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ESTATE PLANNING

Update on Estate Planning for IRAs and Pension Plans

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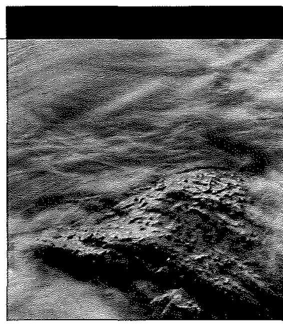

Update on Estate Planning for IRAs and Pension Plans

Recent developments coming out of Congress, the IRS, and the Tax Court present estate planning considerations for those with significant retirement plan assets.

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Retirement savings comprise a large portion of many clients' wealth. Thus, estate planners should keep abreast of the latest tax developments affecting tax qualified retirement plans, including IRAs. The discussion that follows addresses three such recent developments affecting estate planning for IRAs and pension plans that arise from the 2010 Tax Act, a private letter ruling, or a Tax Court decision.

Spousal exclusion amount portability

Many in the estate planning community had been urging Congress for years to pass legislation that would allow the estate of the surviving spouse of a married couple to use any of the applicable exclusion amount that was not used on the death of the first spouse. The concept is that the unused exclusion amount should be transferable, or portable, to the estate of the surviving spouse so that it can be appropriately used regardless of the quality or effectiveness of the couples' estate plan.

Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Act"), Congress has now provided for such transferability, often referred to as "portability." The estate tax provisions of the 2010 Tax Act, including "portability," however, will terminate on 12/31/2012 unless Congress formally acts to extend them. Consequently, for good reason, most advisors are not generally including, nor relying on, portability as a specific component of their clients' estate plans. Furthermore, while the unused exclusion amount can be transferred, the unused generation-skipping transfer (GST) exemption of the deceased spouse cannot. Also, the remarriage of a surviving spouse is likely to terminate the portability of the exclusion amount of the deceased first spouse.

Even so, when analyzing estates with significant IRAs or qualified plan assets, incorporating portability strategically into the estate plan may well generate significant benefits even with the risk of a short time horizon for its availability.

Before expanded Roth conversion rules. In prior years, when a couple's IRAs and pension plans comprised a large part of the estate, a true conundrum existed. How do we maximize the use of the decedent's exclusion amount and yet obtain the maximum "stretchout" of the IRA and pension plan funds? An analysis would first involve considering the estate tax benefits of naming the credit shelter trust (CST) as the "designated beneficiary" of an IRA. This analysis might have been refined if other assets were likely to be available to fund the CST.

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By so naming the CST, the IRA funds could be used, at least in part, to fund the CST and thereby use the decedent's exemption amount. Further analysis, however, showed that this goal of fully using the exemption amount was not likely to be achieved because the distributions to the CST would be taxable income to the CST. Thus, the CST would have to use part of the distribution to pay the income tax. This problem was amplified by the fact that the "compressed" income tax rates of such trusts likely resulted in higher taxes than if a tax rate schedule for individuals applied. This negative aspect could be mitigated with the CST having appropriate distribution provisions resulting in the beneficiary of the CST paying the income tax. In either event, however, the result was that each dollar of the exemption amount was not fully used because some of the IRA funds were "lost" in the payment of the income taxes.

The second problem involved the limitation of the "stretch out" period. Typically the couple would want the surviving spouse to benefit from the decedent's IRA and also from the CST. Consequently, the surviving spouse would be named the primary beneficiary of the CST, with the intent that all income and principal distributions would be paid to the surviving spouse for the remainder of his or her life. Yet, the terms affecting the distributions from the CST to the surviving spouse can vary significantly; the consequences of such terms would vary significantly as well.

By having the surviving spouse named as the primary beneficiary of the CST, and not of the IRA, two things conspired to potentially limit the distribution period. First, the surviving spouse, by not being named personally as the primary beneficiary of the IRA, may not have had the ability to roll over the IRA funds into his or her own IRA. Importantly, several letter rulings have allowed a surviving spouse to do a rollover when a trust has been named as the beneficiary of the IRA and the surviving spouse has the power to demand a complete distribution of the assets from the trust.[1]

With the distributions to the CST now coming from a Roth IRA, no income taxes would have to be paid by the CST or beneficiary.

For the arrangement to obtain the benefits of a CST (i.e., use the decedent's exemption amount and keep the assets out of the surviving spouse's estate), the distributions to the surviving spouse need to be limited and must be subject to an "ascertainable standard." Sometimes a trust would have the ascertainable standard applied to both income distributions as well as principal distributions.[2] These restrictions or limitations on access to the funds by the surviving spouse or in distributions of the funds to the surviving spouse resulted in the IRS ruling that the surviving spouse did not have the ability to do a rollover. This result has been reflected in a couple of letter rulings.[3] Consequently, when a CST was involved, it was reasonable to conclude, as a result of these rulings, that the surviving spouse, as the beneficiary of the CST, could not do a rollover into his or her own IRA.

