or the beneficiary could have part of the inherited plan benefit transferred directly to an inherited IRA and leave the rest of it in the original plan, if he wants to do that for some reason and the plan will allow it. However, once any amount is actually distributed to the nonspouse beneficiary, he loses the ability to roll over *the amount that was distributed*—even if the distribution was a mistake! That is so because:" [END OF INSERT]

¶ 2.6.06 *Deadline for completing a rollover; waivers*, pp. 152–154:

Update: Add the following at the end of this section:

"When the IRS wants to deny a waiver of the 60-day rollover deadline they use certain language that does not appear in the PLRs where they grant the waiver. For example, in PLR 2007-05034 (denying a waiver where a participant withdrew money from a plan based on erroneous advice from his accountant that he had to withdraw the money in order to make a certain kind of investment): "You have not presented any evidence…as to how any of *the factors outlined in Rev. Proc. 2003-16* affected your ability to timely roll over Amount H…" (emphasis added). In other PLRs denying a waiver, the IRS emphasizes that the money was subject to the participant's control at all times; but the money was always subject to the participant's control in many other PLRs where the IRS *granted* the waiver. Apparently the "factors outlined in Rev. Proc. 2003-16," and whether the money was subject to the participant's control, only matter when the IRS wants to deny the waiver."

¶ 2.6.08 ***Must roll over same property received***, p. 157:

Add the following (including the following new ¶ 2.6.09) at the end of ¶ 2.6.08:

"The participant cannot take a cash distribution from one IRA, use the cash to purchase property, then "roll over" the purchased property to another IRA. PLR 2006-47028."

"¶ 2.6.09 ***What type of plan a distribution may be rolled into***

"Generally, a plan or IRA distribution that is eligible to be rolled over (see ¶ 2.6.02) can be rolled or transferred into any other kind of plan or IRA, subject to the following limitations. As with all the rollover and plan-to-plan transfer rules, violating any of the following rules would cause the "rollover" not to be recognized as such, so the distribution would be treated as if it were an outright distribution to the participant (or spouse as the case may be):

"A distribution from a *Roth IRA* cannot be rolled into any type of plan or account except another Roth IRA. Reg. § 1.408A-6, A-4, Prop. Reg. § 1.408A-10, A-5. Similarly, a Roth IRA can *accept rollovers* only from certain types of plans, namely, another Roth IRA, a Designated Roth account (DRAC; see ¶ 5.7), or (in the case of a "conversion" contribution that meets the requirements described in ¶ 5.4) a traditional IRA. There are strict limits on the types of plans into which *DRAC distributions* can be rolled: see ¶ 5.7.06–¶ 5.7.08.

"For the additional limitations on the type of plan into which a *surviving spouse* as beneficiary can transfer an inherited benefit, see ¶ 3.2.07. For the limitations on the type of plan into which a *nonspouse* beneficiary can transfer an inherited benefit, see ¶ 2.6.03.

"For the prohibition against rolling after-tax money from a traditional IRA into a qualified plan, see ¶ 2.6.05.

"Except for the ability of a surviving spouse to roll money from an inherited plan into her own plan (see ¶ 3.2), a rollover may occur only between plans or IRAs held by or for the same individual. Thus, a participant can roll money from his own 401(k) plan account to his own IRA, but cannot roll money from his 401(k) account to someone else's IRA. A beneficiary who inherits an retirement plan cannot transfer the inherited plan to someone else by rollover or otherwise; see ¶ 2.3.03."

Chapter 3: MARITAL MATTERS

¶ 3.2.02(D) *Rollover if surviving spouse is under age 59½*, pp. 166–167:

See PLR 2006-50023 for an example of an under-age 59½ surviving spouse rolling benefits from two inherited qualified retirement plans and an inherited SEP-IRA into an IRA in the name of the deceased participant.

★¶ *3.2.05 Rollover (but no election) for 403(b) plan*, p. 170:

Update citations: There is no substantive change here, but due to the issuance of final 403(b) regulations in July 2007, the citation Reg. § 1.403(b)-3, A-1(c)(2) (at the end of the first paragraph) will change to Reg. § 1.403(b)-6(e)(4), and the citation to Reg. § 1.403(b)-2 (in the second paragraph) will change to Reg. § 1.403(b)-7(b)(1), effective after 2008.

¶ 3.2.06 *Deadline for completing spousal rollover*

C. MRDs if participant died before RBD and 5-year rule applies, p. 172:

IRS Notice 2007-7 confirms that, when the 5-year rule applies, the entire remaining plan balance becomes the "MRD" in the year that contains the fifth anniversary of the participant's death, and thus no spousal rollover is possible after the fourth year when the 5-year rule applies.

¶ 3.2.07 *Plans the spouse can roll benefits into*, pp. 173–174:

See PLR 2006-50023 for an example of a surviving spouse being permitted to roll benefits from two inherited qualified retirement plans and an inherited SEP-IRA into an IRA in the name of the deceased participant.

¶ 3.2.08 *Spousal rollover through a trust or estate*, p. 175:

For rulings permitting a spousal rollover through a trust or estate in conjunction with a waiver of the 60-day deadline for completing a rollover, see PLR 2007-03035 (estate) and 2007-07159 (trust). For more rulings permitting a spousal rollover through a trust or estate, see PLRs 2006-34065, 2006-44031, 2006-50023 (estate); 2006-20028, 2006-21020, 2006-44028, 2006-46026 (trust).

PLR 2006-15032 is particularly interesting because as of the date of death the spouse did not have the sole power to cause the benefits to be distributed to herself through the trust that was the beneficiary of the estate that was beneficiary of the plan. The assets payable to the trust were to be divided into a marital and credit shelter trust. Although the wife had the power to withdraw all assets of the marital trust, the trustee (who was not the wife) had the power to allocate the IRA to the credit shelter trust. To "fix" this situation, the original trustee appointed wife as co-trustee, then delegated to her all of the power to decide, as trustee, which assets would go into which share. The IRS allowed her to roll over the IRA that she, as trustee, allocated to the marital share, despite the fact that discretionary post-death actions of a third party (i.e., the other trustee's appointing the wife as co-trustee and delegating allocation power to her) were required in order to get wife into the position of being "entitled" to the benefits.

Similarly, in PLRs 2007-03047 and 2007-04033, surviving spouses were allowed to roll over benefits through trusts that were judicially reformed *post mortem*; apparently, the reformation of the trust was not considered the type of post-death action that would indicate the spouse inherited from someone other than the decedent.

However, normally the spouse must be the sole payee of the benefits (in her capacity as beneficiary of the estate or trust) for the spousal rollover through an estate or trust to be allowed. Where benefits were distributed (by mistake—the trustee did not realize that he could have left the benefits in the plan and withdrawn them gradually) to a trust under which the spouse was entitled only to income needed for her health and support, the spousal rollover through the trust was NOT allowed. PLR 2006-18030.

Chapter 4: DISCLAIMERS OF RETIREMENT BENEFITS

¶ 4.1.09 *Effect of taking a distribution; partial disclaimers*, p. 210:

A. Taking the MRD for the year of death is not acceptance of the entire plan.

Clarification: Note that Rev. Rul. 2005-36 deals only with IRAs. Thus its conclusions cannot safely be applied to other types of retirement plans. Although the logic of Rev. Rul. 2005-36 should apply equally to all types of defined contribution plans, the Revenue Ruling does not say that it applies to all types of defined contribution plans, just IRAs. The holding may well not extend to acceptance of a payment under a defined benefit or other annuity-type plan, where acceptance of one annuity payment (even if it is an MRD) could be deemed acceptance of the entire benefit, because an annuity is not a "severable" asset.

Chapter 5: ROTH RETIREMENT PLANS

¶ 5.1.03 *Roth IRAs and the minimum distribution rules*, pp. 229–230:

Clarification: Add the following to paragraph B ("Post-death MRD rules do apply") on page 230: "Exactly the same post-death distribution rules and options applicable to a traditional IRA in case of death prior to the RBD (as described in ¶ 1.5.03) also apply to Roth IRAs. A surviving spouse who inherits a Roth IRA has the same options regarding the Roth IRA as she would have regarding a traditional IRA (see ¶ 3.2), except that Roth IRA distributions may not be rolled into any kind of plan other than another Roth IRA. So the surviving spouse can elect to treat an inherited Roth IRA of which she is sole beneficiary as her own Roth IRA; see Reg. § 1.408A-2, A-4; or can roll over a distribution from a Roth IRA she inherited from her deceased spouse into her own Roth IRA or into another Roth IRA she inherited from such deceased spouse.

¶ 5.3.01 *Definition of compensation*, p. 235:

Addition: Change the last two sentences of this section to read as follows:

"In Rev. Proc. 91-18, 1991-1 C.B. 522, the IRS stated that it had been asked to "clarify whether certain types of income can be used as compensation for IRA purposes. These include 1) disability pay, 2) unemployment compensation, 3) accrued annual leave, 4) sick leave, 5) an incentive award, and 6) termination pay." Rather than commenting on those specific types of income or providing guiding principles that would apply to such income, the IRS instead announced that "[a]s a matter of administrative convenience," amounts properly shown as "Wages, tips, other compensation" on Form W-2 would be treated as "compensation" income for purposes of determining the individual's maximum IRA contribution.

"Thus, the practitioner does not need to determine whether a particular item shown on the client's W-2 is or is not "compensation" within the meaning of § 219(f); rather, the practitioner needs to determine instead whether the income was "properly" reported as wages, tips or other compensation by the payer. See also ¶ 5.8.07."

¶ 5.3.03(A) ***Who may make a "regular" Roth IRA contribution*,** pp. 236–237:

"Income must be below certain levels": For 2007, the income limits for making a "regular" Roth IRA contribution are, as a result of cost-of-living adjustments, $99,000 for a single taxpayer, $156,000 for a married taxpayer filing a joint return, or zero for a married taxpayer filing a separate return. Rev. Proc. 2006-53, 2006-48 I.R.B. 996, Section 3.25.

★CHANGES: ¶ 5.7 Designated Roth Accounts

In April 2007, the IRS issued final regulations regarding the *reporting requirements* and *taxation of distributions* for "designated Roth accounts" (DRACs) for 401(k) plans. Similar rules for "Roth 403(b) plans" were adopted in June 2007 as part of the final 403(b) regulations.

The final regulations track the proposed regulations almost exactly. Most of the few changes are merely clarifications. A few of the changes seal up cracks that might otherwise have allowed game-playing to occur, and other changes give some breaks to participants who have lost money in their DRACs. The rules for DRAC-to-DRAC rollovers are made slightly easier; see ¶ 5.7.07. Otherwise, the rules for DRACs as stated in the 6th edition of *Life and Death Planning for Retirement Benefits* are pretty much unchanged. Throughout ¶ 5.7, change "Prop. Reg." to "Reg.," and add the following specific changes:

★¶ 5.7.02 ***DRAC contributions: Who, how much, how, etc.*,** p. 259

B. How much may be contributed, p. 259.

Add at the end of this section (p. 260): "The limit for 2007 is $15,500 (plus $5,000 "catchup" if age 50 or older). IRS Notice 2006-98, 2006-46 I.R.B. 906."

★¶ 5.7.04 *DRACs: Definition of "qualified distribution*", p. 262:

Delete the second paragraph and substitute:

"Note: certain distributions are never qualified, *even if* they meet the following two requirements; see new ¶ 5.7.04A, in this Update for list of never-qualified distributions."

A. **Qualified distribution triggering events,** p. 262:

Add the following to this subsection:

"In the case of a distribution to an alternate payee under a QDRO, or to a beneficiary, it is the death, age, or disability of the participant that determines whether the distribution is qualified. Reg. § 1.402A-1, A-4(d). If an alternate payee-spouse rolls over to his/her own account a portion of the participant's account that is payable to him/her under a QDRO, see this regulation for how to determine the qualified status of subsequent distributions."

B. **How the Five-Year Period is computed for a DRAC,** pp. 262–263:

Add the following at the end of ¶ 5.7.04 on p. 263:

"The regulation confirms that even if the employee takes distribution of the entire account during the Five-Year Period then later makes more contributions, the start of the Five-Year Period is not 'redetermined'; it still begins with the *first* contribution. Reg. § 1.402A-1, A-4(c).

"However, certain contributions do NOT start the Five-Year Period tolling. 'A contribution that is returned as an excess deferral or excess contribution does not begin the 5 taxable- year period of participation. Similarly, a contribution returned as a permissible withdrawal under section 414(w) does not begin the 5 taxable- year period of participation.' Reg. § 1.402A-1, A-4(a). (§ 414(w) is a new Code provision that will not come into effect until 2008, allowing for 'eligible automatic contribution arrangements.') This addendum avoids game-playing: The participant cannot start the five-year clock running with a contribution that is returned to him.

"Once the Five-Year Period has elapsed, and the triggering event requirement is met, subsequent distributions are qualified even if they pertain to an earlier period that was within the Five-Year Period. Qualified status is determined based on *the year in which the distribution actually occurs*, not on some prior year to which it may relate. For example, a minimum required distribution (MRD) that is taken in the year the required beginning date (RBD) occurs (after completion of the Five-Year Period) but which actually is the MRD for the prior year (which was within the Five-Year, is a qualified distribution. A distribution received after completion of the Five-Year Period (and after a triggering event) is a qualified distribution, even if it is part of a series of substantially equal periodic payments that started prior to the completion of the Five-Year Period. T.D. 9324, *Preamble*, 'Determination of 5-Taxable-Year Period for Qualified Distributions.'

"For how to compute the Five-Year Period with respect to a reemployed veteran, see Reg. § 1.402A-1, A-4(e)."

Insert the following new section on p. 263, before ¶ 5.7.05:

★"¶ 5.7.04A *DRAC distributions that can never be qualified*

"Certain DRAC distributions can NEVER be 'qualified distributions,' even if the Five-Year Period and 'triggering event' requirements (see ¶ 5.7.04) are met. Reg. § 1.402A-1, A-2(c), A-11. These 'never-qualified distributions' are listed in § 1.402(c)-2, A-4. They are:

- Corrective distributions of excess plan contributions (including income thereon) made by the plan in order to comply with the 415 limits. A-4(a).
- Corrective distributions of excess deferral amounts (including income thereon) made to comply with the elective deferral limits of § 1.402(g)-1(e)(3) and the cash-or-deferred plan rules. A-4(b), (c).
- Plan loans that are treated as deemed distributions under § 72(p). A-4(d). See ¶ 2.1.03(F).
- Dividends paid on employer securities as described in § 404(k). A-4(e). § 404(k) allows a corporation to take a tax deduction on certain dividends it pays on its stock held in a retirement plan for its employees. If the dividend is paid out to the employee-participant it cannot be a tax-free qualified distribution from the Roth 401(k) account. However, if the dividend is held in the plan and reinvested in more employer stock it loses its never-qualified status, and therefore can be included in a qualified distribution at a later time. Reg. § 1.402A-1, A-11.
- The deemed income resulting from plan-owned life insurance. A-4(f). See ¶ 8.2.01.
- The deemed income resulting from a prohibited transaction. A-4(g). See ¶ 8.6.06.
- 'Similar items designated by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin.' A-4(h).

