Qualified Plans and IRAs: Various Issues

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Estate Planning Goals relating to Qualified Plans and IRAs

- Want to make sure that qualified plan/IRA passes to the correct beneficiaries at death
- Want to avoid having qualified plan/IRA pass directly to a minor or incapacitated person (or a spendthrift)
- Usually (but not always) best to have plan/IRA pass in a way that is consistent with the client's overall estate plan

Estate Planning Goals, continued

- Avoid “fraud on the spouse” with respect to the surviving spouse’s community interest in the decedent’s plan/IRA (e.g., 100% passes to someone other than P’s spouse)
- As a general rule, include a specific bequest of the non-participant spouse’s community interest in the surviving spouse’s IRA to the surviving spouse (i.e., “anti-*Allard* clause”)

Estate Planning Goals, continued

- Structure beneficiary designation to preserve designated beneficiary treatment (e.g., do not name the “estate” or say “per Will” in the beneficiary designation form)
- If a qualified plan/IRA will be passing to a trust, make sure the trust is a “qualified see-through trust” (so that income taxes aren’t accelerated): special drafting required

Estate Planning Goals, continued

Consider how qualified plan/IRA fits into overall estate plan, which may have one or more of these objectives:

- Defer, reduce and/or eliminate estate taxes
- Protect inherited assets from divorce/creditors' claims
- Maximize income tax options for beneficiaries
- Provide asset management for the beneficiaries
- Split benefits between current and future beneficiaries
- Control the ultimate disposition of the assets
- Provide benefits to charity at death

Premise:

To achieve Estate Planning Goals with respect to Qualified Plans and IRAs, must consider the basic rules regarding post-death distributions from inherited Plans and IRAs

(**It's been over 12 years since the final Treasury Regulations were published**)

Participant (“P”)

- Participant: the employee or retiree who is participating in an employer-sponsored qualified retirement plan
- Participant: the “named owner” of an IRA
- Participant must begin taking minimum required distributions from his plan/IRA upon reaching his “required beginning date”

Required Beginning Date ("RBD")

- For IRA owners and 5% or more owners of employer sponsoring qualified plan: P's RBD is April 1 of year after year P attains age 70½
- For less than 5% owners (if plan so provides): P's RBD is April 1 of later of year after

  (i) P attains age 70½ or

  (ii) P retires

Community Property Issues

- Both qualified plans and IRAs can be community property (and usually are in TX)
- Participant's spouse (NPS) has no right to dispose of her community interest in P's qualified retirement plan upon her death if she dies before P: *Boggs v Boggs*
- NPS *can* dispose of her community interest in P's IRA if she dies before P (*Boggs* not applicable to IRAs: *Allard v. Frech* applies)

Designated Beneficiary (“DB”)

- A“defined term”: desirable in most cases
- Only human beings can be DBs
- Special “look through” rule for qualifying trusts
- If multiple DBs of single plan/account (and no timely separation into separate shares), use oldest DB as measuring life for all DBs
- If any *entity* (other than a qualifying trust) included as a beneficiary of single plan/account, no DB (unless entity cashed out before DB Determination Date or unless separate shares created before DB Determination Date)

“DB Determination Date”

- DB determined on September 30 of year following year of P’s death
- Post-death rules recognize effect of qualified disclaimers (relation back to d. o. d.)
- Post-death rules allow “bad” beneficiaries to be “cashed out” before DB determination date (and thus ignored)
- Certain post-death actions involving “bad” trusts (or “bad” b.d. forms) *may* allow DB treatment

Post-death "bad beneficiary fixes" *other than* Qualified Disclaimers

- Successful:
  - PLR 201203033 (release of "bad" powers)
  - PLR 200620025 (transfer to a post-death created SNT--discussed later)
  - PLR 200616039 (court reformation of defective b.d. form)
- Not Successful:
  - PLR 201021038 (post-death modification of "bad" trust ignored)
  - PLR 200846028 (court construction of b.d. wording: "as stated in wills" ignored)
  - PLR 200742026 (court reformed b.d. form w/no contingent benef.-ignored)

Minimum Required Distributions (MRDs) After Death of Participant

- Depend on whether P died before or after his/her RBD
- Depend on whether P is deemed to have a DB as of the DB determination date
- Depend on who the DB is
- Depend on whether P is a participant in a qualified plan or an IRA (Why?)