With no rollover possible, the surviving spouse could not defer until his or her reaching age 70.5 (assuming that, at the decedent's death, the surviving spouse was younger than 70.5) the commencement of the required minimum distributions (RMDs). Rather, the distributions to the CST from the deceased spouse's IRA would have to begin in the calendar year immediately after the year of the decedent's death. Moreover, as the owner of the IRA, the surviving spouse could have used the Uniform Lifetime Table to calculate the RMDs once reaching the required distribution age. The Uniform Lifetime Table, by assuming a beneficiary ten years younger than the IRA owner, requires significantly lower distributions.[4] In contrast, with the CST being the beneficiary of the IRA, such distributions would have to be calculated using the Single Lifetime table, which results in much larger required distributions than those determined under the Uniform Lifetime Table.[5]

Finally, with the CST being the beneficiary of the IRA and the surviving spouse being the primary beneficiary of the CST, the life expectancy of only the surviving spouse could be used to determine the required distributions. This would be true even if the surviving spouse died prematurely and the successor beneficiaries of the CST were the couple's children.[6] If, however, the surviving spouse had been able to roll over the IRA, the children would likely have been named as the beneficiaries of that IRA, and distributions after the death of the surviving spouse could be based on the life expectancy of each child (assuming the "separate accounting" rules in the Regulations under Section 401(a)(9) were followed).[7]

The above factors involve the analysis from an "income tax" perspective and thus generate an ini-

[1] See Ltr. Ruls. 200950053 and 200935045.
[2] See Section 2041(b).
[3] See Ltr. Ruls. 200618030 and 200944059.
[4] Reg. 1.401(a)(9)-9, Q&A-2.
[5] Reg. 1.401(a)(9)-9, Q&A-1.
[6] Reg. 1.401(a)(9)-5, Q&A-7(c)(2).
[7] Reg. 1.401(a)(9)-8 Q&A-2.

tial negative response to naming a CST, for example, as the primary beneficiary of an IRA. The primary goal of the above strategy, however, was to maximize the use of the decedent's exemption amount. In certain scenarios, the estate tax savings from maximizing the use of the decedent's exemption amount would offset the negative "income tax" consequences.

Planning option with Roth conversion. Beginning in 2010, the law eliminated the prior $100,000 adjusted gross income limit as to whom could convert to a Roth IRA.[8] Thus, under the new law, individuals could convert their traditional IRA to a Roth IRA, without regard to income level or tax-filing status. This presents another reason to give serious consideration to naming the CST as the primary beneficiary of the IRA (and not the surviving spouse) if other assets are insufficient in amount to take full advantage of an IRA owner's exemption amount.

Including in a long-term planning arrangement the near-term conversion of a traditional IRA to a Roth IRA often can mitigate much of the adverse "income tax" consequences noted above. With the distributions to the CST now coming from a Roth IRA, no income taxes would have to be paid by the CST or beneficiary. Instead, each dollar in the Roth IRA would effectively use up a dollar of the exemption amount. This full exploitation of the exemption amount could significantly increase the projected estate tax savings when compared to the scenario involving a traditional IRA.

Of course to achieve this result, the IRA owner really had to have sufficient funds outside the traditional IRA to pay the tax resulting from the conversion. For many individuals, the recent "great recession" was a significant deterrent to using other "investable funds" to pay the current tax that would be due from a Roth IRA conversion, regardless of the size of the estate tax savings projected to be realized on the second death.[9]

Using "portability" and naming the surviving spouse as the IRA beneficiary, one can avoid the drafting "traps" and in-depth analysis required when a CST is the beneficiary.

Portability. The 2010 Tax Act has revised the definition of "applicable exclusion amount" as found in Section 2010(c). Now the applicable exclusion amount is the sum of the "basic exclusion amount" and, in the case of a surviving spouse, the "deceased spousal unused exclusion amount."[10] The "basic exclusion amount" is $5 million.[11] The term "deceased spousal unused exclusion amount" means the lesser of: "(A) the basic exclusion amount, or (B) the excess of (i) the basic exclusion amount of the last such deceased spouse of such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse."[12]

Thus the unused portion of the basic exclusion amount is not "terminable" but is "portable" to the estate of the surviving spouse. But this "portability" does not happen automatically, nor can it be invoked solely by the executor of the estate of the surviving spouse. Alas, Section 2010(c)(5) indicates that an election at the time of the death of the decedent must be made:

> A deceased spousal unused exclusion amount may not be taken into account by a surviving spouse ... unless the executor of the estate of the deceased spouse files an estate tax return on which such amount is computed and makes an election on such return that such amount may be so taken into account [by the estate of the surviving spouse].

For clients with smaller estates (e.g., $1 million to $2 million), the idea of incurring the cost to file an estate tax return on the first death in order to "preserve" the unused exemption amount of the deceased spouse may not be compelling. In contrast, as the magnitude of the spouses' assets increases to the point where the estate of the surviving spouse is likely to incur an estate tax absent the use of the portability provision, the possible role of portability warrants greater attention. This focus on portability will especially increase if a significant part of the estate of one or both spouses is an IRA.

With the availability of a "portable" exemption amount, the attention will now be on:

1. The benefits of naming the surviving spouse as the primary beneficiary of the IRA.
2. The ability of that surviving spouse to roll over the IRA into his or her own IRA.
3. The opportunity for converting that traditional IRA to a Roth IRA.
4. Extending the time before the required minimum distribution (RMD) rules kick in (i.e.,

[8] Section 408A(d)(3)(B).

[9] Even so, the number of Roth conversions increased very significantly since the conversion rule change in 2010. For example, Fidelity Investments announced on 4/14/2011 that it experienced a fourfold increase in conversions in 2010 (see http://www.fidelity.com/inside-fidelity/individual-investing/fidelity-investments-experiences-fourfold-increase-in-roth-ira-conversions-in-first-quarter-of-2010).

[10] Section 2010(c)(2).

[11] Section 2010(c)(3)(A).

[12] Section 2010(c)(4).

because of the younger surviving spouse or the Roth conversion resulting in no RMDs).
5. Naming the children as the primary beneficiaries of the surviving spouse's IRA.
6. The benefits of tax-deferred (or possibly tax-free) growth over the life expectancy of each of the children as determined under the Single Life Table[13] and the "separate account" rules mentioned above.