"The never-qualified category is needed to prevent game-playing. For example, if excess distributions (and earning thereon) could be distributed tax-free as long as the participant met the five-year and triggering events test, then everyone over 59½ with five years of DRAC participation would have an incentive to transfer all of his wealth into his DRAC. That would be an excess contribution to his 401(k) plan, but any penalties could be avoided by distributing the excess contribution (and earnings thereon) back to himself by a certain deadline, and if there were no income tax on the distributed earnings the participant would have done an end run around the Code's contribution limits.

"Similarly, Congress presumably did not intend Roth IRAs to be a prohibited transaction playground, but there would be little disincentive to doing PTs with your Roth IRA if the maximum penalty were a tax-free deemed distribution of the entire account.

“Though the above list of never-qualified distributions generally tracks the list of distributions that are not “eligible rollover distributions,” the regulations clarify that some distributions that are not eligible rollover distributions nevertheless CAN be qualified distributions, if the Five-Year and triggering-event requirements are met. Reg. § 1.402A-1, A-11. Hardship distributions, minimum required distributions, and distributions that are part of a series of substantially equal periodic payments would fall in this category.”

★ 5.7.06 *Rollovers of DRAC distributions: General rules*, p. 264

Revise this section to read in its entirety as follows:

“Eligible rollover distributions from a DRAC may be rolled over to another DRAC (¶ 5.7.07) or to a Roth IRA (¶ 5.7.08). Reg. § 1.402A-1, A-5. If the distribution is not a qualified distribution (¶ 5.7.04), so part of it would be includible in income if not rolled over (¶ 5.7.05), and the participant rolls over only part of the distribution, the part rolled over is deemed to come first out of the *taxable* portion of the distribution. § 402(c)(2); Reg. § 1.402A-1, A-5(b). (The erroneous statement in the Preamble to the *Proposed* Regulations, which provided the opposite, has been corrected.)”

★ 5.7.07 *DRAC-toDRAC rollovers*

The IRS made some changes in its DRAC-to-DRAC rollover rules. Accordingly, replace subsections A and B at the top of page 265 with the following:

“A. **Must roll to plan that offers DRACs.** A 401(k) DRAC can be rolled to another 401(k) DRAC, *or to a 403(b) DRAC*; a 403(b) DRAC can be rolled to another 403(b) DRAC *or to a 401(k) DRAC*. Reg. § 1.402A-1, A-5(a), § 1.403(b)-7(b)(1). (The Proposed Regulations had required that the recipient plan for a direct rollover be the same type of plan—401(k) or 403(b)—as the distributing plan; this rule has been dropped.) The only requirement is that the recipient plan must be one that “has a designated Roth program,” i.e., that offers designated Roth contributions under its elective deferral retirement plan. T.D. 9324 (Preamble), “Rollover of Designated Roth Contributions.” Thus, the recipient plan cannot accept DRAC rollovers unless it has an active Roth 401(k) or Roth 403(b) plan. He cannot (for example) open a rollover designated Roth account in a 401(k) plan that does not offer its participants the option of making designated Roth contributions.

“B. **Roll nontaxable amounts by direct rollover only.** The participant can do a DRAC-to-DRAC rollover by means of a direct rollover (¶ 2.6.01(B)).

“The Proposed Regulations specified that after-tax money could be rolled from one DRAC to another ONLY “through a direct rollover of the *entire* distribution (i.e., a 60 day rollover to another [DRAC] is not available for this portion of the distribution).” Prop. Reg. § 1.402A-1, A-5(a) (emphasis added). The final regulations continue the rule that *after-tax money* can be rolled from one DRAC to another only by means of a direct rollover, but eliminate the requirement that such rollover be of the ‘entire distribution.’

"So, there *can* be a **partial** direct DRAC-to-DRAC rollover, and a partial DRAC-to-DRAC rollover can include after-tax money. The first dollars rolled directly to the recipient DRAC would come from the pre-tax money in the account (because of the rule that rolled-over money is deemed to come first from the taxable portion of the distribution; § 402(c)(2); Reg. § 1.402A-1, A-5(b)), but if the amount transferred by direct rollover exceeds the amount of pre-tax money in the account, the balance would be coming from the after-tax money (basis or investment in the contract).

"When there is a DRAC-to-DRAC direct rollover (regardless of whether it is a rollover of all or only part of the account, apparently), computation of the participant's **Five-Year Period** (¶ 5.7.04(B)) for the recipient DRAC plan will begin with the first year he contributed to the recipient DRAC, or the first year he contributed to the distributing DRAC, whichever is earlier. § 402A(d)(2)(B); Reg. § 1.402A-1, A-4(b). With any other type of rollover of a DRAC distribution, the years in the distributing DRAC will not count in computing the Five-Year Period for the recipient DRAC or Roth IRA; see "C," and examples at ¶ 5.7.08.

"Following the DRAC-to-DRAC direct rollover, the portion of the distribution that would have been tax-free had it not been rolled over (i.e., the portion allocable to the participant's **basis** or investment in the contract; the after-tax money) is added to the participant's basis in the recipient DRAC. If the distribution from the first DRAC was a qualified distribution, then the entire amount of the distribution is allocated to the participant's "investment in the contract" (basis) in the recipient DRAC. Reg. § 1.402A-1, A-6(a).

"If the ENTIRE account in the distributing DRAC was transferred by direct rollover to the recipient DRAC, and the employee's basis in the distributing DRAC exceeds the fair market value of the distribution, the employee's basis in the distributing DRAC becomes part of his basis in the recipient plan, despite the fact that his basis exceeds the account's value. This rule helps an employee whose DRAC is "under water" preserve his high basis when he changes jobs, and is a good reason to do a 100 percent DRAC-to-DRAC rollover in those circumstances. Reg. § 1.402A-1, A-6(b). For a similar, but not identical, rule applicable to DRAC-to-Roth-IRA rollovers, see ¶ 5.7.08 in this Update."

★ 5.7.08 *DRAC-to-Roth-IRA rollovers*, p. 266:

After the second paragraph of this section, insert:

"The final regulations added a new special rule for determining basis in the Roth IRA when there is a rollover into the Roth IRA from a DRAC, *if* the employee's basis in the DRAC exceeded the DRAC's value: If the employee takes a distribution of the entire balance of his DRAC, and rolls PART of that distribution to a Roth IRA by means of a 60-day rollover, and at the time of the distribution his basis in the DRAC exceeded the market value of the DRAC, the excess basis is treated as a regular contribution to the Roth IRA (i.e., it is added to the employee's basis in the Roth IRA). Reg. § 1.408A-10, A-3(b). Presumably this ability to preserve "excess basis" also applies to *direct* DRAC-to-Roth-IRA rollovers (not just 60-day rollovers), and to a rollover of the *entire* distribution (not just to partial rollovers), but the regulation for some reason specifically mentions only partial 60-day rollovers. A similar (but not identical) rule has been added for DRAC-to-DRAC direct rollovers; see ¶ 5.7.07(B) in this Update."

After the third paragraph of this section, insert:

“However, despite this reasonable regulation, the way the Code is written, that regulation will apply only through 2007. § 408A(c)(3)(B), as amended in 2006 effective for years *after 2007*, provides that:

“‘(B) ROLLOVER FROM ELIGIBLE RETIREMENT PLAN
“‘A taxpayer shall not be allowed to make a *qualified rollover contribution* to a Roth IRA from an *eligible retirement plan* (as defined by section 402(c)(8)(B)) other than a Roth IRA during any taxable year if, for the taxable year of the distribution to which such contribution related—
(i) the taxpayer’s adjusted gross income exceeds $100,000, or
(ii) the taxpayer is a married individual filing a separate return.’ Emphasis added.

“A ‘qualified rollover contribution’ specifically includes a rollover from a designated Roth account to a Roth IRA. § 408A(e), § 402A(c)(3)(A). An ‘eligible retirement plan’ as defined in § 402(c)(8)(B) includes a ‘qualified trust’ (which would definitely include a DRAC in a 401(k) plan) and ‘an annuity contract described in section 403(b).’ Thus, a person whose income exceeds $100,000 cannot roll from a DRAC to a Roth IRA in the years 2008–2009. After 2009, the $100,000 income cap goes away; see ¶ 5.4.03. Presumably this is a mistake by Congress; they presumably did not mean for the income cap to apply to DRAC-to-Roth IRA rollovers…but the way they wrote the law, it does!”

★5.7.09 *The employer’s obligations; other DRAC details*

In the first paragraph, change “Prop. Reg. § 1.199-2(f)(i)” to “Reg. § 1.199-2(e)(1).”

Regarding accounting for Roth accounts versus nonRoth accounts, “In the case of an annuity contract which contains both a designated Roth account and any other accounts, the Commissioner may prescribe in the future prescribe…additional rules for allocation of income, expenses, gains and losses among the accounts under the contract.” Reg. § 1.402A-1, A-13(b).

Chapter 6: TRUSTS AS BENEFICIARIES OF RETIREMENT PLANS

¶ 6.2.06 *Rule 2: Trust must be irrevocable*, p. 294:

Clarification: Insert the following after the first paragraph of this section:

Reminder

Prior to the revisions of the minimum distribution regulations in 2001–2002, the IRS trust rules required the trust to be irrevocable as of the required beginning date. That rule has been abolished! Under the final regulations, the trust does not have to be irrevocable until the participant’s death.

★*6.2.09* ***Rule 5: All beneficiaries must be individuals***, p. 301:

In the first paragraph, the cross reference to ¶ 6.2.03 should actually be ¶ 6.3.02.

¶ 6.2.10 ***Payments to estate for expenses, taxes***, p. 301:

PLRs continue to confirm that payment of debts, expenses, taxes, and charitable bequests from the trust does not preclude see-through trust status if such payment is complete by the Beneficiary Finalization Date and/or may not be made from retirement assets: See PLRs 2006-10026, 10027, 2006-20026, 2006-08032 (charitable beneficiaries' shares distributed to them prior to the Beneficiary Finalization Date; trust amended post-mortem to prohibit payment of retirement benefits to nonindividual beneficiaries after such date); 2006-20028 (trust had no language "walling off" the benefits from this use, but state statute exempted retirement plans from creditors' claims).

¶ 6.3.05(D) ***Conduit trusts: Payment of trust expenses***, pp. 314–315:

PLR 2006-20026 further confirms the conclusion in this paragraph.

¶ 6.3.06 ***Accumulation trust: O/R-2-NLP***, p. 316:

Update: PLRs 2006-10026 and -10027 confirm the validity of the O/R-2-NLP concept: An IRA was left to a trust that was to terminate immediately upon the participant's death and pass outright to his child and grandchild, but with a proviso that the share of a beneficiary under 18 would be held in trust until the beneficiary reached age 25; and if such a beneficiary then later died before reaching age 25 his share would be paid to his heirs at law. The grandchild was under 18 at the time of the participant's death, so this provision was applicable. The grandchild's heirs at law-apparent (i.e., the people who would inherit his share of the trust if he died before age 25) were his parents. The IRS ruled that the trust qualified as a see-through trust; so far so good.

The IRS also ruled that the "countable" trust beneficiaries were: the participant's child and grandchild (which makes sense since both were direct trust beneficiaries), and also the grandchild's *other* parent (the wife of the participant's child), because she was a potential heir-at-law of the grandchild—even though she could share in the trust only if the grandchild died before age 25! So the ADP was the life expectancy of the oldest member of that group. This ruling continues the regrettable trend started in PLR 2002-28025, whereby the IRS ignores the overwhelming actuarial likelihood that a minor child will survive to age 25. It also continues the regrettable trend (started in PLR 2003-17041) of not allowing "separate accounts" treatment to multiple beneficiaries who take through a trust, even when the trust mandatorily terminates immediately upon the participant's death and is distributed outright (in mandatory shares predetermined by the participant) in separate shares to the individual beneficiaries (or to multiple trusts). See Reg. § 1.401(a)(9)-8, A-2(a)(2), and ¶ 6.3.02.

¶ 6.3.14 *Practical options: trust for spouse*

A. Conduit trust as credit shelter or QTIP substitute, p. 333:

Addition: There is another problem with using a conduit trust for the benefit of the surviving spouse: If the participant and the surviving spouse both die before the participant would have reached age 70½, the IRS may claim there is no "designated beneficiary" when the benefits pass to the remainder beneficiaries of the trust. See Appendix 2 of this Update, discussing PLR 2006-44022.

¶ 6.4.02 *Trust passes out taxable income as part of "DNI"*, pp. 338–341:

IRS CCA 2006-44016 confirms the conclusion in the first full paragraph on p. 339 that post-death distributions from IRAs and other retirement plans are IRD and are included in DNI.

Add the following at the end of subsection "C" (p. 340):

"Note that even though a "formula" pecuniary bequest can carry out DNI, it is still considered a pecuniary bequest for purposes of the rule that assigning the right-to-receive IRD in fulfilment of a pecuniary bequest can trigger realization of income under § 691(a)(2); see ¶ 6.4.08 and Appendix 3 of this Update."

¶ 6.4.07 *Income tax effects of transferring plan*, pp. 346-347:

Add the following at the end of the first full paragraph after the Clothier Example:

"See PLR 2006-52028 for an example of transferring IRAs from the trust to the trust's residuary beneficiaries (charities), ruling that such a transfer is not a taxable assignment of IRD under § 691(a)(2). "

Add the following at the end of the second full paragraph after the Clothier Example:

"See PLR 2006-33009 for an example of transferring IRAs from an estate to the estate's residuary beneficiaries (charities), ruling that such a transfer is not a taxable assignment of IRD under § 691(a)(2)."

¶ 6.4.08 *Funding pecuniary bequest with right-to-receive IRD*, p. 348:

Change: The IRS has finally spoken on this issue, stating that funding a pecuniary bequest by transfer of the right-to-receive IRD always triggers income tax under § 691(a)(2). See Appendix 3 of this Update discussing CCM 2006-44020.

Chapter 7: CHARITABLE GIVING

¶ 7.5.05 *Income tax rules for CRTs; IRD deduction*, section **(A)**, p. 380:

Update: As a result of the Tax Relief and Health Care Act of 2006, the first two sentences of this paragraph need to be reworded as follows; new parts are shown in bold.

