Natalie Choate Special Report:

Retirement Benefits and the Marital Deduction (Including Planning for the Noncitizen Spouse)

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If property passes outright to the spouse, the modified marital deduction can still be obtained if the spouse transfers the property to a QDOT. ¶ 4.1.04. This option poses special problems in the case of retirement benefits that are paid to the spouse individually. If she leaves the benefits in the decedent's plan, the benefits will not qualify for the marital deduction because the retirement plan is not a QDOT. But if she withdraws the benefits from the plan, with the idea of transferring them to a QDOT, she will have to pay income tax on the benefits (unless the benefits are not subject to income tax; see ¶ 2.1.02★).

4.4.01 ***The combination QDOT-IRT***

One way out of this dilemma is for the spouse to take the benefits out of the decedent's retirement plan and roll them over tax-free (¶ 3.2) to a trust that is both a QDOT *and* an IRA under § 408(a). There is no tax or legal obstacle in the way of combining an IRA and a QDOT. An IRA can be in the legal form of a trust (IRT); see ¶ 6.1.06★.

The QDOT-IRT would provide that the spouse had the right to withdraw all the income and principal on demand. As an IRT, it would also have to provide that the minimum required distribution would have to be distributed to the spouse annually. MRDs from this rollover IRT would begin when the reached age 70½, and would be computed using the Uniform Lifetime Table; see ¶ 1.3.02★.

The practical difficulties of this approach include drafting the document and finding a U.S. bank willing to serve as trustee (¶ 4.4.04). Unfortunately, this difficulty may be substantial in the case of a smaller retirement benefit. Larger banks' fee schedules make them good choices, usually, only for accounts worth $1 million or more. Smaller bank trust operations accept smaller trusts and IRAs, but may refuse to accept an *IRA* in the form of a trust because their IRAs are administered by an outside provider who furnishes all the forms and monitors compliance and thus cannot accommodate a custom-drafted IRT.

4.4.02 ***Deferred estate tax on principal distributions***

There is a price to be paid for the greater income tax deferral that can be obtained with a QDOT-IRT. The price is paid when "principal" for which the marital deduction was taken in the decedent's estate is distributed to the spouse from the QDOT-IRT. At that time, the deferred estate tax, as well as income taxes, will have to be paid on the principal distribution.

Of course, deferred estate tax is due whenever principal is distributed to the spouse from *any* QDOT. But with a regular QDOT (¶ 4.3), it is possible for the trust to exist for the spouse's entire lifetime without ever distributing principal. With a QDOT-IRT, the minimum distribution rules require certain amounts to be distributed every year after spouse reaches age 70½. See Chapter 1★. "Principal" will have to be distributed out to the spouse when the minimum required distributions (MRDs) from the IRA exceed the "income" of the IRA (see ¶ 3.3.06, ¶ 6.1.02★).

If (after age 70½) the spouse is taking out only the MRDs under the Uniform Lifetime Table (¶ 1.3.02★), *and* undistributed income inside the IRT retains its character as "income" for purposes of the deferred estate tax (see ¶ 4.7.03), *and* the required distributions could be treated as coming

first out of the "accumulated income," then it is likely that distributions to the spouse would not be coming out of "principal" (i.e., the value of the account as it existed on the participant's death) until very late in the spouse's life. The MRDs would be less than the annual income so long as the Uniform Table divisor expressed as a percentage (i.e., one, divided by the remaining life expectancy) is less than the rate of income, so for many years after the spouse's RBD the IRT will actually be accumulating some of its income.

However, this conclusion depends on treating income accumulated inside the QDOT-IRT as "income" for purposes of the deferred estate tax. If the IRS decides that "principal" for this purpose includes accumulated income (see ¶ 4.7.03), the crossover point (when MRDs must necessarily include principal and therefore trigger deferred estate tax) will be reached much sooner. Accordingly, until further clarification of the IRS's position, accumulating income inside a QDOT-IRT is not recommended without obtaining a ruling on the status of undistributed income under § 2056A. In the absence of such a ruling, the spouse should (1) withdraw all "income" of the QDOT-IRT annually and (2) in any year in which the "income" exceeds the MRD, roll over the excess to an IRA that is not a QDOT (see ¶ 3.3.07).

4.4.03 ***No IRS ruling on QDOT-IRT qualification***

"Receipt of a favorable opinion letter on an IRA...is not required as a condition of receiving favorable tax treatment." Rev. Proc. 87-50, 1987-2 C.B. 647, section 2.08. Although it will issue opinion letters on prototype IRAs, "The Service will not issue rulings or determination letters to individuals with respect to the status of their" IRAs. *Id.*, § 4.03. Fortunately, the IRS has supplied a "Model Trust Account" form for an IRA, known as Form 5305. "[I]ndividuals who adopt the Model Trust ... Account...will be treated as having an arrangement that meets the requirements of section 408(a)." *Id.*, § 5.01. By adopting Form 5305, and adding to it the provisions required for a QDOT (and other provisions deemed desirable for proper trust administration), the spouse has a QDOT-IRT. The IRT should be fully revocable by the spouse to avoid gift tax issues (see ¶ 4.5.01) and assignment-of-IRD issues (¶ 2.3.03★).

4.4.04 ***Trustee of QDOT-IRT must be U.S. bank***

As a practical matter, the trustee of a QDOT-IRT must be a U.S. bank or other financial institution, for the following reasons:

First, in order for the trust to qualify as an IRA, the trustee must be a bank or such "other person who demonstrates to the satisfaction" of the IRS that it will administer the IRA in the required manner. § 408(a)(2). The procedure for a nonbank to seek IRS approval to serve as trustee of IRAs involves a filing fee of several thousand dollars, as well as demonstrating institutional soundness and continuity to the IRS. It is generally undertaken only by a firm which has plans to serve as trustee for many customers. An individual could not demonstrate the required permanence. Therefore, even though an individual can serve as trustee of a QDOT, an individual will *not* be able to be trustee (or even co-trustee) of a QDOT-IRT.

Second, in order to qualify as a QDOT, there must be at least one U.S. trustee. § 2056A(a)(1)(A). This leads to the conclusion that the trustee of a QDOT-IRT must be a U.S. bank.