A Natalie B. Choate Special Report:

The Estate Administrator's Guide to Retirement Benefits

A Guide for Executors and Beneficiaries; Also Published as"Death & Taxes"

I. Executor's Options and Responsibilities Regarding Participant's Lifetime Actions

To what extent can the Executor complete or undo actions taken by the participant? To what extent is the Executor responsible for the participant's failure to take minimum required distributions (MRDs)? This Part I addresses these questions.

A. Roth recharacterizations

Introduction and summary

In this section, IRAs established under § 408 are referred to as "traditional IRAs" to distinguish them from "Roth IRAs" (established under § 408A).

When an individual contributes to a Roth IRA, he has a certain period of time following that contribution to change his mind, "recharacterize" the contribution, and allot it to a "traditional IRA" instead. The effect of a recharacterization is that the contribution is treated as if it had been made to a traditional IRA in the first place. If an individual "converts" a traditional IRA to a Roth IRA, he has a certain period of time to change his mind and undo the conversion (put the money back into the traditional IRA).

Similarly, traditional IRA contributions can, within a limited time frame, be recharacterized as Roth IRA contributions.

This Section explains how, if the decedent had contributed to a traditional IRA or a Roth IRA, or converted a traditional IRA to a Roth IRA, shortly before his death, the participant's executor can exercise these recharacterization rights regarding the participant's contributions and/or conversions. For more background, read Chapter 5 of *Life and Death Planning for Retirement Benefits* regarding Roth IRAs generally, Roth IRA conversions (¶ 5.4) and recharacterizations (¶ 5.6).

Detail:

What a "recharacterization" is

The regulations provide broad relief to taxpayers who wish to "amend" their IRA contributions by switching the contribution from a Roth IRA to a traditional IRA or vice versa. This relief is most helpful for those who need to "undo" Roth IRA conversions that they were not eligible to make. However, the relief is not limited to individuals who find they were ineligible to make the type of contribution they made; it is available for anyone who changes his mind about which type of IRA he wants his contribution to go to, regardless of the reason. Reg. § 1.408A-5, A-10, Example 2.

A "regular" contribution (i.e., the annual-type contribution from compensation income) made, for a particular taxable year, to either type of IRA may be transferred to the other type of IRA before the "extended due date" of the person's tax return for such year. A recharacterized contribution will be treated for Federal income tax purposes as having been contributed to the transferee IRA (rather than the transferor IRA) "on the same date and (in the case of a regular

C. Did the participant take all his MRDs?

Summary: The Code requires an individual to take annual distributions (called "minimum required distributions" or "MRDs" in this Outline) from such individual's retirement plans beginning at a certain point. § 401(a)(9). Failure to take an MRD results in a 50 percent penalty. § 4974. The beginning point for MRDs from IRAs is April 1 following the year in which the participant reaches age 70½ (except for Roth IRAs, from which no distributions are required prior to the participant's death). For other types of plans it may be later. For full detail on the minimum distribution rules, see Chapter 1 of *Life and Death Planning for Retirement Benefits*.

Detail: It may appear that the decedent did not take all of his MRDs. The executor may conclude that the participant (and therefore the estate) is liable for a penalty. Before jumping to the conclusion that a penalty is owed, consider the possibility that for some or all of the years in question the participant may have qualified for a grandfather rule, and so may not have been required to take distributions.

There are several different rules that may have excused the participant from MRDs even though he was over age 70½:

Still employed after age 70½

Although the required beginning date (RBD) is generally April 1 following the year the participant reaches age 70½, under certain circumstances the RBD is April 1 following the year the participant retires, if later than age 70½. § 401(a)(9)(C); Reg. § 1.401(a)(9)-2, A-2(a). Those circumstances are:

- The plan is a QRP, and decedent owned no more than five percent of the employer that sponsors the plan, and the plan permits the postponed RBD; or

- The plan is a 403(b) plan.

Thus, if the decedent had not retired, and met the above conditions, he was not required to take MRDs. Note that MRDs from IRAs cannot be postponed under this provision. It applies only to QRPs and 403(b) plans. For complete detail on the RBD rules, see ¶ 1.3 of *Life and Death Planning for Retirement Benefits*.

TEFRA 242(b) election in effect

TEFRA significantly expanded the minimum distribution rules. For plan years beginning after 1983, § 401(a)(9) would apply to *all* qualified retirement plans (previously it had applied only to Keogh plans). Under the pre-TEFRA lifetime distribution rules, no distributions were required prior to retirement; TEFRA (and the Tax Reform Act of 1984, which cleaned up the TEFRA changes via many retroactive amendments) added a requirement that five percent owners would have to start distributions at age 70½ even if still employed. TEFRA also added requirements for distributions after the employee's death (there had been none previously).