A. Retirement benefits and UBTI. **For taxable years beginning prior to 2007,** A CRT that received unrelated business taxable income (UBTI; ¶ 8.5) lost its income tax exemption for the year of such receipt. § 664(c). **For taxable years beginning after 2006,** A CRT that receives unrelated business taxable income (UBTI; ¶ 8.5) does not lose its income tax exemption for the year of such receipt, but is liable for a 100 percent excise tax on the UBTI. § 664(c)(2).

¶ 7.6.01 ***Lifetime gifts from distributions***, pp. 386–388:

The last four paragraphs on p. 388 discuss "qualified charitable distributions" (QCDs, which some people call charitable IRA rollovers) allowed by the Pension Protection Act of 2006 for the years 2006 and 2007. IRS Notice 2007-7, 2007-5 I.R.B. 395, issued in January 2007 clarified many aspects of QCDs. Accordingly, substitute Appendix 4 of this Update for the last four paragraphs on p. 388.

Chapter 8: INVESTMENT INSIGHTS

¶ 8.1.02 ***Restoring lawsuit winnings to an IRA***, p. 395.

See PLR 2007-05031 confirming that settlement proceeds (not only lawsuit winnings) may be restorable to an IRA. This PLR also explains the difference between "replacement funds" (which can be rolled back into the IRA tax-free) and a "new contribution" (which would be subject to the limits applicable to nonrollover IRA contributions). This PLR involved a late rollover by a surviving spouse of "restorative" payments that were made by her late husband's investment advisor and others to settle the husband's claims based on their malfeasance in managing his IRA. PLR 2007-14030 is similar.

¶ 8.4.01 ***Estate tax avoidance: The life insurance subtrust***, p. 409:

Change: Delete the second to last paragraph on p. 410 ("The bottom line").

In an unpublished Technical Advice Memorandum, the IRS has indicated that a life insurance subtrust may disqualify the pension plan. Though this TAM was not published, the taxpayer to whom it was issued sent a copy of it to Steve Leimberg who published it in his *Employee Benefits and Retirement Planning Email Newsletter* - Archive Message #385 (September 19, 2006).

Prior to the appearance of the "unpublished TAM," there was no ruling or case either upholding or denying estate tax exclusion for life insurance held in a retirement plan subtrust or addressing the effect of the subtrust on the qualified status of the retirement plan. In this unpublished TAM the IRS spoke. Basically they said the subtrust disqualified the plan.

The facts were a bit unusual. This involved a defined benefit plan that was established in 1972 for a closely held business, when the business owner was 51. It terminated when he was "approximately" age 76. In 1994, when he was 74, he elected to have his accrued benefit segregated into a separate account, which constituted a commencement of benefits under the plan. In 1995, the plan was amended to increase benefits and add a life insurance subtrust feature.

Several points on which the IRS found THIS plan disqualified were things that could have been avoided with a different plan design and/or document, such as: failure to comply with the qualified joint and survivor annuity requirement; discrimination in favor of highly compensated employees; lack of specificity about the amount of the death benefit; and specifying a larger death benefit than a plan is allowed to provide.

Of equal interest is what the IRS found did NOT disqualify the plan: The IRS found that the participant's irrevocable naming of a death beneficiary (a trust for his family) did not violate the "anti-alienation rule" (§ 401(a)(13), Reg. § 1.401(a)-13(c)). The IRS suggests that the anti-alienation rule is designed to prevent the participant's creditors from gaining control of the benefits, not to prevent the participant from irrevocably naming the natural objects of his bounty as beneficiary.

However, the bottom line is that the IRS ruled that the subtrust disqualified the plan because it prohibited certain plan assets (the insurance policy) from being used to provide retirement benefits. This prohibition violated the "incidental benefit" rule as expounded in Rev. Rul. 56-656 (1956-2 C.B. 280), the IRS concluded. This ruling strikes at the core of the subtrust concept. If the policy must be made available to provide the participant's retirement benefits in order for the plan to retain its qualification, then the participant will necessarily have an "incident of ownership"in the policy. For more discussion of this unpublished TAM, see "Subtrust Triggers Plan Disqualification," by Choate, N., Leimberg, S., and Zaritsky, H., *Tax Notes,* Vol. 113, No. 8 (11/20/06), p. 753.

Now I need to eat my words: In ¶ 8.4.01, I stated that "If estate tax avoidance is important to the client, buy the life insurance outside of the retirement plan. If the insurance must be bought inside the plan, or is already inside the plan, consider using the subtrust technique, which may work to keep the proceeds out of the gross estate." The first sentence is still true, but I now "revoke" the second sentence. Plan qualification is a more important goal, usually, than estate exclusion. Assuming the unpublished TAM represents the IRS's position on the subtrust issue, having a life insurance subtrust poses a substantial risk of plan disqualification, and so should be avoided.

(In the lengthy professional debates over the subtrust going back many years, who got it right? At least in my substantial collection of articles from all sources on this subject, only Mervin Wilf, Esq., of Philadelphia, correctly "called" the plan disqualification issue based on the incidental benefit rule and Rev. Rul. 56-656!)

★¶ 8.4.05 *Life insurance and IRAs and 403(b)s*

CHANGE: The final § 403(b) regulations address the use of life insurance in connection with 403(b) plans. The regulation cited in the first paragraph of ¶ 8.4.05, Reg. § 1.403(b)-1(c), has been replaced. Life insurance is now covered in Reg. § 1.403(b)-6 ("Timing and distribution of benefits"), § 1.403(b)-8 ("Funding"), and § 1.403(b)-11 ("Applicable dates"). Accordingly, replace the first paragraph of ¶ 8.4.05 with:

"403(b) plans may legally be invested only in annuity contracts and/or mutual funds. The 403(b) regulations call both of these investments 'annuities.' New Reg. § 1.403(b)-6(g) provides that a 403(b) annuity must satisfy the 'incidental benefit requirement' of Reg. § 1.401-1(b)(1)(ii). This requirement does not seem to me materially different from the old formulation (in now-obsolete

Reg. § 1.403(b)-1(c)) that a 403(b) annuity can provide 'incidental life insurance protection.' Yet apparently there is some difference, and the new rule is considered to be somehow more stringent than the old rule.

"Reg. § 1.403(b)-8(c)(2) provides that neither a life insurance contract nor an endowment contract is considered 'an annuity contract' for purposes of § 403(b) (which is not news). It also provides that 'If a contract issued by an insurance company qualified to issue annuities in a State provides death benefits as part of the contract, then that coverage is permitted, assuming that those death benefits do not cause the contract to fail to satisfy any requirement applicable to section 403(b) contracts, for example, assuming that those benefits satisfy the incidental benefit requirement of Sec. 1.401-1(b)(1)(i)….'

"The new rule applies only to contracts issued after September 23, 2007. Reg. § 1.403(b)-11(f)."

¶ 8.6.08 *Other statutory exemptions; do they apply to IRAs?*, pp. 434–436:

Add the following at the end of subsection A, on p. 436:

This statement is repeated in IRS Publication 590 (2006), at p. 47. However, according to *Ed Slott's IRA Advisor* (www.irahelp.com, April 2007, p. 7), the IRS has indicated in informal conversations that (contrary to its own statement in Publication 590) taking *any* compensation (not just unreasonable compensation) for managing your own IRA is a prohibited transaction.

Chapter 9: DISTRIBUTIONS BEFORE AGE 59½

¶ 9.3.06 *What other changes do NOT constitute a modification?*, p. 476:

There is a trend of PLRs in which the IRS rules that a minor math error or an IRA provider error does NOT constitute a forbidden modification:

2006-01044: Minor math error (and catchup distribution to correct the error) ≠ modification. The error amounted to "less than .2 of one percent" in this PLR.

2006-31025: Administrator's error ≠ a "modification"; rollover to new IRA provider ≠ a modification. In this PLR, the participant received SOSEPP payments from his IRA in 1997–2002 using the amortization method. In 2003, he switched to the MRD method, then (in a couple of separate steps) rolled the IRA into a new IRA. The new IRA provider made an error and sent some payments that were larger than they were supposed to be.

Confirming the approach seen in PLR 2005-03036 and 2006-16046, the IRS ruled that this IRA provider error did NOT constitute a modification of the SOSEPP because the participant "did all he could in order to ensure that he continued to receive the correct…amount from IRA Z and had no reason to believe that the distributions from IRA Z would not continue to based [sic] upon the …method as he requested…Taxpayer A did not intend to modify the [SOSEPP]…Rather, the modification is due to…the failure of" the financial institution to compute the payments properly.

Though the excess payments did not constitute a modification, it appears the taxpayer had to pay the 10% penalty on the excess payments.

2006-28029: Administrator's error ≠ a "modification." This is similar to the preceding. The taxpayer was receiving two SOSEPPs concurrently from two IRAs, IRA X and IRA Z. Then for two months the IRA provider sent the IRA Z payments from IRA X by mistake; and when the mistake was pointed out, the IRA provider transferred the erroneously distributed amount from IRA Z to IRA X, thinking to correct its earlier error. The IRS ruled that neither of these steps constituted a modification of either of the two SOSEPPs, using similar language as in the preceding ruling ("Taxpayer A did all he could to ensure," etc.).

★¶ 9.3.07 ***What changes DO constitute a modification?***, p. 478:

Subsection E, "Changing how the payments in the series are determined," p. 478: PLR 2007-16032 confirms the other rulings cited in this section. The participant started his SOSEPP in 2004 at age 50 using the "fixed amortization method, without recalculation." He later (in 2006) sought to *add* recalculation to "increase the annual distribution…due to a change in his financial circumstances." The IRS ruled that adding recalculation to an already-existing SOSEPP constitutes a modification.

★¶ 9.3.09 ***Transfers among IRAs supporting a SOSEPP***, p. 481:

Correction! The conclusion stated in this section (and repeated in the first published "Update" to the 6th edition) is apparently wrong. Accordingly, delete everything after the first paragraph of ¶ 9.3.09, and substitute the following:

"Under Rev. Rul. 2002-62, § 2.02(e)(ii), '…a modification to the series of payments will occur if…there is…any nontaxable transfer of a portion of the account balance to another retirement plan….'. Although two PLRs (2006-31025 and 2006-16046) seemed to confirmed that rolling over or transferring assets from the IRA(s) supporting the SOSEPP to another, new, IRA at a different IRA provider (for the purpose of changing investments or financial institutions) does NOT constitute a "modification" of the SOSEPP, a more recent ruling holds just the opposite.

"In PLR 2007-20023, the participant was receiving a SOSEPP from "IRA X." The SOSEPP commenced in 1999. Later in 1999 and again in 2000, the participant transferred some amounts from IRA X into IRA Y, by means of a trustee-to-trustee transfer. This was done based on the advice of his financial advisor solely for the purpose of diversifying his investments. He continued to take the SOSEPP payments from IRA X. Upon information obtained from the firm that obtained this ruling, IRA Y was a new IRA created solely to receive this transfer, and it did not at any time contain any funds other than the amount transferred from IRA X. In 2005, again on the advice of the financial advisor, he closed IRA Y and transferred all funds back in to IRA X.

"The IRS ruled that all transfers from IRA X to IRA Y, and the 2005 transfer back from IRA Y to IRA X, constituted "modifications" of P's SOSEPP, citing Rev. Rul. 2002-62.

"What should we conclude about this IRS flip-flop?

"Should we conclude that the IRS changed its mind about this issue sometime after issuing PLRs 2006-31025 and 2006-16046?

"Or should we conclude that transfer of *the entire old SOSEPP-supporting IRA* into a clean new account from which SOSEPP payments are subsequently made (as occurred in PLRs 2006-31025 and 2006-16046) is "ok," but a partial transfer into a new clean IRA (as occurred in PLR 2007-20023) is "not ok" (even though neither Rev. Rul. 2006-62 nor any of the three PLRs mentioned this distinction)?

"Or should we conclude that the IRS *simply didn't notice* the plan-to-plan transfers in PLRs 2006-31025 and 2006-16046, because it was focusing on the subsequent financial institution clerical errors (which were ruled not to constitute "modifications") and nobody specifically asked the IRS about the plan-to-plan transfers that had occurred before those errors?

"Whatever the answer is, the moral of the story is obvious: A participant receiving a SOSEPP must not transfer ANY funds into or out of that account (even into a clean new IRA for purposes of changing investments) without getting a prior ruling from the IRS that the move will not constitute a modification."

APPENDIX B: FORMS

Form 4.6 Establishing a Conduit Trust for One Beneficiary

Addition: The next to last sentence of this form in the book says "All amounts so withdrawn (net of expenses properly charged thereto) shall be distributed to the Beneficiary, if the Beneficiary is then living." Deb Lush, Esq., asks why the form does not say that such amounts shall be distributed "to *or for the benefit of* the Beneficiary." Assuming your trust document contains a suitable definition of "for the benefit of," then I see no problem with allowing distributions "for the benefit of" as well as "to" the beneficiary in a conduit trust. I am not aware of any IRS pronouncements one way or the other on this point.

Appendix 1 to the Update of *Life and Death Planning for Retirement Benefits* (6th ed. 2006)

NONSPOUSE BENEFICIARY ROLLOVERS UNDER THE PENSION PROTECTION ACT OF 2006, AFTER IRS NOTICE 2007-7 AND SUBSEQUENT IRS "CLARIFICATION"

I. SUMMARY

Prior to the Pension Protection Act of 2006 (PPA 2006), the Code permitted no one other than the participant and his surviving spouse to "roll over" money tax-free from one retirement plan to another. With enactment of PPA 2006, Congress for the first time allowed a type of rollover by a Designated Beneficiary other than the surviving spouse. Effective 1/1/2007, a Designated Beneficiary is permitted to transfer an inherited qualified retirement plan benefit, *by direct rollover only*, into an "inherited" IRA newly created for that purpose.[1]

The main advantage of this new type of transfer is that it allows a beneficiary to take advantage of a deferred "stretch" payout of the benefits over his life expectancy, even if the plan he/she actually inherited permitted only a lump sum distribution form of benefit. In Notice 2007-7, 2007-5 I.R.B. 1, the IRS addressed the MRD effects and other details of nonspouse-beneficiary rollovers. Notice 2007-7 was further clarified in a special edition of the IRS's "employee plan news" (http://www.irs.gov/pub/irs-tege/se_021307.pdf). Unfortunately, the IRS's approach may negate the benefits of PPA 2006 for many beneficiaries.

II. GROUND RULES FOR NONSPOUSE BENEFICIARY ROLLOVERS

A. When? This option is available *only* for post-2006 distributions. Note that the controlling date is the date of the distribution, not the date of death. Any nonspouse Designated Beneficiary can transfer his inherited benefits to an inherited IRA after 2006, regardless of how long ago his benefactor died, subject to two limitations: See III(C)(2) below regarding issues if the inherited benefits are subject to the 5-year rule for MRD purposes; and see IV below regarding whether the plan is required to permit such transfers.