Participant Dies *Before* RBD: Commencement Date

- No DB: "5 Year Rule" (see next slide)
- Non-Spouse beneficiary (spouse *not* sole DB): Commence post-death MRDs by December 31 of year following year of P's death
- Spouse is *sole* DB: Spouse must commence post-death MRDs by December 31 of year when P would have reached age 70½ (assumes no spousal IRA rollover)

Participant Dies *Before* RBD: Distribution Period

- No DB: "5 year Rule" - Beneficiary must withdraw 100% from P's plan/IRA by December 31 of year containing 5th anniversary of P's death
- Non-Spouse Beneficiary (spouse not *sole* DB): Take MRDs over *non-recalculated* life expectancy of (oldest) DB, starting with divisor* for DB's age as of birthday in year following year of P's death; reduce divisor by 1 each year thereafter
- Spouse is *sole* DB: Take MRDs over spouse's *recalculated* life expectancy, using divisor* for spouse's age as of birthday in each distribution year (assumes no spousal IRA rollover)

Participant Dies *On or After* RBD: Commencement Date

- If not already distributed before P's death, pay final MRD due P to P's beneficiary/ies by December 31 of year of P's death
- Commencement Date for post-death MRDs to P's beneficiary/ies is December 31 of year following year of P's death

Participant Dies *On or After* RBD: Distribution Period

- No DB: Take MRDs over P's remaining, *non-recalculated* life expectancy, starting with divisor* for P's age in year of death; reduce divisor by 1 each year thereafter
- Non-Spouse Beneficiary (spouse *not* sole DB): Take MRDs over (oldest) beneficiary's *non-recalculated* life expectancy, starting with divisor* for DB's age as of birthday in year following year of P's death; reduce divisor by 1 each year thereafter; *OR*, can use "No DB" method, if desired
- Spouse is *sole* DB: Take MRDs over spouse's *recalculated* life expectancy, using divisor* for spouse's age in each distribution year (assumes no spousal IRA rollover); *OR*, can use "No DB" method, if desired

Spouse as P's Beneficiary

- Spouse as P's beneficiary can *either*:
  - Remain in position of being P's beneficiary (post-death distribution rules and Single Life Table apply), *OR*
  - Do (spousal) IRA rollover and become new P (lifetime distribution rules and Uniform Lifetime Table apply)
- Spouse who does spousal IRA rollover becomes Participant herself (and is no longer P's beneficiary)
- Spouse who does not do spousal IRA rollover, remains as P's beneficiary, but can still name successor beneficiary/ies to take amounts remaining in P's plan/IRA upon her death (and can do rollover later)

Community Property and Spousal Rights Issues

- ERISA Plans—REACT requirements
- *Boggs v Bogg*s (USSCt)—how far does federal preemption go?
- *Allard v Frech* (TXSCt) and "anti-Allard clause"
- "Fraud on the Spouse" doctrine
- Consent of NPS and gift tax issues

Community Property and Spousal Rights Issues, cont.

- Per REACT, all defined benefit plans must provide P's surviving spouse with either a QPSA or QJSA (unless waived by P and spouse consents)
- Per REACT, P's spouse must be primary beneficiary of qualified contribution plans (unless waived by P and spouse consents)
- Per *Boggs v. Boggs*, non-participant spouse (NPS) has no right to dispose of her community property ½ interest in P's qualified plan upon her death if she dies before P
- *Boggs* does ***not*** apply to IRAs, even an IRA that was derived from a qualified plan (i.e., P's IRA rollover)

Beneficiary Designations

- WHO?
  - Individuals
  - Charities
- HOW?
  - Outright
  - In trust
- WHERE?
  - Beneficiary Designation Form
  - Addendum to Beneficiary Designation Form

Reasons for Naming A Trust as Beneficiary of Plan or IRA

- Obtain estate tax marital deduction
- Utilize estate tax exclusion amount
- Ultimate control (e.g., second marriage)
- Divorce protection
- Creditor protection (*Clark v Rameker*)
- GST planning
- Management of plan/IRA
- Split plan/IRA between individual and charity