Now all of these "income tax" benefits can be realized, and the unused exemption amount of the deceased spouse will not be lost.

Consequently, "portability," while not necessarily very attractive in other scenarios, may well be planned for and relied on when IRAs are a large part of one or both spouses' estates. Moreover by using "portability" and naming the surviving spouse as the beneficiary of the deceased spouse's IRA, one can avoid the drafting "traps" and in-depth analysis required when a CST is the beneficiary. The discussion below of a recent private letter ruling points out such drafting "traps" and the need for an in-depth analysis of virtually all provisions of the related trust in order to be confident that the planned for "stretch-out" will be achieved.

Revocable trusts and IRAs: symbiotic or toxic?

Naming the family revocable trust as the beneficiary of one's IRA often seems the most practicable and logical alternative. The client may well have spent significant time and effort (not to mention fees) evaluating the various alternatives for transferring family assets to the children in order to identify the most tax efficient way.

Ltr. Rul. 201021038 provides an excellent example of the various traps when a family revocable trust (or one of the subtrusts formed on the first death) is listed as the IRA beneficiary. This ruling underscores the differences between "conduit"[14] provisions and "accumulation" provisions, and between "contingent beneficiary"[15] and "successor beneficiary."[16] It demonstrates how the commonly used "power of appointment" results in having to consider a broader swath of beneficiaries for IRA distribution purposes than might have been intended, especially if one such beneficiary does not qualify as a "designated beneficiary."[17]

The ruling strongly expresses the IRS view that the requirement specified in the Regulations that a "designated beneficiary" must be so listed on the beneficiary form as of the date of death of the IRA owner cannot be altered.[18] Finally, the ruling points out the case law precedents that the IRS relied on to ignore and disregard a state court order that attempted to retroactively name a "designated beneficiary" (and remove all "undesirable" beneficiaries) effective as of the date of death.

Facts of the ruling. Dad and Mom created a revocable trust as part of their estate plan and restated it at some later date ("restated trust"). The restated trust had fairly typical provisions in that on the first death, the trust would divide into these traditional types of trusts:

1. Survivor's trust.
2. Bypass trust.
3. Marital deduction trust.
4. Disclaimed property trust.

The key subtrust of this ruling was the bypass trust. Under its terms, the trustee was required to distribute income from the bypass trust in installments, at least quarterly, for the health care, maintenance, support, and welfare of the beneficiary of the bypass trust but only if other resources are clearly inadequate. The primary beneficiary of the bypass trust (i.e., the surviving spouse) possessed the power to allocate principal from the bypass trust to the "secondary beneficiaries" of the bypass trust and their descendants as long as the surviving spouse remained competent. The balance of the bypass trust not so appointed or allocated would be disposed of under Article X of the restated trust on the death of the surviving spouse/grantor.

Article X first provided for specific bequests and an amount, determined by a formula, to be distributed outright to the grandchildren of Mom and Dad.

Protective trusts. In addition, Article X created and provided for the administration of two separate "protective trusts," one for each of the two children of Mom and Dad. The provisions of these protective trusts became the focus of the ruling.

Under the restated trust, the trustee of each protective trust was to distribute "appropriate amounts of income and principal for the health care, maintenance, support and education" to the beneficiary of each such protective trust. Neither the distribution of the income nor the principal was mandatory; thus the income as well as the principal (and distributions from the IRA to the protective trust) could be retained and thus "accumulated" within the protective trust potentially for the benefit of a beneficiary other than one of the children of Mom and Dad.

As a result, the protective trusts were not "conduit" trusts" since the trustee was not obligated to distribute to the primary beneficiary

[13] Reg. 1.401(a)(9)-9, Q&A-1.
[14] Regs. 1.401(a)(9)-4, Q&A-5 and 1.401(a)(9)-5, Q&A-5.
[15] Reg. 1.401(a)(9)-5, Q&A-7(b).
[16] Reg. 1.401(a)(9)-5, Q&A-7(c).
[17] Reg. 1.401(a)(9)-4, Q&A-3.
[18] Reg. 1.401(a)(9)-4, Q&A-4(a).

the required distribution received each year from the IRA. Consequently, the "investigation" of whether there was a "designated beneficiary" could not stop after determining that a child was the "primary beneficiary" of each protective trust.

In addition, each of the beneficiaries of the protective trusts who attained a "designated age" had a lifetime power of appointment over the assets in her protective trust, and *such power extended to charities*. In the ruling, each child had attained the "designated age."

Moreover, each beneficiary of a protective trust, on attaining the designated age, also had a testamentary power of appointment and thus could select who would receive the assets of the protective trust after such child's death. The potential "appointees" included certain persons and entities, including charities, with certain specified exceptions.

Article XI of the Restated Trust provided for the distribution of assets not disposed of under Article X. This Article XI provided for specific bequests to persons named in Schedule H. In addition, this Article provided that any residue would be divided among the persons named or described in Schedule I. While a charity or other non-natural person was eligible to be a contingent beneficiary, none was listed on Schedule I.

