RR2006-26webUpdate.wpd 5/31/06

The following update has been added to the updates to the 5th edition of *Life and Death Planning for Retirement Benefits* at www.ataxplan.com. I am also posting it as a stand-alone item due to the importance of this Revenue Ruling. For more information about Rev. Rul. 2006-26, see my article to be published in the July 2006 issue of *Trusts & Estates* and articles by Virginia Coleman and others that have appeared in Steve Leimberg's highly recommended *Employee Benefits* and *Estate Planning* newsletters (email only; subscribe or visit one time for free at www.leimberg.com).

Marital Trusts Named as Beneficiary of Retirement Plans:
Rev. Rul. 2006-26 Explains What "Income" Means

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[update to ¶ 3.3.06 of *Life and Death Planning for Retirement Benefits*, 5th ed. 2003]

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

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

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

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

However, the Rev. Rul. 2006-26 holds that a trust DOES qualify for the marital deduction,

even in a state that has adopted UPIA 1997 with the 10 percent rule, **if the trust instrument specifies that the spouse is entitled to "the income of the IRA"** in addition to "the income of the trust."

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

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

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