US Supreme Court Ruling: *Clark v Rameker*

- Conflict in the Circuits resolved by US Supreme Court in *Clark v Rameker* (June 12, 2014)
- Inherited IRAs are not "retirement funds" that debtor may exclude from bankruptcy estate per Section 522(b)(3)(C) of the Bankruptcy Code
- Case does not override state exemptions that can be elected in bankruptcy
- Debtors domiciled in Texas can still elect state exemptions in bankruptcy (but note that IRAs are not exempt assets in some states)

Allocating IRAs and Qualified Plans to Trusts used in Estate Planning

Consider **conflict** between post-death minimum distribution rules (income tax rules) applicable to qualified plans and IRAs and client's estate planning goals (reduce, defer or avoid future estates taxes, provide divorce/creditor protection for beneficiaries, provide for multiple beneficiaries [e.g., spouse for life, then to children on spouse's death or charity and individuals], control the ultimate disposition of the assets, reduce post-death fees and expenses, keep estate plan simple to administer, etc.)

Trusts as Beneficiaries of Plans & IRAs: DB Treatment

Requirements for **trust** named as beneficiary **to obtain DB treatment** (i.e., to be a "qualified see-through trust"):

- Must be a valid trust under state law
- Trust is (or becomes) irrevocable on P's death
- All trust beneficiaries who will (or could) receive P's IRA/Plan benefits are identifiable from trust instrument
- All beneficiaries of P's benefits are human beings (or other qualifying trusts)
- Required trust documentation has been timely provided to plan administrator/IRA custodian

Trusts as Beneficiaries of Plans/IRAs: **Special Drafting Required**

If client plans to name a trust as the beneficiary of all or part of his qualified plan or IRA, the standard trusts used in estate planning have to be *modified* in view of the MRD rules, otherwise, the trust named as beneficiary may not qualify for DB treatment (and *acceleration of income taxes* will result)

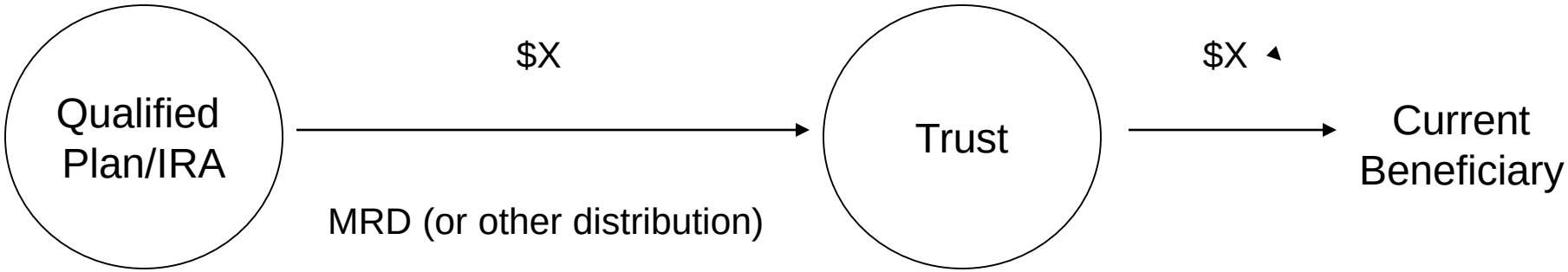
Types of Trusts in Terms of MRD Rules

- Conduit Trust: All distributions from the plan/IRA to the trust must be distributed currently out of the trust to the current beneficiary/beneficiaries
- Grantor Trust: Trust beneficiary who is treated as "grantor" has a withdrawal right over the trust assets
- Accumulation Trust: Distributions from plan/IRA to the trust can be distributed currently to current beneficiaries or accumulated (if accumulated, can be distributed later during term of trust to one or more current beneficiaries or distributed to remainder beneficiaries upon termination of the trust; may also be distributed to p.o.a. appointees)

Types of Trusts in Terms of MRD Rules, continued

- Conduit Trust: Current beneficiary is DB; remainder beneficiaries can be ignored
- Grantor Trust: Current beneficiary—i.e., person treated as "grantor" of trust—is DB; remainder beneficiaries can be ignored
- Accumulation Trust: All potential beneficiaries of plan/IRA distributions made during THE DB's life must be identified "up front" to see if all of them are DBs and to determine who is the oldest DB (and, therefore, THE DB or "measuring life")—this is a "circular" analysis—must draft to fix ambiguity