III. Cleanup Strategies: If Benefits Are Left to a Trust

This Part of the Guide addresses strategies that may be available when retirement benefits are left to a less-than-ideal trust. The trust may have one or more of the following defects: benefits left to the trust will be subject to a "pecuniary" funding formula, risking imposition of tax under § 691(a)(2) (having to do with "assignments" of income in respect of a decedent); benefits are to pass to a marital trust that does not contain the language promulgated in Rev. Proc. 2002-2; or qualification of the trust as a see-through trust under the minimum distribution regulations is jeopardized by a provision allowing or requiring the trust to make distributions to the participant's estate or for other reasons.

For definition of a see-through trust, and further description of the problems addressed in this Section, see Chapter 6 of *Life and Death Planning for Retirement Benefits*. Portions of this section 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).

A. Benefits are left to a trust that contains a pecuniary funding formula

Although it is highly advisable to steer clear of funding a pecuniary bequest with qualified plan or IRA benefits, inevitably some participants will leave their benefits payable to a trust which contains a pecuniary funding formula. In these circumstances, first look into the possibility of using disclaimers to get the benefits payable to the "right" beneficiary. If that course is not available, read the following discussion of whether funding the pecuniary gift by assignment of retirement benefits triggers immediate taxation of the benefit.

1. CCM 2006-44020

In Chief Counsel Memorandum 2006-44020 (released in November 2006), 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.

C. Distributing the retirement plan itself, intact, out of the estate or trust

The IRS states twice that an estate cannot be a "designated beneficiary." Reg. § 1.401(a)(9)-4, A-3(a), § 1.401(a)(9)-8, A-11. This problem can NOT be cured by distributing the retirement plan itself (intact) out of the estate to the individual beneficiaries of the estate (either before or after September 30 of the year after the year of the participant's death), unless by some chance the estate beneficiaries are identified as the beneficiaries "under the plan"—which would be unusual.

The executor can transfer the IRA to the estate's residuary beneficiaries; see PLR 2002-34019. That's not a problem. The problem is that such transfer will not have the effect of allowing the estate beneficiaries to use their own life expectancies for computing MRDs.

Jane Example: Jane dies without having named a beneficiary for her IRA. Under the terms of the IRA agreement, the IRA is payable to her estate as default beneficiary, so she has no "designated beneficiary." The only beneficiaries of her estate are her children Gray and Seymour. The executor of her estate, before taking any distributions from the IRA, transfers the IRA account to Gray and Seymour. This transfer does not trigger any income tax, because it is an assignment of the right-to-receive-IRD to the persons entitled to receive the IRD under the decedent's will. The children are now the sole owners of the account. However they do not qualify as "designated beneficiaries" because they are not "designated as a beneficiary under the plan." It does not matter, for this conclusion, whether the transfer occurred before or after September 30 of the year after the year of Jane's death.

It is also common for a trust to distribute a *retirement plan itself*, intact, out of the trust to the trust beneficiary. Here are some typical examples of such distributions:

Foster Example: Foster names the Foster Revocable Trust as beneficiary of his IRA. The Foster Revocable Trust provides that, upon Foster's death, the trustee is to divide all assets of the trust into two separate trusts, the Marital Trust and the Credit Shelter Trust, pursuant to a fractional formula. All retirement benefits are to be allocated to the Marital Trust. The trustee instructs the IRA provider to change the name of the owner of the IRA from "Foster Revocable Trust, as beneficiary of Foster, deceased," to "Marital Trust, as beneficiary of Foster, deceased." The trustee has distributed (transferred) the IRA from the Foster Revocable Trust to the Marital Trust.

Stanley Example: Stanley names his testamentary trust as beneficiary of his IRA. The testamentary trust provides that, after Stanley's death, the trustee is to pay income of the trust to Mrs. Stanley for life. On her death, the principal of the trust is to be paid outright to Stanley's two children, A and B. The trustee takes annual MRDs from Stanley's IRA. Because the testamentary trust complies with the "trust rules," these MRDs are computed using the life expectancy of Mrs. Stanley (the oldest trust beneficiary), which is 18 years. Mrs. Stanley dies 12 years later. There are six years left to go in the life expectancy payout. The trustee instructs the IRA provider to change the name on the IRA from "Stanley Testamentary Trust, as beneficiary of Stanley, deceased," to "Child A and Child B, as beneficiaries of Stanley, deceased." The trustee has distributed (transferred) the IRA from the testamentary trust to the two children. See PLRs 2004-10019 and 2004-10020 allowing such distribution on exactly these facts.