B. Where? The inherited plan must be rolled into an "inherited" IRA that is created for the purpose of receiving the rollover. § 402(c)(11)(A); Notice 2007-7, Part V (first paragraph). The "inherited" IRA must have the same (deceased) "owner" and beneficiary as the originally inherited plan, and must be titled to indicate it is an inherited IRA, e.g., "Tom Smith as beneficiary of John Smith." Notice 2007-7, A-13. Whether this newly-created inherited IRA can then later be merged with another inherited IRA in the name of the same participant and beneficiary remains to be seen.

[1] See § 402(c)(11), added to the Code by § 829(a)(1) of PPA 2006. The new rule applies to 403(b) plans and 457 plans as well as qualified plans. PPA 2006 § 829(a)(2)–(4). For ease of reference this paper will speak mostly of qualified plans, but all statements apply equally to 403(b) and 457 plans.

C. **Who?** The rollover-to-an-inherited-IRA option is available *only* for Designated Beneficiaries, other than the participant's surviving spouse; see V(D) below regarding the surviving spouse. A Designated Beneficiary is an *individual* who inherited the benefits on the participant's death under the terms of the participant's beneficiary designation form or under the terms of the plan. For more detail on the definition of designated beneficiary, see § 401(a)(9)(E), Reg. § 1.401(a)(9)-4, A-1 and A-2, and ¶ 1.7 of *Life and Death Planning for Retirement Benefits*. The law also specifies that the IRS is to provide rules whereby a trust maintained for the benefit of one or more Designated Beneficiaries is treated as a Designated Beneficiary for this purpose. § 402(c)(11)(B). Notice 2007-7, A-16, as expected, confirms that the IRS's existing "see-through trust" rules (see Reg. § 1.401(a)(9)-4, A-5(b), and ¶ 6.2 of *Life and Death Planning for Retirement Benefits*) will be used for this purpose. See V(A) below for the effect of § 402(c)(11) on benefits left to estates and non-see-through trusts.

D. **Which distributions?** The new rule applies only to *post-death* distributions. If the participant took a distribution *prior to* death, then died before rolling it over, see ¶ 2.6.03 of *Life and Death Planning for Retirement Benefits* for whether the executor can complete the rollover. § 402(c)(11) has no effect on that situation. Also, as is always true, minimum required distributions (MRDs) are not eligible for rollover; see III(F) below.

E. **How?** § 402(c)(11) allows the nonspouse beneficiary rollover to occur ONLY by means of a trustee-to-trustee transfer (what the IRS calls a "direct rollover") from the QRP, 403(b), or 457 plan to the "inherited" IRA. § 402(c)(11)(A). A permissible means of accomplishing a direct rollover is for the distributing plan to issue a check payable to the distributee IRA, then give the check to the beneficiary and have the beneficiary deliver the check to the distributee plan. Notice 2007-7, A-11. See Reg. § 1.401(a)(31)-1, A-3, A-4, for full details regarding permissible methods of accomplishing a direct rollover. If the plan makes the check *payable to the beneficiary*, instead of *to the IRA*, then the distribution is taxable and rollover of the distributed funds becomes impossible. Notice 2007-7, A-11.

NOTE: The beneficiary can take a distribution of SOME of the inherited plan and still roll over THE REST of the plan; for example, as discussed at III(F) below, the beneficiary must take certain MRDs before he/she can be allowed to roll over the rest of the inherited plan. However, once the beneficiary has taken a distribution of any amount, there is no way that *distributed amount* can be put back into the plan it came out of or rolled into another plan, even if the distribution was accidental. The IRS has no power to authorize the contribution of the distributed amount to the same or another plan. PLR 2005-13032.

III. MINIMUM DISTRIBUTION ASPECTS OF NONSPOUSE ROLLOVERS

A. Background

The main advantage of tax-favored retirement plans is the ability to defer distributions from the plan. Money remains in the plan, growing tax-deferred, until it is actually distributed.

Deferral cannot last forever; the minimum required distribution (MRD) rules of § 401(a)(9) set the outer limits of deferral. When the original owner of the plan dies, the MRD rules generally require that the benefits must be paid out in annual instalments over the life expectancy of the designated individual beneficiary. This type of payout is usually referred to as the "life expectancy of the beneficiary," "life expectancy," or "stretch" payout.

Under the Code, that is the *slowest* rate at which the benefits can be paid out after the owner's death; nothing in the Code prevents a plan from paying out the benefits more rapidly. In short, plans are not required to offer the beneficiary the option of a life expectancy payout, and many (most?) qualified retirement plans do *not* offer the life expectancy payout for death benefits. Rather, they offer a single lump sum distribution as the only form of death benefit; typically, plans do not want the expense and trouble of administering an employee's retirement plan account after the employee has died.

However, this common plan policy created an unfortunate situation for many beneficiaries. The Code says the beneficiary can take the benefits out gradually over his life expectancy, but the plan won't allow him to do that. Prior to the PPA 2006, there was usually nothing the beneficiary could do about this situation, other than take a fully taxable immediate lump sum and forget about continued tax deferral, because the law did not allow a nonspouse beneficiary to do any type of "rollover" of inherited plan benefits into another retirement plan.

B. What Minimum Distribution Rules Apply after the Rollover?

The purpose of the new § 402(c)(11) was to allow beneficiaries who were entitled under the law to a life expectancy payout to actually *get* that life expectancy payout, even if the inherited plan offered only a lump sum payout, by transferring the inherited plan to an "inherited" IRA. Let us now drill down and see what the Code and the IRS tell us about what minimum distribution rules will apply to the "inherited" IRA.

§ 402(c)(11)(A) provides that the transferee plan "shall be treated as an inherited individual retirement account…for purposes of this title" and that "section 401(a)(9)(B) (other than clause (iv) thereof) shall apply to such plan." § 401(a)(9)(B) contains all the post-death minimum distribution rules; the excluded clause (iv) deals with benefits payable to a surviving spouse. It would thus appear under the new Code provision that the minimum distribution rules are to be applied *ab initio* to the transferee "inherited" IRA. The report of the Joint Committee on Taxation supports this interpretation: "The IRA is treated as an inherited IRA of the nonspouse beneficiary. Thus, for example, distributions from the inherited IRA are subject to the distribution rules applicable to beneficiaries." JCT, "Explanation of Provisions."

However, the IRS, in Notice 2007-7, A-19, provides exactly the opposite of what Congress provided: "The rules for determining the required minimum distributions *under the [originally inherited] plan* with respect to the nonspouse beneficiary also apply *under the [transferee "inherited"] IRA*. Thus, if the employee dies before his or her required beginning date and the 5-year rule in § 401(a)(9)(B)(ii) applied to the nonspouse designated beneficiary…the 5-year rule applies for purposes of determining required minimum distributions under the IRA." Emphasis added. If this rule is applied literally, the benefits of PPA 2006 will be denied to many of the people it was intended to help; see "D" below for one exception to this rule.

C. The MRD rules that apply to a nonspouse Designated Beneficiary

The MRD rules that apply to a nonspouse Designated Beneficiary are different depending on whether the participant died before or after his required beginning date (RBD).[2]

1. Death after the RBD: No Problem

If the participant died *on or after* the RBD, the Applicable Distribution Period (ADP) for the benefits is the life expectancy of the beneficiary, or, if longer, what would have been the life expectancy of the deceased participant.[3] So, a beneficiary who inherits a plan from someone who died on or after his RBD can (after taking any accrued MRDs; see III(F) below) transfer the inherited plan benefit to an "inherited" IRA. Under Notice 2007-7, and under any interpretation of the Code, MRDs from the inherited IRA will continue to be based on the life expectancy of the designated beneficiary (or the life expectancy of the participant if longer). The inherited plan might require a lump sum distribution of the benefits, and is perfectly entitled to do so; but the *minimum required distributions* under the law (as opposed to the distribution options under the plan document) are based on the life expectancy of the beneficiary (or of the participant, if longer).

2. Death before the RBD: A Problem

As noted above, when death occurs on or after the RBD, there is only one possible ADP for benefits payable to a Designated Beneficiary. The same is true *under the Internal Revenue Code* when the participant dies *before* the RBD—there is only one possible ADP, namely, the life expectancy of the Designated Beneficiary.[4]

However, the IRS regulations do not follow the Code in this regard. The IRS's regulations substantially modified the Code's MRD rules in several ways and this is one of them. Under the IRS regulations, there are *two* possible MRD schemes for benefits payable to a Designated Beneficiary when death occurs before the RBD. One scheme calls for annual distributions over the life expectancy of the Designated Beneficiary. The other, the 5-year rule, requires that all amounts be distributed no later than the end of the calendar year that contains the fifth anniversary of the date of death. Reg. § 1.401(a)(9)-3, A-1.

[2] The RBD is generally April 1 of the year following the year in which the participant reaches age 70½ (or in which the participant retires, in some cases). § 401(a)(9)(C); Reg. § 1.401(a)(9)-5, A-1(c). See ¶ 1.4 of *Life and Death Planning for Retirement Benefits*.

[3] Reg. § 1.401(a)(9)-5, A-5(a)(1). See ¶ 1.5.04(B) of *Life and Death Planning for Retirement Benefits*.

[4] § 401(a)(9)(B)(iii). See ¶ 1.5.07 of *Life and Death Planning for Retirement Benefits*.

Unless the designated beneficiary is over 90, the life expectancy payout will provide a longer potential period of permissible tax deferral than the 5-year rule. Obviously, the goal for tax-sensitive individuals under age 90 is to avoid having the 5-year rule apply. But Notice 2007-7 is saying, if the 5-year rule applied under the plan it will apply under the transferee IRA as well. Thus, you generally cannot (according to Notice 2007-7) use the § 402(c)(11) rollover as a way to escape the 5-year rule and switch to a life expectancy payout under the transferee/inherited IRA (for the one exception, see "D").

Under the *Code*, the 5-year rule applies *only* when there is no Designated Beneficiary. But under the *regulations*, the 5-year rule can apply even when benefits are left to a Designated Beneficiary. This can happen in one of three ways:

(a) The plan can provide that the 5-year rule always applies in cases of death before the RBD, regardless of whether there is a designated beneficiary. Reg. § 1.401(a)(9)-3, A-4(b).

(b) The plan can give the beneficiary the right to choose between the 5-year rule and the life expectancy payout, and the beneficiary could choose the 5-year rule. Reg. § 1.401(a)(9)-3, A-4(c), first sentence.

(c) The plan can give the beneficiary the right to choose between the 5-year rule and the life expectancy payout, and can provide that the default rule (if the beneficiary fails to elect otherwise by a certain deadline) is the 5-year rule. Reg. § 1.401(a)(9)-3, A-4(c), fourth sentence.

If the 5-year rule is triggered in any one of those three ways then the plan's MRDs for that benefit are determined under the 5-year rule, and (according to A-19 of Notice 2007-7) the 5-year rule carries over to the inherited IRA—unless the following special rule/exception applies:

D. Special Rule Provides Limited Exception

Despite the clear statement in A-19 that "The rules for determining the required minimum distributions under the plan…also apply under the IRA," Notice 2007-7 allows *some* beneficiaries who are subject to the 5-year rule to change to the life expectancy payout. Specifically, the beneficiary "may determine the required minimum distribution under the plan using the life expectancy rule in the case of a distribution made prior to the end of the year following the year of death." In order to use this rule, the required minimum distributions under the transferee IRA must also be determined "under the life expectancy rule using the same designated beneficiary." Notice 2007-7, A-17(c)(2) ("Special Rule"). This Special Rule applies to any beneficiary who is subject to the 5-year rule in the plan.

Although the following is only implied in Notice 2007-7, the IRS's later "clarification" makes clear that the A-17 "special rule" is an exception to the general rule in A-19; and that if the 5-year rule applies to the benefit under the plan that the beneficiary actually inherited, then:

1. The 5-year rule will also apply to the transferee/inherited IRA, *unless* the rollover to the inherited IRA is "made prior to the end of the year following the year of the participant's death." Thus, the rollover can occur either during the year of death or during the following year, and the beneficiary can switch to the life expectancy method in the inherited IRA.

2. If the rollover occurs in the same year as the participant's death, the entire amount can be rolled over, or the beneficiary can take part of the plan benefit as a distribution if he chooses and roll over the rest.

3. If the rollover occurs in the year after the year of the participant's death, and the beneficiary wants the life expectancy payout method to apply to the inherited IRA, then the beneficiary must take as a distribution (i.e., not roll over) at least the amount that would have been the MRD for the year after the year of the participant's death if the life expectancy payout method had applied to the plan.

4. If the rollover occurs later than the year after the year of the participant's death, then the 5-year rule will apply to the "inherited" IRA. Since an MRD cannot be rolled over, the latest that a rollover could occur at all would be the year that contains the fourth anniversary of the participant's date of death; in the fifth year, the entire account becomes the "MRD" and accordingly no part of it is eligible for rollover.

The Special Rule is not clearly written. It does not provide any particular procedure for electing out of the 5-year rule.

What if, in the year after the year of the participant's death, the plan distributes the entire amount of the account to the transferee IRA, without cutting a separate check to the beneficiary for the MRD? Presumably, the beneficiary can treat the rollover (to the extent of the year-after-death MRD that should not have been rolled over) as an excess IRA contribution and distribute it to himself to avoid penalties. However, the Notice does not say what happens in this case.

E. PPA 2006 does not help with pre-2006 deaths if 5-year rule applied

One of the great disappointments in Notice 2007-7 is that it effectively limits the benefits of PPA 2006 to cases where death occurs in 2006 and later. A beneficiary who is subject to the 5-year rule under the plan is stuck with the 5-year rule if he does not get the rollover done in the year after the year of the employee's death—regardless of whether he took life expectancy-based "MRDs" from the plan every year:

> **Jeff Example:** Jeff inherited his uncle's 401(k) plan in 2003. The uncle died before his RBD. The plan requires use of the 5-year rule for all benefits, so the 5-year rule applies to Jeff's benefit under the plan. However, the plan allows beneficiaries to withdraw as much or as little as they want prior to the 5-year deadline. Sensing that Congress might someday allow nonspouse beneficiary rollovers, Jeff withdrew, in 2004, 2005, and 2006, what would have been the minimum required distributions had MRDs under the plan been based on

> Jeff's life expectancy. When he read the PPA 2006, he joyfully concluded he could transfer the rest of the plan balance (minus the 2007 MRD) to an inherited IRA in 2007 and use the life expectancy method forever after for the "inherited" IRA. But the IRS in Notice 2007-7 spoiled his plans.