CONDUIT TRUST

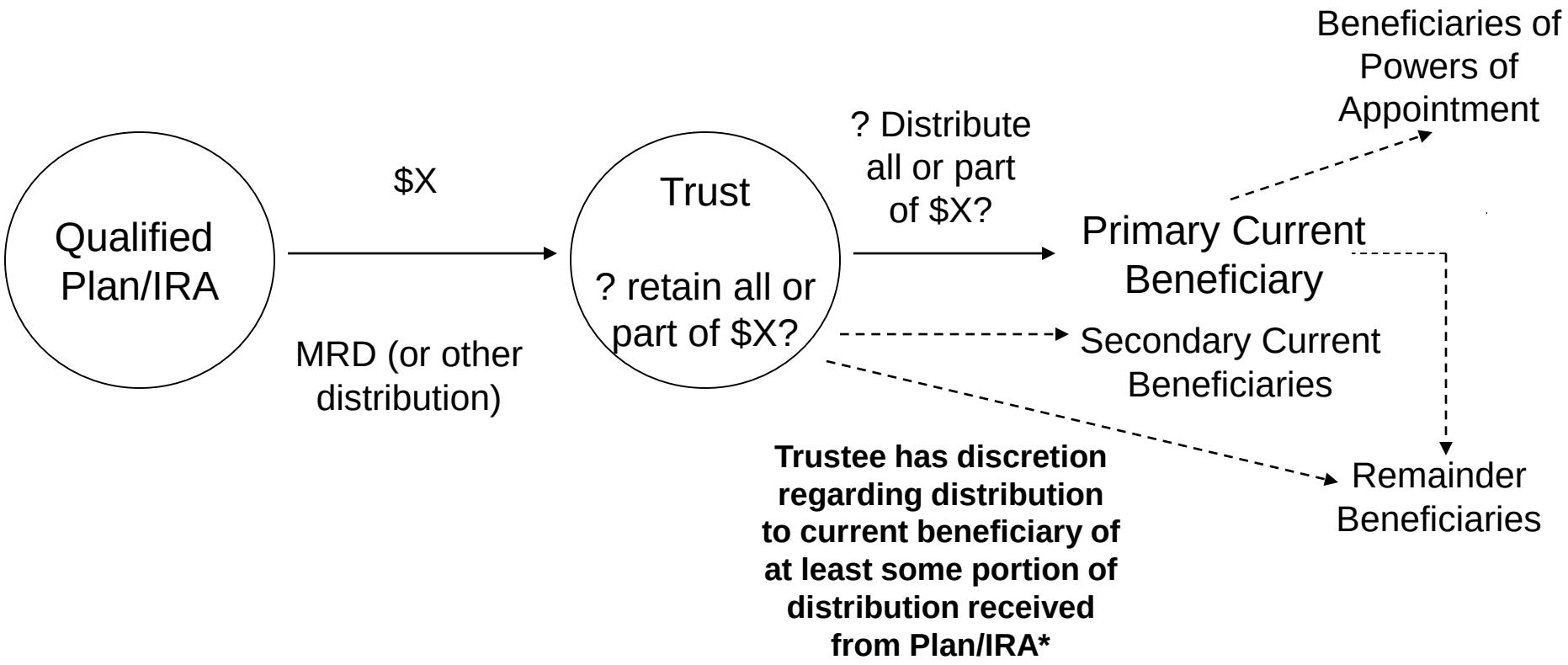


Per Trust instrument,
Trustee has no discretion:
Trustee must distribute 100% of plan/IRA distribution ($X) out of Trust to Current Beneficiary

Current Beneficiary = DB

(All remainder/other beneficiaries can be ignored)

ACCUMULATION TRUST



All beneficiaries who might end up with any part of distribution ($X) made during DB's life must be taken into account in determining qualification for DB treatment and who is DB

***Distribution from Plan/IRA ($X) might be all income or part income/part principal or all principal for trust accounting purposes

Identifying All Trust Beneficiaries: Conduit Trust

Since all distributions made from P's plan/IRA after P's death to conduit trust must be distributed by Trustee of conduit trust to current beneficiary of trust, current beneficiary is sole DB and remainder beneficiaries of trust can be ignored (they are "mere successor potential beneficiaries")