Generally, the transfer of an inherited retirement plan after the participant's death would trigger immediate realization of the income represented by the retirement plan, because it is the transfer of a right to receive "income in respect of a decedent." § 691(a)(2). However, there is an exception to the § 691(a)(2) "trigger" rule: it does *not* apply to 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." § 691(a)(2).

This exception applies to the transfer of the right to receive income in respect of a decedent by a terminating trust to the trust beneficiaries. Reg. § 1.691(a)-4(b)(3). Thus, the distribution of a retirement plan from a trust to the trust beneficiaries, as in the above examples, does *not* cause realization of income. The same would be true in the case of distribution of a retirement plan by an estate to the estate's residuary beneficiaries.

PLR 2001-31033 (Rulings 5, 6 and 7) illustrates this rule (although the ruling didn't mention § 691). This ruling allowed the distribution of "IRA Y" from a terminating trust to the participant's children, C and D. From the ruling: "The provision of Trust X which provides for its termination does not change either the identity of the individuals who will receive the IRA Y proceeds or the identity of the designated beneficiary of IRA Y.... Furthermore, the Trust X termination language which results in distributions from IRA Y being made directly to Taxpayers C and D instead of initially to Trust X and then to Taxpayers C and D was language in Trust X approved by [the participant] during his lifetime which reflects [the participant's] intent to pay his children directly instead of through Trust X."

There are numerous other letter rulings describing such transfers in detail and with approval. See, *.e.g*, PLRs 2006-15032, 2006-17020, 2006-33009 (both involving IRAs assigned to charitable residuary beneficiaries), 2006-18023 (involving a nonqualified annuity).

Unfortunately, they are all private letter rulings, which cannot be cited as precedent. (Private Letter Rulings that are less than 10 years old can be cited as "substantial authority" for a position taken on a tax return, even though they cannot be cited as "precedent." Reg. § 1.6662-4(d)(3)(iii).) The Revenue Ruling these PLRs rely on (Rev. Rul. 78-406, 1978-2 C.B. 157), which can be cited as precedent for the proposition that a custodian-to-custodian transfer of an IRA does not have to meet the requirements of a "rollover," does not deal with this precise situation, so many plan administrators and IRA sponsors balk at permitting these transfers (unless a ruling is obtained). This is another example of the IRS's strange insistence on issuing only PLRs to illustrate a well-defined non-controversial legal principle (see Part IV(E) for similar situation regarding spousal rollovers through an estate or trust).

If the retirement benefits are in a QRP rather than an IRA, another issue that arises concerning a transfer of the benefits from a trust to the trust's beneficiaries (or from an estate to the estate beneficiaries) is whether the transfer violates § 401(a)(13)(A) ("benefits provided under the plan may not be assigned or alienated"). Reg. § 1.401(a)-13(c)(1)(i) defines the type of assignment prohibited by § 401(a)(13) as "Any direct or indirect arrangement...whereby a party acquires from a ...beneficiary a right or interest enforceable against the plan in, or to, all or any part of a plan benefit payment which is, or may become, payable to...[the beneficiary making the assignment]." Although § 401(a)(13) is clearly aimed at pledges and garnishments of benefits, a quick reading could lead to the conclusion that it applies to this type of "transfer" as well.

Appendix A
Disclaimers of Retirement Benefits

The uses of qualified disclaimers in planning for retirement benefits.

This Appendix A to the *Special Report: Estate Administrator's Guide to Retirement Benefits* is an exact reproduction of Chapter 4 of the book *Life and Death Planning for Retirement Benefits* (6th ed. 2006) by Natalie B. Choate. Www.ataxplan.com.

A disclaimer is the refusal to accept a gift or inheritance. Federal tax law recognizes that a person cannot be forced to accept a gift or inheritance. Therefore, a disclaimer (provided it meets the requirements of § 2518; ¶ 4.1.02) is not treated as, itself, a taxable transfer. § 2518(a). Since the person making the disclaimer never accepted the property in the first place, the theory goes, he never owned it and therefore he could not have given it away.

Disclaimers of inherited retirement benefits can be very useful in *post mortem* planning. Unfortunately, not every refusal to accept an inheritance is a qualified disclaimer, entitled to the blessings of § 2518.