It is clear that Jeff can transfer the remaining plan balance to an inherited IRA in 2007, but the Special Rule will not allow him to use the life expectancy method rather than the 5-year rule for that inherited IRA. The Special Rule applies only to rollover distributions made *no later than the end of the year after the year of death*. It does not allow any exception to the A-19 rule for rollover distributions that occur *later* than the year after the year of death.

F. Beneficiary must take MRDs before doing the rollover

Two well-established rules apply to nonspouse beneficiary rollovers just as they apply to all types of rollovers. Rule 1: An MRD cannot be rolled over. § 402(c)(4)(B). Rule 2: The first money distributed out of a plan in any year is the MRD. Reg. § 1.402(c)-2, A-7(a). See ¶ 2.6.04 of *Life and Death Planning for Retirement Benefits*.

Thus, the beneficiary who wishes to have his inherited QRP benefit rolled over to an "inherited" IRA must first take distribution of the MRD for the year of the rollover. Taking the MRD for the year of the rollover (and any prior years) does not preclude the beneficiary from rolling over the rest of the plan; in fact, it is a prerequisite of rolling over the rest of the plan. (Even taking distributions in excess of the MRD does not preclude rolling over the rest of the plan, i.e., the nondistributed part; of course, any amount that is actually distributed to the beneficiary, whether it is in MRD or otherwise, cannot later be rolled over. See II(E).

If the benefit to be rolled over is subject to the 5-year rule (see III(C) above), 100 percent of the account is the "MRD" in the year that contains the fifth anniversary of the participant's death and there is no MRD in any year before that. Notice 2007-7, A-17(b).

> **Debby Example:** Debby inherited her father's 401(k) plan when he died in 2005, before his RBD. The plan provides that all pre-RBD death benefits are subject to the 5-year rule, and that all benefits must be paid in a single lump sum. The plan does permit nonspouse beneficiary rollovers. Debby and her advisor conclude that the 5-year rule applies to Debby's inherited plan and will continue to apply to the inherited IRA to which she transfers the benefit. Debby would like to have her own investment choices (rather than the plan's choices) for the benefit, and also would like to spread out the taxation of the income to the extent the law allows her to do so. Accordingly, in early 2007, she had the plan transfer her entire benefit to an inherited IRA. In late 2007, she will take a partial distribution from the IRA. She will take out the rest of the IRS in three instalments in 2008, 2009, and 2010, thus at least getting a four-year "spread" of the income taxation. Under the plan she inherited, it would have been impossible to avoid taxation of the entire amount in one taxable year.

IV. ARE PLANS REQUIRED TO ALLOW THESE ROLLOVERS?

If plans are not required to offer nonspouse beneficiary rollovers, then some (many?) plans will choose not to offer such rollovers. Offering another option to beneficiaries may appear to complicate things, so some plans will choose not to bother. The IRS has decided that plans are not required to offer this option to beneficiaries. Notice 2007-7, A-14, A-15.[5]

This IRS interpretation seems contrary to the Internal Revenue Code.

Under § 401(a)(31)(A), a QRP *must* transfer any "eligible rollover distribution" to an eligible retirement plan if so elected by the "distributee." Thus, direct rollovers are not optional with the plan—they are required by the Code if requested by the distributee.

For purposes of § 401(a)(31)(A), "eligible rollover distribution" is defined in § 402(f)(2)(A). § 401(a)(31)(D). § 402(f)(2)(A) defines "eligible rollover distribution" by reference to § 402(c)(4) (and to the comparable provisions of § 403 and § 457, defining eligible rollover distribution for purposes of § 403 and § 457).

§ 402(c)(11)(A)(i) provides that the transfer of an inherited plan benefit by a nonspouse beneficiary to an inherited IRA "shall be treated as an eligible rollover distribution for *purposes of this subsection*." Emphasis added. The "subsection" referred to must be § 402(c), which contains all the rules for qualified plan rollovers. "This subsection" cannot mean § 402(c)(11) (or any subsection thereof), because the term "eligible rollover distribution" does not appear anywhere else in § 402(c)(11). It cannot mean § 402 because that is a section not a subsection.

Therefore, the nonspouse rollover is an eligible rollover distribution *for purposes of § 402(c)*, which includes *§ 402(c)(4)*, which in turn *is incorporated in § 402(f)(2)(A)*, which in turn provides the definition of "eligible rollover distribution" for purposes of § 401(a)(31)(A). Therefore, it would appear that these nonspouse rollovers are, under the Code, subject to the mandatory language of § 401(a)(31)(A), and plans must honor the request made by the distributee.[6] However, the IRS does not agree with this interpretation.

V. WHEN THE BENEFICIARY ROLLOVER HELPS (OR DOESN'T)

Despite the defects of Notice 2007-7, the following beneficiaries can use a nonspouse beneficiary rollover under § 402(c)(11) to transfer inherited QRP, 403(b) plan, or 457 plan benefits to an "inherited" IRA, and can use the life-expectancy payout method for the "inherited" IRA, provided (according to Notice 2007-7) the distributing plan permits such rollovers:

[5] There is one exception: In the case of certain terminated defined contribution plans, "the plan will be considered to offer direct rollovers pursuant to § 402(c)(11)…without regard to plan terms." Notice 2007-7, A-14.

[6] I thank Brent A. Ritchey, JD, CFP, CLU, of Northwestern Mutual's Advanced Planning Division, for pointing this out to me—before Notice 2007-7.

1. Any Designated Beneficiary or see-through trust that inherited from a participant who died on or after his RBD; and

2. Any Designated Beneficiary or see-through trust that inherited from a participant who died before his RBD, where *either* MRDs under the plan are determined under the life-expectancy-of-the-beneficiary payout method *or* (under the Special Rule; see III(D) above) the benefits under the plan are subject to the 5-year rule but the rollover occurs by the end of the year after the year of the participant's death.

If the Designated Beneficiary or see-through trust inherited benefits from a participant who died before the RBD, and the 5-year rule applied to those inherited benefits, and the rollover did not occur prior to the end of the year after the year of the participant's death, see III(D) above regarding why § 402(c)(11) does not help.

Here are some other situations in which the nonspouse beneficiary rollover will NOT help:

A. **An estate or non-see-through trust cannot use § 402(c)(11).** Because nonspouse beneficiary rollovers are restricted to Designated Beneficiaries, § 402(c)(11) does not allow an estate or non-see-through trust to transfer plan benefits left to such estate or trust into an "inherited" IRA payable to the estate or trust. At first, it would appear that this limitation is immaterial; after all, an estate or a non-see-through trust does not qualify for the life-expectancy-of-the-beneficiary payout method anyway, so why should it care whether it receives a lump sum? The answer is that, even though it does not qualify for the life-expectancy-of-the-beneficiary payout method, an estate or trust might like to use the limited deferral that is allowed under the applicable "no-designated beneficiary" rule, i.e., the 5-year rule or the remaining life expectancy of the participant (depending on whether the participant died before or after his RBD). Unfortunately, such an estate or trust will still be stuck with a lump sum distribution if that's all the plan allows.

B. **You cannot use § 402(c)(11) to fix a defective beneficiary designation.** § 402(c)(11) can NOT be used to "create" a Designated Beneficiary when there is no Designated Beneficiary. For example, suppose widowed Father dies without having named any beneficiary for his 401(k) plan. Under the plan terms, the benefits are payable to Father's estate. Father's three children are the sole beneficiaries of his estate. An estate is not and cannot be a Designated Beneficiary under the IRS rules. See ¶ 1.7.04. The children will still not be able to use the life expectancy payout method. Even if PPA 2006 permitted the estate to transfer the inherited 401(k) plan to an "inherited" IRA (which it does not; see V(A)), that would not permit the family to change the beneficiary of the plan from "the estate" to "the children."

C. **A nonspouse beneficiary still cannot roll over benefits to his own plan.** A nonspouse beneficiary is never allowed to roll over inherited benefits to the beneficiary's *own* plan. § 402(c)(9), § 408(d)(3)(C). PPA 2006 does not change this.

D. **Why the spouse is left out.** § 402(c)(11) applies only to nonspouse beneficiaries. The surviving spouse as beneficiary has even more options, and always has had such options, under other provisions of the Code, so the surviving spouse has no need to use § 402(c)(11). The Code and regulations clearly establish the surviving spouse's right to roll over inherited plan benefits to her own IRA.[7] The IRS (in private letter rulings) has also long recognized the surviving spouse's right to transfer inherited plan benefits to an IRA *in the name of the decedent*. See, e.g., PLRs 9418034, 9842058, 2004-50057, and 2006-08029. Interestingly, in none of these IRAs did the IRS specify that the same MRD rules that applied to the inherited plan also applied to the "beneficiary IRA" into which the spouse transferred the benefits. In fact, it appears probable that in some of these rulings the spouse was doing the transfer just to escape the 5-year rule that might otherwise have applied to the plan benefit.

VI. IMPLICATIONS FOR PLANNERS

When a plan participant retires, the question always arises whether he/she should roll money out of the former employer's retirement plans and into the participant's own IRA. In a few cases, the decision is driven by concerns about vulnerability to creditors' claims or unique state tax law attributes, but for the vast majority of retirees the decision is about their personal convenience and/or what is most desirable for their beneficiaries.

Prior to PPA 2006, most estate planners would urge most clients to roll over their employer plan benefits to an IRA as soon as possible in order to assure the best payout options for the client's death beneficiaries: "If you don't roll over now while you're alive, Mr./Mrs./Ms. Client, your beneficiaries won't be able to roll over after your demise!" This was a powerful motivator for anyone whose death benefits might be going to pass at his death to a beneficiary other than his surviving spouse or charity.

PPA 2006 *appeared* to remove this motivation for rolling over money from an employer plan to an IRA. Since PPA 2006 *appeared* to allow nonspouse beneficiaries freely to roll plan money to an inherited IRA after the participant's death, there was no longer any need (it seemed) to pressure clients to roll over prior to death. However, Notice 2007-7 makes clear that the beneficiaries of deceased employees cannot count on this option being available. So Notice 2007-7 has put us right back where we were before PPA 2006: Barring special considerations, most clients should still roll over from a qualified plan to an IRA as soon as they are permitted to do so!

[7] § 402(c)(9); see ¶ 3.2.03.

Appendix 2 to the Update of *Life and Death Planning for Retirement Benefits* (6th ed. 2006)

PLR 2006-44022: CONDUIT TRUST FOR SURVIVING SPOUSE:
HOW TO DETERMINE MRDS AFTER DEATH OF SURVIVING SPOUSE

Executive summary: § 401(a)(9)(B)(iv)(II) is an obscure minimum required distribution (MRD) rule. Since it applies only when a participant dies before his required beginning date (RBD) leaving an IRA (or other retirement plan) to his surviving spouse as sole beneficiary, AND the spouse-beneficiary, having survived the participant, ALSO dies before the end of the year the participant would have reached age 70½ (without having withdrawn or rolled over the benefits), it does not get called into action very often. When this rule does apply, it dictates that MRDs after the surviving spouse's death are determined "as if" the surviving spouse were the "participant." See § 401(a)(9)(B)(iv)(II); Reg. § 1.401(a)(9)-3, A-5, A-6; § 1.401(a)(9)-4, A-4(b); and ¶ 1.6.05 for details on this rule. In PLR 2006-44022, the IRS got that part of the rule right, but then veered off track in finding that the spouse had no "designated beneficiary," so the 5-year rule applied. The IRS forgot its own definition of designated beneficiary; what the IRS SHOULD have said is that the surviving spouse's son qualified as a designated beneficiary and the applicable distribution period (ADP) for the benefits after the wife's death was the son's life expectancy.

Facts of PLR 2006-44022

In PLR 2006-44022 the IRS had an opportunity to apply the special rule and blew it.

In this PLR, the participant ("P") died in 2001, the year he reached or would have reached age 63, leaving his IRA to Trust T. After P's death, "litigation ensued" among the beneficiaries of Trust T, ultimately leading to a settlement under which Trust T was reformed. "Pursuant to said reformation, Wife is treated as the beneficiary of Trust T entitled to received distributions from" the IRA. It appears that under the reformed trust P's Wife was entitled to receive automatically the MRD from the IRA (based on her life expectancy) and also to demand distribution to herself of the income of the IRA (if greater than the MRD) and also to demand distribution of the entire IRA to herself. Upon her death, under the reformed trust, "amounts remaining in IRA X were to be paid to her living lineal descendants."

Wife died in 2004 (the year the deceased original participant would have reached age 66—i.e., before the year in which the deceased participant would have reached age 70½), so the IRA passed to Son, her only living descendant.

IRS Applies the Law to the Facts (Incorrectly)

First, the IRS had to determine whether the spouse was considered the participant's "sole beneficiary" in these circumstances, where the actual beneficiary of the IRA was a trust. Because all IRA distributions during the wife's life had to be paid to the wife, the IRS correctly determined that the son's interest was as a mere "successor beneficiary" to the wife (for purposes of determining who was or were the participant's beneficiary(ies)), so the wife was considered the sole beneficiary of the trust and therefore of the IRA. See Reg. § 1.401(a)(9)-5, A-5(c)(2), and A-7(c)(3), Example

2; Rev. Rul. 2000-2, 2000-1 C.B. 305; and ¶ 1.6.07(A) of *Life and Death Planning for Retirement Benefits*. Therefore, the IRS correctly concluded, the special rule of § 401(a)(9)(B)(iv)(II) applied.

Because § 401(a)(9)(B)(iv)(II) applied, the ADP for the IRA after the wife's death would be the life expectancy of *wife's* designated beneficiary, or (if there were no designated beneficiary upon wife's death) the 5-year rule would apply.

On this point, the IRS states that "Wife did not name a beneficiary of her interest in IRA X. Thus, as a result, pursuant to section 1.401(a)(9)-4 of the 'Final' regulations, Q&A-4(b), the 5-year rule…applies to the distribution of amounts remaining in IRA X at her death." This part of the ruling is erroneous.

First, it is wrong to say the spouse did not "name" Son as her beneficiary. As a party to the settlement agreement that established the reformed trust, she DID "name" Son as her beneficiary.

But more to the point, it is not necessary for the spouse to *name* a designated beneficiary in order for the spouse to *have* a designated beneficiary. Reg. § 1.401(a)(9)-4, A-4(b), does not say that the surviving spouse must "name" a designated beneficiary. Rather, it says that "the relevant designated beneficiary for determining the distribution period after the death of the surviving spouse is the designated beneficiary of the surviving spouse," and the 5-year rule applies only if "there is no designated beneficiary under the plan with respect to that surviving spouse." And the IRS's own regulations stipulate that a designated beneficiary can exist WITHOUT being "named" by the participant:

> "A designated beneficiary is an individual who is designated as a beneficiary under the plan. … *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 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." Reg. § 1.401(a)(9)-4, A-1. Emphasis added.