Identifying All Trust Beneficiaries: Grantor Trust

- No specific authority in Treasury Regulations for grantor trust as recipient of plan/IRA, but many PLRs
- If beneficiary of trust has power to withdraw trust assets=grantor trust
- Because grantor can withdraw all trust assets, grantor is sole beneficiary of P's plan/IRA allocated to the grantor trust

Tricky Requirement for Accumulation Trusts: Identify all beneficiaries who have a potential interest in P's plan/IRA

- All trusts have at least 2 beneficiaries: a current beneficiary and a remainder beneficiary
- Many trusts have multiple current beneficiaries and multiple remainder beneficiaries
- Some trusts also have possible beneficiaries: beneficiaries of powers of appointment
- Must identify all potential beneficiaries of all distributions made from the plan/IRA during the life of the "measuring beneficiary" (i.e., *the* DB)
- But, who is *the* DB? (circular)

Identifying All Trust Beneficiaries: Accumulation Trust

When an Accumulation Trust receives a distribution from P's plan/IRA, since the full amount received by the Trustee does not have to be currently distributed out of the trust to the current beneficiary, all potential recipients of those *accumulated* plan/IRA benefits must be taken into account to determine (i) if all possible beneficiaries of the accumulated benefits qualify as DBs, and (ii) if so, which one out of all of those multiple DBs is the oldest (since the oldest DB is the particular DB whose life expectancy must be used to calculate MRDs to the trust each year)

Powers of Appointment

- General Powers of Appointment: No beneficiary of intended DB trust should have a general power of appointment because the potential appointees of the power are not identifiable up front and some may be entities
- Limited Powers of Appointment: Can be used if carefully drafted--should be exercisable only in favor of identifiable human beings (no charities or other entities) who are younger than the *intended* DB (i.e., the proposed measuring life beneficiary)

Powers of Appointment, cont.

Q: What if the donee of the power of appointment can appoint “in further trust”?

1. Would that *further trust* be considered irrevocable as of P’s date of death?

2. What type of trust documentation for that *future* appointed trust can be delivered to the Plan Administrator by October 31 of the year following the year of P’s death?

Idea: Perhaps the power to appoint in further trust should be limited to other trusts already created in the same instrument creating the intended DB trust

Special Drafting of Recipient Trust

- For any trust that is intended to receive all or part of P's plan/IRA upon P's death, **special drafting** is required
- Conduit trust is easier to draft than accumulation trust and may be better from an income tax standpoint, but has some disadvantages
- Accumulation trust drafting can be difficult and "circular" (also: conflict between income tax rules and desired disposition)

Trust Documentation Requirement

After P's death, if a trust is named as a beneficiary of P's plan/IRA, a copy of the instrument creating the trust (Will or Trust Agreement) or all relevant trust information must be provided to plan administrator/IRA custodian by October 31 of year following P's death

Separate Account Treatment

- Separate Accounts/Segregated Shares must be created by December 31 of year following year of P's death
- Not just an accounting concept—need actual separation into separate accounts by due date
- Must be done **pro rata**
- Post-death gains, losses, distributions, etc. must be taken into account
- Wording used on beneficiary designation form can **preclude** separate account treatment

Separate Account Treatment, cont.

- Separate account treatment means that MRDs to **the** DB of a separate account will be based on **the** DB's life expectancy (and not on another possible DB's life expectancy)
- IRS rule: To obtain separate account treatment, the separation into shares *must occur in the beneficiary designation form itself*, and not due to provisions in the Will or Trust or due to decisions made by the Trustee

Separate Account Treatment, cont.

- If beneficiary designation form says: “To the Trustee in P’s Will”, the separation of P’s plan benefits among the beneficiaries in P’s Will is NOT occurring in the beneficiary designation form itself (it is occurring in the Will)—therefore, no separate account treatment
- But, if the beneficiary designation form says: 50% to Trust A and 50% to Trust B, whether true separate account treatment is available depends on the terms of trust and actual facts

Separate Account Treatment, cont.

- If plan/IRA beneficiary designation form itself names multiple **conduit** trusts, each receiving a specified percentage, and separate accounts are timely created, MRDs to each conduit trust will be based on the life expectancy of **the** DB of the particular conduit trust
- If the beneficiaries are multiple **accumulation** trusts, even if the separation of shares occurs in the beneficiary designation form itself, true separate account treatment may not be available, depending on trust terms and facts*

Separate Account Treatment, cont.