IRA beneficiary designation. At some later date, Dad and Mom apparently discussed with their advisor the possibility of naming either the restated trust or one of the subtrusts formed on the first death as the designated beneficiary of his or her IRA. The advisor apparently drafted an amendment to the restated trust that was approved by Dad and Mom. Because of its importance to the ruling, it is fully quoted below:

> With respect to any IRA, 401K or other retirement plan payable to the trust on the death of either Trust Creator, it is the Trust Creators' desire that the Trustee utilize the minimum distribution rules described in the Internal Revenue Code ("IRC") and applicable regulations when making withdrawals from said retirement account.... In particular, the trustee should be guided by the following: (a) The Trustee should first determine whether the custodian allows for long-term deferral of income taxes by the Trustee; ... (c) the Trustee should determine what requirements exist, if any, in order to elect the longest tax-deferral period; (d) Having made the appropriate election in order to elect the longest tax-deferral period of time, the Trustee should withdraw funds from the retirement plan in the minimum amounts required under IRC and applicable regulations without penalty; additional amounts should be withdrawn only if the Trustee determines that a need exists; ... (f).... The provisions of this instrument are intended to inform the Trustee of the Trust Creators' desire that the rules commonly known as the "stretch IRA" rules should be applied to all retirement plans. It is the Trust Creators' hope that the Trustee will use his or her best efforts to minimize income taxes on these assets for the maximum duration permitted by law.... For purposes of qualifying as a Designated Beneficiary under IRC and applicable regulations, each Beneficiary may amend the terms of the trust which govern the distribution of his or her trust at death in the absence of a complete and effective exercise of any applicable power of appointment; ...

Stretching IRA distributions. This amendment seems to reflect a sense that a trustee, once instructed by the trust grantors, had the power and authority to interpret and apply the rules affecting RMDs from the IRA in such a way as to exploit and maximize the "stretch IRA" rules to the extent desired.

But such an objective cannot be realized without also understanding the significance of the other very relevant provisions of the restated trust (i.e., the powers of appointment and the potential "appointees") in determining who (or what) would be the beneficiary and whose life expectancy (if any) would determine the required distributions (i.e., who are the "primary beneficiaries," the "contingent beneficiaries," or the "successor beneficiaries"). The differences in consequences depending on whether the protective trust contains "conduit' provisions (i.e., mandatory distribution to the beneficiary of the required distributions from the IRA) versus "accumulation" provisions (i.e., trustee has discretion as to whether to make the distributions of the funds from the IRA or retain (and accumulate) them) must also be understood.

Finally, the need to be aware of, and to satisfy, the four requirements that allow the beneficiaries of a trust to be treated as the beneficiaries of the IRA even though it was the trust that is named as the beneficiary on the beneficiary designation statement appears lacking in the terms of the amendment.

The four requirements are as follows:

1. The trust is a valid trust under state law, or would be but for the fact that there is no corpus.
2. The trust is irrevocable or will, by its terms, become irrevocable on the death of the IRA owner.
3. The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the IRA are identifiable under the terms of the trust instrument.
4. Certain documentation regarding the trust are provided to the plan administrator or IRA custodian.[19]

Death of trust grantors. Subsequent to the adoption of the above amendment, Mom dies. Dad then becomes the sole trustee of the various subtrusts referenced above. Dad decides to name his two adult daughters (hereafter Taxpayer C and Taxpayer D) as the co-trustees of the bypass trust. At some point before his death, Dad had named the trustees of the bypass trust (i.e., his two daughters) as the beneficiary of his IRA.

After Dad's death, pursuant to Article X of the restated trust, all the subtrusts that had been created on the death of Mom were consolidated and equally divided into the above-described two protective trusts, one for each daughter. In addition, they each became the trustee of her respective protective trust.

At this point the two daughters apparently sought the advice of a different advisor. The daughters, acting as trustees of the bypass trust, filed for a declaratory judgment in the local state court. The daughters asked the state court to modify the restated trust in order to comply with certain requirements under Reg. 1.401(a)(9). The court issued an order modifying the restated trust retroactively to the date of Dad's death, apparently as requested.

Modification of trust. The court order modified the restated trust, in relevant part, as follows:

1. All amounts received from the custodian of the IRA are to be distributed to the beneficiaries of the protective trusts. (This changes the protective trusts from "accumulation" trusts to "conduit" trusts. This suggests the new advisor was aware of the potential problems if such trusts were left as "accumulation" trusts.)
2. The trustee is authorized to arrange direct distributions to the beneficiary. (The observations in the parenthetical in #1 apply here as well.)

An individual may be designated as a beneficiary under the plan either by (1) the terms of the plan, or, (2) if the plan so provides, by an affirmative election by the employee.

3. If a special independent trustee is selected, distributions to descendants of beneficiaries born before 1955 are prohibited. (This suggests that the oldest daughter was born in 1955, and, thus, it is desirable not to have any beneficiary older than the oldest daughter.)
4. Descendants of beneficiaries born before 1955, contingent beneficiaries, and charities are removed as potential appointees of a beneficiary's lifetime power of appointment. (This reflects awareness that charities cannot be "designated beneficiaries." With the cutoff year of 1955, this, as described above, likely eliminates any beneficiary who is older than the oldest daughter.)
5. Any individual born before 1955 is removed as a potential appointee of a beneficiary's testamentary power of appointment. (As noted above, this apparently eliminates from consideration any person older than the oldest daughter.)
6. Taxpayer C (the oldest lineal descendant of Dad) is named as the designated beneficiary under Reg. 1.401(a)(9)-4, Q&A-4, and the restated trust is to be administered so that all beneficiaries following the two daughters are "successor beneficiaries," as defined in Reg. 1.401(a)(9)-5, A-7(c)(1). (This attempts to have the oldest daughter treated as the "designated beneficiary" for determining which life expectancy is to be used in calculating the RMDs. It also attempts to eliminate the problems associated with having "contingent" beneficiaries.)
7. The trustee is directed to use IRA proceeds to pay debts, administration expenses, or taxes of Dad's estate only after other assets are exhausted, and is prohibited from using any IRA proceeds to make such payments after a specified date. (This "prohibition" on using IRA funds to pay expenses associated with Dad's estate is likely an attempt to avoid having Dad's estate viewed as a "beneficiary" of the IRA, which would result in there being no "designated beneficiary" because only individuals can be "designated beneficiaries.")