> "Q-2. Must an employee...make an affirmative election specifying a beneficiary for a person to be a designated beneficiary under section 40l(a)(9)(E)?"
>
> "A-2. No, a designated beneficiary is an individual who is designated as a beneficiary under the plan *whether or not the designation under the plan was made by the employee*." Reg. § 1.401(a)(9)-4, A-2. Emphasis added.

Son was the remainder beneficiary under the exact same trust instrument that named Wife as sole life beneficiary and that was named as beneficiary of the IRA. Thus, Son was just as much a designated beneficiary "under the plan" as Wife herself. If Son isn't a "designated beneficiary under the plan," then Wife wasn't either!

The benefits did not pass to Son at Wife's death as a result of state intestacy laws, or through Wife's estate; the benefits passed to Son at Wife's death under the see-through trust that was (as a result of the reformation) the named beneficiary of the IRA. Thus, the IRS should have ruled that the ADP after Wife's death was the life expectancy of her designated beneficiary, Son.

This PLR represents a misstep by the IRS, and should be withdrawn.

Appendix 3 to the Update of *Life and Death Planning for Retirement Benefits* (6^{th} ed. 2006)

CCM 2006-44020: FUNDING A PECUNIARY BEQUEST BY TRANSFER OF THE RIGHT-TO-RECEIVE IRD

This Appendix updates ¶ 6.4.08.

Executive Summary: In Chief Counsel Memorandum 2006-44020, the IRS addressed the tax consequences of a trustee's transferring an IRA to a beneficiary to fulfill a pecuniary legacy. The Chief Counsel advised that the trustee's assignment of an interest in an IRA to a trust beneficiary in satisfaction of a pecuniary gift triggered realization of income at the trust level under § 691(a)(2), and further ruled that (even though the beneficiary was a charity) the trust was not entitled to an income tax charitable deduction for the transfer. Although the wording of the Memorandum is overly broad (and would be contrary to law if applied to all situations it appears to cover), the Memorandum may be correct as applied to the fact situation in this ruling.

Facts: A participant ("Decedent") died leaving his IRA to his revocable trust ("Trust") as beneficiary. Trust provided that, upon the Decedent's death, the trustee was to distribute the sum of $100,000 ("in cash or in kind") to three charities, "$x to Charity 1, $y to Charity 2, and $z to Charity 3." The residue of the trust was to be distributed outright to (and/or held in trust for) the participant's children. The Trust gave the trustee the "discretion and power to make distributions or division of principal in cash or in kind, or both, at fair market values current at a date of distribution fixed by the trustee, without any requirement that each item be distributed or divided ratably." The IRA was not the only asset available to fund the pecuniary bequests.

The trustee instructed the IRA provider to divide the IRA into shares, "each titled in the name of a beneficiary under" the Trust. In accordance with these instructions, an inherited IRA worth $x was carved out of the original IRA and placed in the name of Charity 1 as beneficiary, an inherited IRA worth $y was carved out of the original IRA and established in the name of Charity 2 as beneficiary, etc. "Thus, each of the Charities became the owner and beneficiary of an IRA equal in value, at the time of division, to the dollar amount it was entitled to under Trust."

Obviously, the trustee was trying to avoid having the trust be subject to income taxes on the IRA funds that were used to fund the charitable bequests. If the trustee had simply withdrawn $100,000 from the IRA and then distributed $100,000 to the charities, the Trust would have been stuck paying the income taxes on the IRA distribution. The IRA distribution would have been included in the trust's gross income as "income in respect of a decedent" (IRD) under § 691, and the Trust would not have been entitled to an income tax deduction for the distributions to the charities (see ¶ 7.4.01).

The trustee wanted to avoid that scenario. The trustee wanted to fund the charitable bequests with pre-tax dollars by assigning shares of the IRA, intact, to the charities in fulfilment of their bequests. The charities, being tax-exempt, could then withdraw funds from the IRAs without incurring income taxes.

The Chief Counsel concluded that the trustee's strategy did not work. The Chief Counsel treated the transfer of the IRA shares as a taxable "assignment of the right to receive IRD" under § 691(a)(2). The Chief Counsel stated that the trust must treat the IRA assignments as "sales or exchanges" of the IRD asset, and therefore the trust must include in its gross income the value of the IRAs it assigned to the charities. Citing *Kenan v. Comm'r*, 114 F. 2d 217 (2d Cir. 1940), the IRS said it believes the trust "has received an immediate economic benefit by satisfying its pecuniary obligation to the Charities with property on which neither Trust nor Decedent have previously paid income tax which [sic] is a disposition for § 691(a)(2) purposes."

Is the Chief Counsel correct? Reasonable practitioners apparently disagree on this point. The highly esteemed Professor P___'s reaction was "Obviously the IRS is correct!," but the equally expert estate planner Attorney C___ assured me that "The IRS is obviously wrong!" Let's analyze, and you be the judge.[8]

The taxpayer's argument

The trustee argued that § 691(a)(2) should not apply because that Code section was "trumped" by § 408(d)(1), which provides that "any amount paid or distributed out of an individual retirement plan shall be included in gross income by the payee or distributee." The taxpayer's argument was that § 408(d)(1) prohibits income taxation of an IRA on any occasion other than actual distribution.

The Chief Counsel made short shrift of this argument, concluding that Congress's sole purpose in enacting § 408(d)(1) was to avoid having the doctrine of "constructive receipt" applied to IRAs. If it were not for § 408(d)(1) (and § 402(a) and § 403(b)(1), the similar provisions applicable to qualified and 403(b) plans), the doctrine of constructive receipt would make a retirement plan participant or beneficiary immediately taxable on all benefits held for him in the plan merely by virtue of his right to withdraw such benefits. Because of § 408(d)(1), § 402(a), and § 403(b)(1), income taxation of these benefits is delayed until actual distribution (or until certain other events that cause deemed distribution[9]). The doctrine of constructive receipt still *does* apply to *non*qualified retirement plans; see § 402(b)(2).

The Chief Counsel accordingly concluded that the transfer of an IRA by the participant or beneficiary may be a taxable event without violating § 408(d)(1). It is hard to argue with this conclusion. For one thing, since § 691(a)(2) specifically provides for the immediate income taxation of certain transfers of the "right-to-receive-IRD," and since an IRA or other retirement plan clearly is a right-to-receive-IRD, it is just as logical to conclude that § 691(a)(2) trumps § 408(d)(1) as the other way round. If the trustee had transferred the IRA to the IRS in satisfaction of the estate tax bill would anyone argue that § 408(d)(1) prevented treating such transfer as a taxable assignment? Thus, let us concede Round 1 to the IRS.

[8] Portions of this Appendix were previously published in the author's article "Mysteries of IRD," *Tax Management Memorandum*, Vol. 38, No. 20, p. 235 (Tax Management Inc., Washington, D.C., 9/29/97).

[9] See list at ¶ 2.1.03.

The Chief Counsel's argument

The Chief Counsel's reliance on *Kenan* is just as inappropriate as the trustee's reliance on § 408(d)(1). *Kenan* did not deal with IRD. It dealt with a fiduciary's transfer of *appreciated property* in fulfilment of a pecuniary bequest. § 691(a)(2), the Code section that governs the transfer of an inherited IRA, is not even mentioned in the case.

A fiduciary's transfer of appreciated non-IRD property (which is what *Kenan* was about) is an entirely different transaction from the transfer of a right to receive IRD. When a pecuniary bequest is fulfilled by a transfer of appreciated property in kind, the transaction is treated as a "sale" of that property because the residuary estate has, by this transaction, realized the benefit of the appreciation that has occurred between the date of death and the date of funding the bequest. The residuary estate has an asset which has grown in value, and uses this to satisfy a fixed dollar liability, thereby in effect "cashing in" that appreciation to satisfy its obligation. The residuary beneficiaries have realized the profit inherent in the appreciated property, while correspondingly the recipient of the pecuniary bequest did *not* benefit from the appreciation, because he would have received the same dollar value either way, whether in cash or in property.

The transfer of the right-to-receive IRD is a completely different situation. The right-to-receive IRD is not "appreciated property." In fact a retirement plan such as an IRA could easily have *depreciated* in value between the date of death and the date of funding particular bequests. The residuary estate does not realize any "profit" by funding the pecuniary bequest with IRD, or, if it has realized a gain, it is only to the extent there has been appreciation after the date of death, not to the extent of the entire value of the asset. It may be appropriate in some circumstances to treat the transfer of IRD in fulfilment of a pecuniary bequest as an income-realization event—but not because it is similar to funding a pecuniary bequest with appreciated property.

Having disposed of the taxpayer's and the Chief Counsel's arguments, let us turn now to the correct analysis of this question.

What the Code says

§ 691(a)(1) generally provides that all items of income in respect of a decedent (IRD) shall be "included in the gross income, for the taxable year when received, of: (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent; (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or (C) *the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.*" Emphasis added.

§ 691(a)(2) provides that if a right-to-receive IRD (as described in § 691(a)(1)), "is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer…. For purposes of this paragraph, the term "transfer" includes sale, exchange, or other disposition, …*but does not include*

...a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent." Emphasis added.

Under the second sentence of § 691(a)(2), an estate's transfer of the right-to-receive IRD to an estate beneficiary is NOT an income-realization event if the beneficiary is entitled to receive that asset "by bequest, devise, or inheritance from the decedent." Rather, the IRD inherent in the asset will be realized by the transferee-beneficiary when such income is actually received. Although the Code speaks only of transfers by estates, the IRS recognizes that the same principle applies to transfers of rights-to-receive IRD by trusts. Reg. § 1.691(a)-4(B)(3).

The CCM states that the transfer of an IRA in fulfilment of a pecuniary bequest is a "sale or exchange," citing the irrelevant *Kenan* case, as if the first sentence of § 691(a)(2) completely disposes of the matter. The CCM does not even purport to address the extent if any to which the *second sentence* of § 691(a)(2) might bear on the question.

Background: Previous Pronouncements on this Issue

It is axiomatic among many estate planners that a distribution of the right-to-receive IRD in fulfillment of a pecuniary bequest triggers immediate realization of income by the estate or other funding entity[10]—yet this result is not specified in any Code section, Treasury regulation, or Revenue Ruling, nor has any reported case ever so held.

However, this widely held belief does not spring out of thin air. It derives partly from the regulations under § 691(a)(2). The IRS, in its regulations, does not come right out and say that transferring the right-to-receive IRD in fulfilment of a pecuniary bequest is treated as a nonexempt transfer of the right-to-receive IRD, but implies it. Reg. § 1.691(a)-4(b)(2) says that, if the right-to-receive IRD is transferred to "a *specific* or *residuary* legatee" (emphasis added), only the legatee includes the IRD in income. The negative implication is that fulfilling a *pecuniary* bequest with the right-to-receive IRD does *not* carry out the income tax burden to the legatee. In other words, the regulation implies that satisfying a pecuniary bequest with the right-to-receive IRD should be treated

[10] See, *e.g.*, Blattmachr, J.G., "Income in Respect of a Decedent," 12 Probate Notes 47 (1986), 50; Choate, N.B., *Life and Death Planning for Retirement Benefits*, 1st ed., (Foundation for Continuing Education, 1993); CCH 1997 *Standard Federal Tax Reporter*, ¶25,306.0112; Ferguson, M.C., *et al.*, *Federal Income Taxation of Estates, Trust and Beneficiaries* (2d ed. 1997) at 3:27; Gamble, E.J., "Planning for Distributions from Retirement Plans," *N.Y.U. Proceedings of the Forty-Fifth Institute on Federal Taxation*, Vol. 1, Ch. 27, § 27.04[5] last paragraph (1987, p. 27-15); Lane, N.H., and Zaritzky, H.M., *Federal Income Taxation of Estates and Trusts*, 2d Ed., (Warren Gorham & Lamont, 1988–1997) ¶ 15.08, pp.15-54,55; Martin, A., Esq., "Recent Developments/Estate Planning/Post Mortem Planning for QRPs and IRAs," in course materials for ALI-ABA seminar *Professional Organizations, Qualified Plans, etc.*, 2/98, at p. 103; Mezzullo, L.A., *Estate and Gift Tax Issues for Employee Benefit Plans*, 378 Tax Mgmt. (BNA) A-31; Mulligan, M.D., "Planning for Income in Respect of a Decedent Can Minimize Effects of Double Taxation," 57 J. Tax'n 22, pp. 106-112 (1982); Thompson, W.B., "How to Structure a Trust as Beneficiary of a Qualified Plan or IRA Death Benefits," *Estate Planning*, Jan./Feb. 1988 at p. 10.

as a “sale,” just as (under Reg. § 1.661(a)-2(f)(1)) satisfying a pecuniary bequest with appreciated property is treated as a “sale.”

Furthermore, the IRS had (even before CCM 2006-44020) indicated in several private letter rulings that it considers the “sale” principle of Reg. §1.661(a)-2(f)(1) applicable to funding a pecuniary bequest with the right-to-receive IRD. PLRs 9123036 (using an installment obligation to fund a pecuniary credit shelter gift would trigger realization of gain); 9315016 and 9507008 (satisfying pecuniary legacies with Series E or H bonds triggers realization by the funding entity of the untaxed interest accruals on the bonds, which were IRD).

Thus, whatever its merits or lack thereof, CCM 2006-44020 should not come as a shock to the estate planning community.

Why the IRS Analysis is Wrong

Why did the IRS cite a 66 year-old case instead of citing its own post-*Kenan* regulation, Reg. §1.661(a)-2(f)(1), as authority for the proposition that the transfer of appreciated property in fulfilment of a pecuniary bequest is treated as a sale or exchange of the property? Perhaps because that regulation is issued under § 661, and established case law holds that the tax treatment of a fiduciary’s transfer to a beneficiary of the right-to-receive IRD is governed by § 691, *not* by § 661–§ 663. Such transfers are outside of the “Distributable Net Income” (DNI) scheme that generally determines income taxation of trusts and estates (and their beneficiaries) under § 661–§ 663.[11]

As one source put it, “the general distribution rules of subchapter J...do not apply to distributions of rights to [IRD]...[the DNI] scheme is antagonistic to the rules of section 691...Section 691...prevails over the rules relating generally to distributions, and a transfer to a beneficiary of property representing [IRD] is treated as a neutral event.” James J. Freeland, *et al.,* “Estate and Trust Distribution of Property in Kind After the Tax Reform Act of 1984,” 38 Tax L. Rev. 449, 463 (1985).

We now turn to the proper analysis (under § 691(a)(2)) of the funding of a pecuniary bequest by assignment of a right-to-receive IRD.