Requested rulings. Based on the above, the daughters requested the following letter rulings from the IRS:

1. That the IRA be distributed as though the beneficiaries of the bypass trust administered under the restated trust, as amended by the court order, were named beneficiaries of the IRA, thereby satisfying the guidance set forth in Regs. 1.401(a)(9)-4, Q&As 4 and 5.
2. That Taxpayer C, the oldest daughter, is the "designated

[19] Reg. 1.401(a)(9)-4, Q&A-5(b).

beneficiary," as that term is used in Section 401(a)(9)(A)(ii), of Dad's IRA based on the judicial modification of the restated trust *retroactively* to Dad's date of death, which modification is valid under State S's Revised Code.[20]

3. *Alternatively*, that Taxpayer C, the oldest daughter, is the "designated beneficiary," of the IRA as a result of removing certain discretionary distributees and potential objects of appointment before a specified date in 2009 through the judicial modification of the restated trust under State S's Revised Code.[21]
4. That the applicable distribution period as used in Reg. 1.401(a)(9)-5, A-5(c)(1) for the applicable calendar year (2009) is 30.5 years (reduced yearly), which is Taxpayer C's life expectancy based on her current year (2009) birthday.[22]

IRS analysis. The IRS starts its analysis by citing and summarizing provisions in the Regulations that address the definitions of a "designated beneficiary," "contingent beneficiary," and "successor beneficiary." It is instructive to see how the IRS analyzed the issues and which IRC sections and Regulations it emphasized in its analysis. Thus, the following highlights those provisions referenced by the IRS in the ruling with respect to the different issues and concepts.

Designated beneficiary. Section 401(a)(9)(E) states that the term "designated beneficiary" means any *individual* designated as a beneficiary by the employee.

Reg. 1.401(a)(9)-4, Q&A A-1 provides, in part, that a "designated beneficiary" is an individual who is designated as a beneficiary *under the plan*. Thus an individual may be designated as a beneficiary under the plan either by (1) the terms of the plan, or, (2) if the plan so provides, by an affirmative election by the employee (or the employee's surviving spouse) specifying the beneficiary. Under these Regulations, a designated beneficiary need not be specified by the plan in order to be a "designated beneficiary" so long as such individual is identifiable under the plan. In addition, even a member of a class of beneficiaries capable of contraction or expansion will be treated as being identifiable if it is possible to identify the class member with the shortest life expectancy. It is also noted that under these Regulations, the passing of an employee's interest to an individual under a will or otherwise under applicable state law does not make that individual a designated beneficiary unless that individual is designated as a beneficiary under the plan.

Reg. 1.401(a)(9)-4, Q&A-3 emphasizes again that only individuals may be "designated beneficiaries." A person who is not an individual, such as an estate or a charitable organization may not be a designated beneficiary. Indeed, if a person other than an individual is designated as a beneficiary, then the employee will be treated as not having a beneficiary for purposes of Section 401(a)(9), even if there are also individuals designated as beneficiaries.[23]

Reg. 1.401(a)(9)-4, Q&A-4 provides, in relevant part, that in order to be a designated beneficiary, an individual must be a beneficiary as of the date of the employee's death. Thus, designated beneficiaries generally are determined based on those designated as beneficiaries as of the date of death and who remain beneficiaries as of September 30 of the year following the calendar year of the date of death.[24]

Contingent beneficiary vs. successor beneficiary. The IRS then references the regulations that define a "contingent beneficiary" and a "successor beneficiary" and the very important significance of distinguishing between the two.

Reg. 1.401(a)(9)-5, Q&A-7(b) provides, in essence, that if a beneficiary's entitlement to an employee's benefit after the employee's death is a "contingent right," the "contingent beneficiary" is nevertheless considered to be a beneficiary for purposes of determining who, if anyone, is the designated beneficiary.

In contrast to a "contingent beneficiary," a "successor beneficiary" is not considered when determining who is the beneficiary with the shortest life expectancy. A "successor beneficiary" is defined as a person who could become the suc-

20 This presents the issue of whether a state court can retroactively designate a beneficiary of an IRA despite the requirement in the Regulations that a beneficiary must be named on the beneficiary form as of the date of death of the IRA owner. Reg. 1.401(a)(9)-4, Q&A-4(a).

21 Under the above Regulation, a beneficiary not only must be named as of the date of death of the IRA owner but also remain a beneficiary as of September 30 of the calendar year following the year of the IRA owner's death. This ruling request seems to be asking concurrence that the state court had the authority to remove the "discretionary distributees" and potential objects of the powers of appointment as beneficiaries before the September 30 cutoff date. This essentially acknowledges that some "unfavorable" beneficiaries were effectively named under the terms of the protective trusts as of the date of death.

22 If the IRS agrees that the order of the state court effectively removed all of the "unfavorable" beneficiaries, then Taxpayer C can be treated as the "designated beneficiary" whose life expectancy will be used to determine the RMDs.

23 This is likely the basis for the petition to the state court to amend the protective trusts to remove certain discretionary distributees and potential appointees under the powers of appointment that included charities.

24 This is the basis for the position that to be considered as a beneficiary one must be named as such as of the date of death. But, importantly, all such named beneficiaries (and all those who can be determined to be such as of the date of death) are considered in determining whether there is actually a "designated beneficiary" whose life expectancy can be used to determine the RMDs

cessor to the interest of one of the employee's beneficiaries only after that beneficiary's death.[25] (Note: It is the interest arising after the death of the employee's (designated) beneficiary, not after the death of the employee him or herself.)

Trust reformation and potential tax consequences. The IRS then states that a reformation of a trust instrument is not effective to change the tax consequences of a completed transaction. The IRS references *Estate of La Meres*,[26] where the trustees retroactively reformed a governing instrument solely for the purpose of qualifying the bequest for the estate tax charitable deduction. In that case, the Tax Court held that the retroactive reformation, undertaken solely for tax consequences, was not effective for federal tax purposes:

> This and other courts have generally disregarded the retroactive effect of State court decrees for Federal tax purposes. [Citations omitted.]

The IRS then states that while it will look to local law in order to determine the nature of the interests provided under the trust document, it does not feel bound to give effect to a local court order that modifies the dispositive provisions of the document after respondent has acquired rights to tax revenues under its terms.

The IRS further states that it will treat a state court order as controlling with respect to a reformation if the reformation is specifically authorized by the Code, such as under Section 2055(e)(3), which allows for the reformation of split-interest charitable trust in order for the charitable interest to qualify for the charitable deduction as authorized under that statute.

The IRS then determined, however, that no applicable federal statute authorizes, in this instance, the daughters' retroactive reformation of the restated trust. As a result, the IRS concluded, the subject modification of the restated trust is not recognized for federal tax purposes:

> In this instance, the efforts undertaken to modify the terms of the Restated Trust will not be given retroactive effect for federal tax purposes and the designated beneficiary of IRA X *must be determined under the terms of the Restated Trust as it existed at the time of Taxpayer B (Dad's) death.* [Emphasis added.]

Bypass trust as beneficiary of the IRA. The analysis then turns to the bypass trust created under the restated trust since it was named as the beneficiary of Dad's IRA.

In contrast to a "contingent beneficiary," a "successor beneficiary" is not considered when determining who is the beneficiary with the shortest life expectancy.

The IRS states that, provided the restated trust meets the requirements for a "see through" trust as set forth in Reg. 1.401(a)(9)-4, Q&A-5, it is then permissible to "look through" the trust in order to determine who, if anyone, is the designated beneficiary. But after doing the "look through," the IRS concludes that there was no identifiable beneficiary of the IRA at the time of Dad's death.

How did the IRS reach this conclusion? First, the IRS points out that the relevant terms of the restated trust, and specifically the terms of the bypass and the protective trusts, do not require or authorize either of the daughters under their respective protective trusts to receive all amounts that are distributed from the IRA. Rather, the terms of the restated trust makes all distributions of either income or principal subject to a standard, essentially the typical "ascertainable standard."

Moreover, the relevant restated trust terms do not require that amounts distributed from the IRA, even if based on Taxpayer C's life expectancy, be paid either to Taxpayer C or Taxpayer D "*or any other natural person (human being).*" In essence, the IRS is pointing out that there were no "conduit provisions" mandating that all IRA distributions be, in turn, distributed from the respective "Protective Trusts" to the daughters. The result? Such distributions from the IRA could be "accumulated" by the trustee.

This, in turn, means that such accumulated IRA distributions could be the subject of the powers of appointment granted to the daughters. But these powers of appointment could be exercised not only in favor of individuals but also charities:

> Because the terms of the Restated Trust allow for the *accumulation of amounts distributed from the IRA X*, the remainder beneficiaries *must be considered beneficiaries of IRA X. Charitable organizations are clearly authorized to be potential/contingent beneficiaries* under the relevant provisions of the Restated Trust. However, *only individuals may be designated beneficiaries* for purposes of satisfying the requirements of Code section 401(a)(9) and related Income Tax Regulations. As a result, Taxpayer B (i.e. Dad) is treated as having *no* beneficiary of his IRA for purposes of section 401(a)(9) of the Code. [Emphasis added.]

The IRS then repeats the rules for the proper timing for designating a beneficiary. First it is noted, as above, that "potential

[25] Reg. 1.401(a)(9)-5, Q&A-7(c).
[26] 98 TC 294 (1992).

beneficiaries" may be eliminated after the death of an IRA owner and prior to September 30 of the year following the IRA owner's death for purposes of determining who is the "designated beneficiary." But, in contrast, while "beneficiaries" may be eliminated,[27] "beneficiaries" cannot be added during this period. Furthermore, a "designated beneficiary" must be in existence as of the IRA owner's death:

> A designated beneficiary *cannot be created after the date of death* by means of a State Court Order, even if said Order is valid under State Law.

The IRS concludes by emphasizing the importance of the terms of the restated trust:

> In this case, *due to the language of relevant terms of the controlling Restated Trust document there is no designated beneficiary* for purposes of section 401(a)(9) analysis. *Subsequent efforts to obtain a post-mortem judicial modification had the effect of creating a designated beneficiary after the death of the taxpayer.* Said efforts *will not be given effect* for purposes of Code section 401(a)(9). [Emphasis added.]

The IRS then provides its specific response to each of the ruling requests.

As to the first requested ruling, as noted above, the IRA will have to be distributed as if the IRA had no designated beneficiary. The reason for this is that entities ineligible to be treated as "designated beneficiaries" were, in fact, eligible to receive amounts from the IRA. Consequently, those entities (i.e., the charities) had to be considered "contingent beneficiaries." Thus, the IRA has to be treated as having no "designated beneficiary."