There are three pecuniary funding situations, not just one

There are three different situations in which a fiduciary might assign retirement benefits in fulfilment of a pecuniary bequest. The Chief Counsel considered only one of these, ignoring the other two, yet phrased its conclusion as if the conclusion applied to all three. I suggest that the Chief Counsel’s conclusion is erroneous if applied to Situations #1 and #2. Regarding Situation #3 (which was the actual situation involved in the CCM), the Chief Counsel is on firmer ground; it may take litigation to determine who is right.

[11] See *Rollert Residuary Trust*, 80 T.C. 619, 644 (1983), *aff’d*, 752 F. 2d 1128 (6th Cir. 1985) (85-1 USTC ¶ 9139). For explanation of this principle and discussion of that case, see the highly recommended Acker, Alan S., *Income in Respect of a Decedent* (862-2nd T.M.), Part VIII(D), p. A-62 (2003).

Here are the three situations the IRS and practitioners need to consider in deciding whether the assignment of an IRA in fulfilment of a pecuniary bequest always, never, or sometimes results in acceleration of income tax on the IRA. In the following examples, we will assume that the pecuniary beneficiary is an individual, not a charity, to remove the complicating additional factor of whether an income tax charitable deduction is available (see further discussion of the charitable issue below).

Situation #1: Funding with IRD Required by Instrument

Under Situation #1, the governing instrument (unlike the trust discussed in the CCM, which gave the trustee discretion regarding which assets to use to fund which bequests), requires the trustee to use the retirement benefits to fulfill the pecuniary bequests.

Example: The trust says, "Upon my death the Trustee shall pay the sum of $100,000 to my son Junior. This gift shall be fulfilled by transferring to Junior a portion of my IRA having a fair market value (as of the date of such transfer) of $100,000."

If the funding of the pecuniary bequest by assignment of the right-to-receive IRD is required by the governing instrument, presumably all would agree that this should be treated as a "specific bequest" of the IRD item. As such, the transfer would be governed by Reg. § 1.691(a)-4(b)(2), and would accordingly not be a taxable event. The IRD would be realized by the transferee upon his, her, or its later receipt of the actual income, not by the estate or trust upon its transfer of the right-to-receive such income.

Although there are no PLRs directly addressing this theory, it seems to be supported by the "Pecuniary Marital Formula" PLRs discussed below.

Situation #2: Trustee nominally has discretion, but there is no other asset available

The second situation is one in which the trust instrument (like that discussed in the CCM) gives the trustee discretion regarding which assets to use to fund which bequest, but in fact the only asset available to fund the pecuniary bequest is the IRA.

Example: The trust says, "Upon my death the Trustee shall pay the sum of $100,000 to my son Junior, and shall pay all other property of the trust to my daughter Sis." The trust's only asset is a $500,000 IRA. The trustee has no choice; he must use the IRA one way or another to pay Junior's bequest.

When the fiduciary has no assets available to fund the pecuniary legacy other than the IRA, and the trustee transfers the IRA to the pecuniary legatee, there is a strong argument that the legatee is receiving the IRA "by bequest, devise, or inheritance from the decedent." Since the decedent decreed that the beneficiary should receive $x, and the fiduciary has no assets with which to fulfill such bequest other than the IRA, the decedent must have intended that the beneficiary's gift be funded in full or in part with this specific asset. Accordingly, the transfer of the IRA to the beneficiary should not be a taxable event, because of the second sentence of § 691(a)(2), even though the legacy is a fixed dollar amount.

As with Situation #1, there are no PLRs directly addressing this theory, but it seems to be supported by the "Pecuniary Marital Formula" PLRs discussed below.

Situation #3: Trustee has discretion under the instrument and a choice of assets

In Situation #3, the Trustee has discretion to use the IRA to fund the pecuniary bequest or any other bequest, and the trustee has a choice of assets that allows him to actually exercise this discretion, i.e., he is not forced to use the IRA due to a lack of other assets. This was the situation considered in the CCM.

Example: The trust says, "Upon my death the Trustee shall pay the sum of $100,000 to my son Junior, and shall pay all other property of the trust to my daughter Sis." The trust has two assets, a $100,000 IRA and $400,000 bank account not held in a retirement plan. The trustee assigns the IRA to Junior in fulfilment of Junior's bequest.

Arguably, even this type of transfer does not trigger income realization under § 691(a)(2). The pecuniary legatee is acquiring the IRA under the will or trust of the decedent; he is entitled to receive that amount from the estate or trust, and the governing instrument gives the fiduciary the right to use this asset to fulfill this gift. Thus, arguably, the beneficiary is acquiring the IRA "by bequest, devise, or inheritance from the decedent," and the transfer should not be income-taxable under § 691(a)(2).

However, the CCM position seems at least equally valid. Where the trustee has a choice of assets, the IRS can rightly say that the beneficiary is entitled to receive a certain *amount*, not a *specific asset*, from the estate or trust, and the trustee's choice to use the IRD asset means that the beneficiary has acquired the IRA *from the trustee* not by bequest *from the decedent*. While this result can be very tough on the residuary beneficiary (see discussion below), that is more the result of bad estate planning than bad IRS logic; the problem should be avoided at the planning stage, though there is a chance it can be corrected by post-mortem planning.

Note, however, that the IRS did not apply this CCM principle in a PLR involving a trustee's discretionary allocation of an IRA to a marital trust; see discussion of PLR 2007-05032 below.

Treating the assignment as taxable to the estate or trust under § 691(a)(2) would never result in double taxation because the pecuniary legatee would get a basis in the IRA equal to the amount included in his/her income as a result of the distribution. § 643(e)(1).

PLRs Involving Pecuniary Marital Bequests

While CCM 2006-44020 is the first IRS pronouncement to directly discuss the applicability of § 691(a)(2) to funding a pecuniary legacy by transfer of retirement benefits, there are several letter rulings in which the IRS has allowed an estate or trust to transfer retirement benefits, intact, to a spouse or marital trust under a pecuniary marital gift *without* having such transfer result in immediate taxation to the estate or trust.

In a number of letter rulings, the IRS has allowed a surviving spouse to roll over retirement benefits that were paid to her under a trust or estate *despite the fact* that the marital gift was a pecuniary amount. If funding a pecuniary gift by assignment of retirement benefits is always a taxable event under § 691(a)(2) (as CCM 2006-44020 seems to suggest), then all these PLRs were improperly decided. The IRS should have required the funding trust or estate to recognize income upon the transfer of the retirement benefits to the spouse/marital trust in fulfilment of the pecuniary bequest payable to such spouse or marital trust.

In PLR 9524020, a participant died leaving his qualified retirement plan (QRP) benefits payable to his estate. The surviving spouse elected to take a statutory share of the estate under state law. The statutory share was a pecuniary amount ($969,633 out of a total estate of $3,097,242). The spouse was allowed to remove this pecuniary amount from the decedent's QRP and roll it over to her own IRA. The estate's "assignment" of these benefits to the spouse in fulfilment of her pecuniary-amount statutory share was apparently not deemed to trigger income to the estate, since the spouse was allowed to continue deferring the income by means of a rollover. Since it appears that the spouse (not the executor) had the right to choose which assets she would take to fulfill her share, it is appropriate to consider this as a right received from the decedent (Situation #1).

PLR 9608036 involved the transfer of an IRA by a pourover trust in fulfillment of a pecuniary formula marital gift. The ruling treated the IRA, for purposes of the spousal rollover rules, as acquired by the spouse "from the decedent," not "from the trust." If the IRA were deemed acquired "from the trust" (a "third party") rather than "from the decedent," it would not have been eligible for rollover under § 408, according to the ruling. Although there was a choice of assets for fulfilment of the marital share, the surviving spouse as trustee had the right to choose which assets would be assigned to the marital trust, so it is appropriate to consider this as a right received from the decedent (Situation #1).

In PLR 9623056 the decedent's IRA was payable to a trust which was also the residuary beneficiary of his will. The trust created a marital trust by means of a pecuniary marital formula, and a residuary credit shelter trust. The IRA was not payable to either of these specific subtrusts. Almost (but not quite) all of the IRA had to be allocated to the marital trust, since there were few other assets available to fund the marital trust. All the nonIRA assets were allocated to the marital trust, then the rest of the marital trust was funded by transfer of part of the IRA. The IRS permitted a tax-free rollover by the spouse of the portion of the IRA that had to be, and was, allocated to the marital trust (Situation #2).

In PLR 9808043 an IRA was payable to the participant's estate. The will left a "pecuniary formula marital bequest outright to" the spouse, and left "the remainder" to a "credit shelter trust." Because the surviving spouse, as executrix, was entitled to and did use the IRA to fund the pecuniary marital bequest, and the bequest was outright, the IRS ruled that the surviving spouse was entitled to roll over the IRA proceeds distributed to her via the pecuniary bequest. As with the other rulings, if funding the pecuniary bequest by transferring the IRA to the spouse was an income-realization event under § 691(a)(2), as CCM 2006-44020 would seem to require, then there would be nothing to roll over, as the IRA would be deemed to have been distributed to the estate and all the income would have been realized at the estate level, but that did not happen. Since the spouse had the right to choose which assets would be paid to her, this should be deemed a Situation #1.

In PLR 2007-05032, the decedent left his four IRAs payable to a trust with a pecuniary marital share and residuary credit shelter share. The trustees "satisfied their obligations under the law of State…by allocating life insurance proceeds to the Family Trust, and…[the IRAs] to the Marital Trust." The IRS allowed the spouse to roll over the IRAs payable to the Marital Trust. This PLR appears to have been a Situation #3, since it appears that the trustees had a choice of which assets to use to fund the marital and credit shelter shares. However, it is possible that the PLR is suggesting that somehow under state law the trustees were required to allocate that assets as they did, so it may be a Situation #2.

Although the IRS did not mention IRD or § 691(a)(2) in any of these five rulings, in view of the emphasis on the fact that pecuniary bequests were involved it is hard to believe the IRS overlooked the § 691(a)(2) issue time after time.

Can these rulings be reconciled with CCM 2006-44020? Apparently, the rulings were not based on the notion that § 408(d)(1) "trumps" § 691(a)(2), despite my speculation to that effect in *Life and Death Planning for Retirement Benefits*. Therefore, the rulings can be reconciled with CCM 2006-44020 only in one of three ways. Either:

1. The IRS would not give those rulings today, and CCM 2006-44020 "overrules" them? That can't be the answer; PLR 2007-05032 (2/2/07) was issued AFTER CCM 2006-44020 (11/3/2006).

2. Despite the broad language of CCM 2006-44020, the IRS recognizes that it applies only to Situation #3? PLR 2007-05032 (issued after the CCM) appears to have been a Situation #3, so this does not seem to be the answer.

3. The IRS applies different (more lenient) standards to funding a marital bequest than it applies to funding other types of bequests? This is possible; the IRS sometimes has more lenient standards for spouses than for others. For example, the "look-through rules" for a trust are considerably more lenient for purposes of the spousal rollover than for purposes of the minimum distribution rules. Similarly, the IRS did not treat a surviving spouse's "swap" of an IRA for an interest in community property as a sale of the IRA, though generally heirs who "swap" their shares of an estate with each other so each can receive the assets he/she wants are treated as having engaged in sales or exchanges; see PLR 1999-25033 in which the IRS ruled that a non-pro rata division of community property, in which a surviving spouse took the decedent's IRA as part of the surviving spouse's share of the community property, did not constitute a § 691(a)(2) "assignment."

4. The people who give the spousal rollover rulings are not communicating with the Chief Counsel's Office? This seems likely since the spousal-rollover-through-trust rulings do not even mention § 691.

The Charitable Deduction Aspect

As noted, the CCM ruled that the estate was not entitled to a charitable deduction for its transfer of inherited IRAs to the charitable beneficiaries. Why not?

First because there is no DNI deduction for any distribution to a charity. § 651(a)(2), § 663(a)(2). Second because even if the beneficiaries were not charities, there is no DNI deduction for payment of a bequest of a specific sum of money unless the governing instrument requires that such distribution is to be paid in more than three instalments (which would be quite unusual). § 663(a)(1), Reg. § 1.663(a)-1.

Finally, there *can* be a *charitable* deduction for a trust's distribution to a charity—but that's available only if the distribution is paid out of the "gross income" of the trust and "pursuant to the governing instrument." § 642(c). The CCM ruled, without discussion, that the transfer of the IRAs to the charities did not meet these tests of. The law and lore of what constitutes a payment from "gross income" for this purpose, and the meaning of "pursuant to the governing instrument," are incredibly complex; for explanation, see Zaritsky, H. and Lane, N., *Federal Income Taxation of Estates and Trusts* (third Edition, 2000, as updated through 2006; Warren, Gorham & Lamont).

Message for Practitioners: Pre-Mortem Planning

The first message for practitioners is an old one: Do not draft an estate plan in such a fashion that the fiduciaries will be required to run retirement benefits through a pecuniary formula. This message has been clearly stated in every edition of *Life and Death Planning for Retirement Benefits* since the first one in 1996. Here are other ways around the problem:

1. **Put the pecuniary gift into the beneficiary designation form.** The problem discussed in CCM 2006-44020 arises ONLY when the benefits are payable to a trust or estate and the trustee or executor attempts to fulfill a pecuniary gift by assigning those benefits. If the pecuniary gift is spelled out in the beneficiary designation form, the entire issue is avoided. It simply does not arise, because no fiduciary is placed in the position of assigning the IRA to a beneficiary. In this CCM, if the participant had specified *in his IRA beneficiary form* "Pay $100,000 to Charities X, Y, and X in the following amounts," and named his trust as beneficiary of the *rest* of the IRA, the entire problem would never have arisen.

2. **If desired, mandate funding the bequest with the IRA.** Even if the pecuniary bequest is in the will or the trust, if the governing instrument specifies that the bequest must be fulfilled by transfer of retirement benefits the transfer should be income tax-free under the second sentence of § 691(a)(2). See Situation #1, above. However, note that CCM 2006-44020 does not recognize this exception.

3. **If making pecuniary bequests that are substantial in amount, and/or if retirement benefits are a significant portion of the estate or trust, consider very carefully who will pay the income taxes on the benefits and draft as necessary to achieve your desired result.** The real problem is that the issue of who will pay the taxes on the benefits is often not properly considered and drafted for. This may be the estate planner's fault, or may be the fault of a client who does not keep the plan up to date. See "cleanup mode" suggestions.

4. **If benefits are to be transferred from an estate or trust to a beneficiary, use a residuary gift not a pecuniary gift.** As a reminder, the transfer of the "right to receive IRD" (such as an IRA), intact, to a *residuary* beneficiary does not trigger realization of the income under § 691. This was confirmed most recently in PLR 2006-52028, where the IRS ruled that a trustee's transfer of IRAs to certain charities that were residuary beneficiaries of the trust did

not trigger income tax under § 691(a)(2). Distributions from the IRAs would be includible in the gross income of the charities when received (and accordingly would be tax-exempt).