As to the second ruling request, the IRS stated that no response could be provided because of the response to the first ruling request.

As to the third ruling request, Taxpayer C cannot be treated as the "designated beneficiary" of the IRA simply because of the above-described court order because that order created a "designated beneficiary" of the IRA where none existed prior to the entry of the court order. Such "creation of a designated beneficiary after the death of the IRA owner" does not comply with the requirements of Section 401(a)(9).

As to the fourth ruling request, it was noted that Dad had attained the "required beginning date" prior to his death. Consequently, the applicable required distribution period is Dad's remaining life expectancy in accordance with the relevant regulations.[28]

The ruling underscores how powers of appointment may well eviscerate all the benefits that could have been realized by the proper designation of beneficiaries.

Observations. This ruling presents an excellent list of typical provisions of a family revocable trust that must be considered, and potentially revised, before such a trust (or any of its subtrusts) is designated as a beneficiary of an IRA. Moreover, the ruling underscores how powers of appointment, typically inserted intentionally to provide flexibility, may well eviscerate all the benefits that could have been realized by the proper designation of beneficiaries. Indeed, the ruling may appropriately guide advisors away from naming the family revocable trust as the IRA beneficiary and toward using what is often referred to as the "standalone IRA trust," a trust where certainty over flexibility is the desired objective.

Who pays the estate tax?

The above discussions revolve around how best to transfer IRA funds from one spouse to another and then onto the children. One objective of such planning is to make sure the IRA funds are available to the surviving spouse if needed. A second objective is often to pass on a significant financial legacy to the children to the extent such funds have not been needed by the surviving spouse. The transfer of the IRAs to the children typically occurs only on the death of the surviving spouse. But important issues must be analyzed and planned for if it is likely that there will be a taxable estate on the surviving spouse's death.

If a taxable estate will result at that time, the source of the funds to pay the estate tax should be addressed. Often the "family revocable trust" will state that any taxes and expenses should be paid from the "residue" of the assets held in the trust after the distribution or transfer of specifically described bequests. As IRAs have become a larger percentage of individuals' estates, however, more consideration is being given to stating that any such taxes and expenses are to be paid pro rata from all the beneficiaries of the estate—including the designated beneficiaries of the decedent's IRAs.

Whether this result is intended or not, when a provision is included indicating that the taxes must be paid from the "residue," the beneficiaries of the IRAs—which may be substantial—avoid "losing" any of their IRA funds in the payment of such

[27] E.g., by qualified disclaimers. Reg. 1.401(a)(9)-4, Q&A-4(a).

[28] Reg. 1.401(a)(9)-5, Q&A-5(a)(2).

taxes. Or do they? A recent case suggests that may not be the result.

Estate of Mangiardi[29] demonstrates the need for designing, and ultimately implementing, a plan that designates the source of funds for the payment of any estate taxes, especially if the intent is to avoid the loss of IRA funds through the beneficiaries being forced to take taxable distributions to pay the estate tax.

Facts of the case. The decedent, Joseph L. Mangiardi, died on 4/5/2000. The trustee of decedent's revocable trust and "statutory executor" filed the estate tax return on 7/5/2001 that showed an estate tax liability of $2,621,810. The return stated that the value of the gross estate was $8,050,042, most of which was not subject to probate. The non-probate assets included the assets in the decedent's revocable trust valued as of the alternate valuation date at $4,577,360 and IRAs totaling $3,433,007, of which the decedent's nine children were the named beneficiaries.[30]

Unfortunately, the decision does not state whether the revocable trust had a provision directing the source (or sources) from which any estate tax should be paid. Ultimately, however, such a provision was not relevant to the issue before the court.

IRS grants extensions to pay. The trustee requested, and the IRS granted, a total of six extensions to pay the estate tax. In the last request for an extension, the trustee requested an additional 12 months "to pay estate taxes under the hardship provisions[31] ... or in the alternative, request is made under the reasonable cause provisions...."[32] To support the request, the trustee claimed that "the assets in the gross estate which must be liquidated to pay the estate tax can only be sold at a sacrifice price or in a depressed market, if the tax is to be paid on the" prior extended due date.

The trustee also stated that the unliquidated value of the trust account as of 5/31/2004 was approximately $542,713. This clearly is a dramatic reduction in value from the originally stated value of trust assets, namely $4,577,360. The trustee did provide a detailed description of the events that had led to the devaluation of the assets in the trust account.

The estate tax liability could be collected either from the executor/personal representative or from the IRA beneficiaries without a prior assessment against the beneficiaries.

A description of the trust assets was not provided in the opinion, which might help in understanding why there was such a dramatic reduction in value of the trust assets. Interestingly, the value of the IRA assets was not mentioned. One might reasonably assume from this omission that the trustee was thinking, or trying to convince the IRS, that only the trust assets were available to pay the estate tax.

In September 2004, the Service advised the trustee it was approving the request for additional time to pay the estate tax but only until 12/5/2004. The Service also advised the trustee that no further extensions to pay the estate tax would be granted. In the Service's letter it warned:

> The extension to pay is only being allowed until 12/5/2004 because, if the liability is not paid in full by that date, the IRS will begin making *transferee assessments against the heirs of the estate that received assets and have not paid to the IRS their portion of the estate tax and interest owed.* [Emphasis added.]

Collection actions. With the estate tax still unpaid, the Service sent the trustee, on 7/13/2006, a notice of intent to levy under Section 6330. In response to the levy notice, the trustee requested a collection due process (CDP) hearing.[33]

At the CDP hearing, the trustee claimed that the IRS was precluded from collecting the tax from the IRA beneficiaries because the time for making a transferee assessment under Section 6901 had expired.[34] The trustee requested that the estate tax liability be resolved through an offer-in-compromise in which the trustee would offer a reduced amount based on doubt as to collectability of the remaining assets in the trust.

Thus, at least at this juncture, the trustee appears to feel that the beneficiaries of the IRAs (and the IRA funds) were now no longer subject to the IRS levy for the estate tax because of Section 6901 and its "period of limitation."

The IRS Settlement Officer sought legal advice from the Service's counsel as to whether the unpaid estate tax liability could be collected. Counsel advised that the estate tax liability could be collected either from the executor/personal representative or from the IRA beneficiaries by enforc-

29 TCM 2011-24.

30 An amended return was filed on 12/28/2001, but with seemingly no consequence. Indeed, the return was selected for examination but no additional assessment was made. Instead, an abatement of tax of $143,152 was made in 12/22/2003.

31 Reg. 20.6161-1(a)(2.)

32 Reg. 20.6161-1(a)(1).

33 Form 12153, Request for a Collection Due Process Hearing.

34 This period of limitation is generally one year after expiration of the period of limitation for assessment against the transferor. Section 6901(c).

ing the estate tax lien under Section 6324(a)(2) without the need for a prior assessment against the beneficiaries under Section 6901.

Based on the above advice, the Appeals Settlement Officer sustained the proposed levy. The trustee responded by filing a petition in the Tax Court for judicial review of the Notice of Determination Concerning Collection Action. The court ruled in favor of the Service and stated:

> Both (the trustee's) and the (Service's) arguments turn on whether a section 6901 assessment is required before the initiation of collection action under section 6324(a)(2). Few courts have considered this issue directly; however, the Courts of Appeal for the Third Circuit and the Tenth Circuit have held that respondent may collect estate tax from a transferee pursuant to section 6324(a)(2) without a prior assessment against the transferee under section 6901. *United States v. Geniviva,* 16 F.3d 522, 525 (3d Cir. 1994); *United States v. Russell*, 461 F.2d 605, 607 (10th Cir. 1972).
>
> This Court has found those cases to be persuasive and well reasoned. *Ripley v. Commissioner*, 102 T.C. 654, 659 (1994). In its holding in *United States v. Geniviva*, *supra* at 525, the Court of Appeals for the Third Circuit noted "a certain sorrow that what seems inherently unfair is also quite in accordance with the law." We also sympathize with the beneficiaries of decedent's estate in that years later they find themselves at risk of forfeiting their inheritance without prior notice, especially after respondent had ample opportunity to make assessments against them. Nevertheless, as discussed above it has previously been determined that a section 6901 assessment is not required before initiation of collection action under section 6324(a)(2).

Consequently, the court upheld the Appeal Settlement Officer's denial of the trustee's offer in compromise of the remaining assets in the estate (approximately only $700,000). Under Section 7122(a), the Service is authorized to compromise a liability on the basis of doubt as to collectability, which "exists in any case where the taxpayer's assets and income are less than the full amount of the liability."[35] Thus the Service will generally compromise a liability due to doubt as to collectability only if the liability exceeds the taxpayer's reasonable collection potential.

The trustee continued to argue that the reasonable collection potential should not include any amount that could be collected from the beneficiaries of the IRAs through an action in equity under Section 6324(a)(2). The court, however, rejected this argument based on its holding that the Service is not required to make a Section 6901 assessment before initiating collection action under Section 6324(a)(2). Thus the court concluded that "any amount of the unpaid estate tax liability that respondent could collect from the beneficiaries should be included in petitioner's reasonable collection potential; i.e. the amount of the IRA distributions."

The court noted that the trustee offered the remaining assets in the estate (approximately $700,000) as an offer-in-compromise; however, the IRS determined that the trustee's reasonable collection potential was at least $3 million, given that the beneficiaries received $3,433,007 in IRA distributions. Because the trustee had not offered an "acceptable amount," the court held that the IRS had not abused its discretion in rejecting the trustee's offer-in-compromise.

Observations. Without knowing the types of assets held in the trust, it is not clear why the trustee had made no attempt to pay any part of the estate tax. It may be the unfortunate result of the trustee thinking that the value of the assets would at some point bounce back after declining very significantly. Also, without knowing if the trust had contained a provision directing how and from what assets any estate tax would be paid, it is uncertain whether the IRA beneficiaries were relying on the trustee to pay any estate tax solely from the trust assets. Finally, the decision suggests that the beneficiaries had completely withdrawn all of the $3 million from the IRAs. It would be interesting to know if the beneficiaries had attempted to apply, and to what extent, the deduction under Section 691(c) (i.e., the "income in respect of decedent" deduction) for a pro rata portion of the estate tax.

Conclusion

The above discussion attempts to demonstrate the potential benefits that "portability" may achieve when applied in connection with estates containing large pension and IRA assets, the need for careful analysis of the terms and provisions of a family revocable trust (and its subtrusts) when it is being considered as the "designated beneficiary" of an IRA, and the risks of losing the IRA as a financial legacy if the trust itself or its administration have not adequately provided for the payment of any estate tax liability. The new "portability" provision in the 2010 Tax Act, the recent letter ruling, and the recent Tax Court case discussed above, all present interesting issues and challenges as we advisors work with clients who have significant IRAs in their estates. ■

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35 Reg. 301.7122-1(b)(2).