Message for practitioners: Post-mortem planning (cleanup mode)

The funding problem becomes extremely serious when the IRD assets are a major part of the estate and the pecuniary bequest is substantial. If a client has a $600,000 estate, of which $300,000 is inside an IRA payable to the estate, and the will provides a pecuniary $300,000 legacy to Child A and the residue to Child B, Child B is going to get "screwed" (legal term). The estate will pay its $300,000 cash hoard to Child A to fulfill the pecuniary legacy, leaving Child B with the income-taxable IRA. Although Child B can defer taxes on the IRA for a short period of time (a longer life expectancy payout is not available for an IRA payable to an estate), basically Child B as the residuary beneficiary ends up paying all the income taxes on the IRA and getting less money than the pre-residuary beneficiary received.

In some such cases, a post-death judicial reformation of the governing instrument may be in order (to create a more equitable allocation of the income tax burden, if it can be demonstrated that that was the client's intent), or an equitable adjustment of the sizes of the respective legacies to reflect the income tax aspects (if that is doable under state law).

If the amount of the pecuniary legacy exceeds the estate's nonIRA assets, the executor should seek to fulfill the pecuniary legacy partly or entirely by assigning the IRA to the pecuniary beneficiary, but it would be wise to seek an IRS ruling regarding the income tax treatment first; or reformation or equitable adjustment should be sought.

Conclusion

Despite CCM 2006-44020, the transfer of an inherited retirement plan to a beneficiary in fulfilment of a pecuniary legacy to such beneficiary should NOT result in immediate taxation of the IRD inherent in the plan if either (1) there is no other asset available to fund such legacy or (2) the instrument or applicable state law requires that asset to be used to fund that particular legacy (either because the instrument or state law specifically requires that asset to be so used, or because the instrument or state law gives the *beneficiary* the choice of which assets shall be used and the beneficiary chooses the retirement plan). However, if the trustee has a choice of IRD and nonIRD assets it may use to fund a pecuniary bequest, and the trustee chooses to fund the pecuniary bequest by assigning to the legatee all or part of an inherited retirement plan, the assignment may result in taxable income to the estate or trust under § 691(a)(2).

Appendix 4 to the Update of *Life and Death Planning for Retirement Benefits* (6th ed. 2006)

QUALIFIED CHARITABLE DISTRIBUTIONS: IRS NOTICE 2007-7

¶ 7.6.01.1 *Qualified charitable distributions: The ground rules*

§ 1201 of the Pension Protection Act of 2006 (PPA 2006) creates a temporary way to avoid *some* of the drawbacks discussed in ¶ 7.6.01. Under new § 408(d)(8), an IRA may make a "qualified charitable distribution" (QCD), which is a transfer directly from the IRA to a charity; the QCD will be excluded from the IRA owner's gross income. Here are the limitations and restrictions on QCDs:

A. **When:** This is a temporary measure, good for distributions in 2006 and 2007 only. § 408(d)(8)(F). According to Notice 2007-7, any direct IRA-to-charity transfer that occurred in 2006 is a QCD (assuming it otherwise qualifies; see B–F below), even if it occurred before PPA 2006 was enacted (August 17, 2006). Notice 2007-7, A-38.

B. **How much:** The QCD income exclusion is limited to $100,000 per year. § 408(d)(8)(A). "For married individuals filing a joint return, the limit is $100,000 per IRA owner," according to Notice 2007-7, A-34. This IRS statement in Notice 2007-7 helpfully clarifies that, if each spouse gives $100,000 from his or her IRA, they each get the $100,000 exclusion (i.e., they are not limited to one $100,000 exclusion per couple). However, the IRS statement leaves some ambiguity: If one spouse gives $200,000 from his or her IRA, and the other spouse owns an IRA but gives nothing, does this mean they can exclude $200,000 from income on their joint return? If not, then why does the IRS mention the joint return? Isn't it also true that for a married couple filing separate returns the limit is $100,000 per IRA owner?

C. **Which plans:** QCDs may be made from IRAs only (other than SEPs and SIMPLEs). § 408(d)(8)(B). So, you cannot have a QCD from a QRP, 403(b) plan, or 457 plan. Notice 2007-7 clarifies that the prohibition against QCDs from SEPs and SIMPLEs applies only to "ongoing" plans, i.e., one to which an employer contribution is made for the plan year ending within the same taxable year as the year of the charitable contribution. Notice 2007-7, A-36. PPA 2006 would apparently permit QCDs from Roth IRAs (to the extent the distribution would otherwise be included in the owner's gross income; see "D").

D. **Which IRA assets:** The QCD must be a distribution that would otherwise be includible in the taxpayer's gross income. § 408(d)(8)(B). Thus, a qualified distribution from a Roth IRA could not be a QCD. In the case of a distribution from a traditional IRA, the *usual* rule for allocating basis to an IRA distribution is that the distribution is deemed to come proportionately from the pre- and after-tax money in all of the participant's aggregated IRAs (the "cream-in-the-coffee rule"; see ¶ 2.1.10). However, PPA 2006 creates a special exception to the cream-in-the-coffee rule for QCDs. A QCD is deemed to come *first* from the owner's pre-tax money in all of his aggregated IRAs, until that has been used up. § 408(d)(8)(D). See "Planning Idea," below.

E. **Who:** The IRA owner must be age 70½ or older. § 408(d)(8)(B)(ii). This is the first tax provision that has made the age 70½ "birthday" itself a significant event; minimum required distributions are based on the year the participant reaches age 70½, not the DAY he reaches that age. Notice 2007-7, A-37, clarifies that an IRA *beneficiary* who is over age 70½ can also make a QCD, from his inherited IRA.

F. **Which charities:** A QCD can be made to any charity EXCEPT a donor-advised fund (which is now a defined term in the Code, for the first time), a supporting organization (§ 509(a)(3)), or certain private foundations. § 408(d)(8)(B)(i). Also, there is a requirement that the QCD must be a contribution that would be 100 percent deductible if paid from the owner's nonIRA assets, so a split-interest gift will NOT qualify. Thus, QCDs cannot be made to a charitable remainder trust, pooled income fund, or charitable gift annuity, or in exchange for any consideration. Note that in determining whether the gift would be 100 percent deductible if made with nonIRA assets the percentage-of-income limits in § 170(b) are ignored. § 408(d)(8)(C).

G. **Excluded from income; no deduction.** The QCD is excluded from the individual's gross income for all purposes. Thus it cannot be counted as part of the individual's gross income for purposes of applying the percentage-of-income limits in § 170(b) with respect to his other charitable gifts. Of course, there is no deduction for the QCD.

H. **QCD does count towards the MRD requirement.** A QCD counts as a distribution for purposes of determining whether an individual has fulfilled the MRD requirement. Regs. § 1.401(a)(9)-5, A-9(a), and § 1.408-8, A-11(a), state that, except as otherwise provided in A-9(b) or A-11(b) of such regulations, or as may later be otherwise provided by other IRS pronouncements, "all amounts distributed" from a plan or IRA "are taken into account in determining whether section 401(a)(9) is satisfied…." No law or IRS pronouncement says that QCDs do NOT count towards the MRD requirement. The Joint Committee on Taxation's "Technical Explanation of H.R. 4" confirms this conclusion (p. 276), as does Notice 2007-7, A-42.

¶ 7.6.01.2 *Qualified charitable distributions: Planning uses*

Here are examples of how and why individuals would use QCDs, and how the $100,000 limit interacts with the MRD requirement.

A. **Advantages of QCD.** The QCD eliminates many of the problems that arise when making lifetime charitable gifts from an IRA (see list at ¶ 7.6.01). Since there is no distribution involved, the gift does not increase AGI and therefore does not: decrease the deductibility of medical expenses or of miscellaneous itemized deductions; reduce the individual's AMT exemption; increase the taxability of Social Security benefits; increase the reduction of other itemized deductions under § 68(a); adversely impact Roth IRA eligibility; or increase state income taxes (in a state that uses federal AGI as the basis for computing state income tax but does not allow a charitable deduction). Since there is no itemized charitable deduction involved, the gift does not "count" for purposes of the percentage-of-income limits in § 170(b); does not get reduced by § 68(a); and is "deductible" even for someone who does not itemize deductions.

B. Wealthy charitable individuals.

Donna Example: Donna, age 78, has a $1 million IRA. Because she has extensive other assets and income, she regards the IRA as a nuisance—generating taxable distributions every year and posing the risk of a 50% penalty if she miscalculates her MRD. She leaves the IRA to her favorite charity as beneficiary; but she would love to just get rid of the IRA by giving it to the charity while she is still alive. So far she has been discouraged from giving the charity more than the MRD each year by the unfavorable tax treatment that would occur if she simply cashed out the entire account and donated the proceeds to charity. The PPA 2006 gives her the chance to reduce her problem. She had $100,000 transferred directly from her IRA to the charity in 2006, and will do so again in 2007. She hopes that Congress will extend and/or expand the QCD to enable her to get rid of the entire IRA in this manner so her favorite charity will benefit from her largesse without having to wait for her death.

C. **Regular folks.** The charitable IRA rollover is an ideal way for a charitably-inclined individual over age 70½ to fulfill his MRD requirement.

Juanita Example: Juanita is turning age 73 in 2007. Her IRA MRD for 2007 is $15,000. Usually she gives $5,000 a year to her church. For 2007, she satisfies her IRA distribution requirement by having the IRA provider send $5,000 directly to her church as a QCD, and taking a $10,000 cash distribution paid to herself. She has satisfied the MRD requirement for 2007, but will have only $10,000 of gross income to report rather than $15,000.

Andre Example: Andre, who always makes large charitable gifts, also turns 73 in 2007. He also has an IRA MRD for 2007 of $15,000. He withdraws $15,000 from the IRA in January 2007. Later in the year he learns about QCDs. He wants to know if he can put the $15,000 back into his IRA, then have the IRA send the $15,000 to one of his favorite charities, since a QCD would be a more favorable way to fulfill his MRD requirement. Unfortunately he can NOT do this. He cannot return the MRD to the IRA, or otherwise "roll it over" tax-free in order to use the QCD rather than a cash distribution to fulfill his MRD requirement. Why not? This has nothing to do with the 60-day rollover deadline; the problem is that a minimum required distribution is not an eligible rollover distribution. § 408(d)(3)(E).

Vaughan Example. Vaughan turns age 70½ in 2007. He has $100,000 in a 401(k) plan at Acme Widget Company, from whose service he retired several years ago. He is a very wealthy high-income individual and hates the idea of taking MRDs. He had been planning to postpone taking his 2007 MRD from the 401(k) plan until his required beginning date (RBD), which is April 1, 2008. However, he now wants to take advantage of the QCD opportunity. He asks if he can roll over the 401(k) plan to an IRA in 2007, then use a $100,000 QCD from the IRA in 2007 to eliminate the necessity of ever taking any MRD from the 401(k) plan funds.

The answer: He CAN roll over the 401(k) plan to his IRA in 2007, but only AFTER he takes the 2007 MRD from the 401(k). Why? Because as noted above (Andre Example) an MRD cannot be rolled over…and the corollary rule is that the FIRST MONEY THAT COMES OUT OF A PLAN IN ANY YEAR IS DEEMED TO BE THE MRD. Reg. § 1.402(c)-2, A-7(a). Thus, there IS an MRD that has accrued in Vaughan's 401(k) plan for the year 2007, because the year he reaches age 70½ is his first "distribution year." Normally that first year's MRD can be postponed until April 1 of the following year; but if the participant wants to roll over money from that plan to another plan, he must first take the MRD, even though it is technically not payable until the following year.

The rule really is, "You can postpone the first year's MRD until April 1 of the second year, UNLESS you want to do a rollover in the first year, in which case you must take the MRD before you do the rollover." So Vaughan can still do the rollover, and still make a QCD from the IRA that receives the rollover, but he cannot do so without first taking the 2007 MRD (which will be includible in his 2007 AGI).

D. **Reminder: There is no relation between the $100,000 limit and the MRD!** The limit on QCDs is $100,000 per calendar year; this limit is the same REGARDLESS of the amount of the individual's MRD and REGARDLESS of whether the QCD is used to satisfy or partly satisfy the MRD requirement. Thus, Juanita can have any amount up to $100,000 transferred from her IRA to charity in 2007, even though her 2007 MRD is only $15,000. Andre can have any amount up to $100,000 transferred from his IRA to charity in 2007, even though he has already taken his 2007 MRD in full in cash. An individual who is over 70½ can have any amount up to $100,000 (but cannot have more than $100,000) transferred from his IRA to charity in 2007 even if his MRD is more than $100,000.

E. **Planning idea.** Burton is a wealthy charitably-inclined individual age 71 who does not like to pay taxes. He happens to own a $70,000 IRA with a $20,000 basis resulting from nondeductible contributions in prior years. In 2007, he directs the IRA provider to transfer $50,000 from the IRA to the Santa Fe Opera Company, his favorite charity. This is a QCD and also fulfills his 2007 MRD requirement. Now he is left with a $20,000 IRA which is 100 percent after-tax money. He converts this small "stub" IRA to a Roth IRA tax-free if he is eligible (see ¶ 5.4.03); otherwise, he cashes it out tax-free instead.

¶ 7.6.01.3 *Qualified charitable distributions: Other points*

Here are some miscellaneous other points regarding QCDs:

A. **State law treatment.** Whether states that have income taxes will recognize the QCD as an exclusion from the individual's income depends on each state's law, and will have to be determined state by state.

B. **Substantiation required.** Since a QCD must be a gift that would otherwise be deductible under § 170, these charitable gifts have the same substantiation requirements as other gifts for which a charitable income tax deduction is claimed, even though there is no income tax deduction for a QCD. § 408(d)(8)(C), Notice 2007-7, A-39.

C. **Mechanics.** The QCD may be made by having the IRA write a check to the charity, then give the check to the IRA owner and have the IRA owner deliver the check to the charity. Notice 2007-7, A-41. By using this method of making the gift the IRA owner can make sure he personally collects the necessary receipt from the charity.

D. **Reporting.** For the 2006 year, IRA providers simply report the distributions as part of "gross distributions" on form 1099-R, with no indication that the distribution may be nontaxable. It is then up to the IRA owner to report the gross distribution on line 15a of Form 1040, then report the taxable part (i.e., the gross distribution minus the QCD) on line 15b (writing "QCD" next to line 15b). See IRS Instruction for Form 1040, 2006 tax year.

E. **Pledges; prohibited transactions.** A QCD is not a prohibited transaction, even if the charitable gift fulfills a pledge made by the IRA owner/donor. See ¶ 7.1.03 and Notice 2007-7, A-44.