- When multiple *lifetime accumulation trusts for children and issue* are beneficiaries, those trusts will usually be drafted to include the siblings of the primary trust beneficiary as remainder beneficiaries if the primary beneficiary dies without issue
- If a trust beneficiary has no issue on the DB Determination Date, then it doesn't matter if the separation of shares occurs in the beneficiary designation form itself because the beneficiary's siblings are "countable" beneficiaries of his trust
- Thus, oldest child is the DB for all children's trusts in a case like this (see examples on next slides)

Separate Account Problem with Trusts: Example 1: Accumulation Contingent Trust

- Beneficiary Designation Form itself says: equal shares to P's 3 children, subject to an age 35 Contingent Trust created in P's Will
- At time of P's death, Child A is 37, Child B is 36 and Child C is 34—Child C has no children as of DB Determ. Date
- Per numerous PLRs, Child A and Child B, as remainder beneficiaries of Child C's Contingent Trust, are "countable" beneficiaries because plan/IRA distributions can be *accumulated* in Child C's trust and, thus, may end up being distributed to Child A and Child B if Child C dies before reaching age 35 without issue
- **Result**: Child A is the DB of Child C's Contingent Trust

Separate Account Problem with Trusts

Example 2: Lifetime Accumulation Trusts for Descendants

See next slide

Beneficiary Designation Form:

1/3 to Child's Trust for Ann

1/3 to Child's Trust for Ben

1/3 to Child's Trust for Carl

(Note: same result if form had named "Trustee in Will" as beneficiary)

Terms of Each Child's Trust:

- Accumulation Trust
- Child is primary beneficiary for life (Child's descendants, if any, are secondary beneficiaries)
- On Child's death, remainder to Child's descendants, per stirpes, if any, otherwise to Child's then living siblings, in equal shares (etc.), *with all distributions subject to same lifetime trust provisions*

Result: each child is a "countable" beneficiary of each other Child's Trust and, therefore, oldest child who survives P is the DB for all*

IS SEPARATE ACCOUNT TREATMENT REALLY THAT IMPORTANT?

- When children are close in age, difference in divisors is nominal—look at divisors in Single Life Table, for example
- "Hyper-focusing" on separate account treatment can lead to cutting out older siblings as remainder beneficiaries of younger siblings' accumulation trusts if younger siblings die without descendants—usually not the result the client wants

Ann Smith Example

- Ann Smith, divorced mother of 2 children, Amos, age 12, and Andy, Age 9, dies while employed by ABC Oil Company
- Ann's qualified plan had a prior year-end value of $400,000
- Ann leaves her plan to her 2 children, in equal shares, subject to trust provisions in her Will
- Inherited IRAs will be established to receive each child's share of Ann's qualified plan

Ann Smith Example, continued

- Ann's 50-50 division could be indicated on the beneficiary designation form itself (50% to the ____Trust for Amos and 50% to the ____ Trust for Andy) *or* the beneficiary named on the form could be the "Trustee in the Will of Ann Smith," with Ann's Will providing the Trustee with division and allocation instructions
- In determining WHO will be treated as THE DB of each share of Ann's plan, must consider (i) the PLACE where the beneficiaries are named (in the form itself or in Ann's Will), (ii) the TYPE of trusts used, and (iii) how the trusts are drafted

Ann Smith Example, continued

- "Trustee in the Will" named as beneficiary on b.d. form (doesn't matter what type of trusts are created in Ann's Will): THE DB for both children will be Ann's oldest child
- Conduit Trusts named as beneficiaries on b.d. form: Each child will be THE DB of his own share
- Accumulation Trusts named as beneficiaries on b.d. form: Depends on HOW the trusts are drafted--is primary beneficiary to be treated as THE DB?--most clients DON'T want to cut out older siblings as remainder beneficiaries of younger siblings' trusts (and difference in MRD is minimal in most cases)

Ann Smith Example, continued: *If* separate account treatment

Child	Initial Divisor (from Single Life Table)	Percentage Distribution for that divisor for 1st distribution year	1st year MRD (in dollars)	Amount remaining in Trust after 1st MRD
Amos, Age 12	70.8	1.412	$2,825	$197,175
Andy, Age 9	73.8	1.355	$2,710	$197,299

Natalie Choate's Accumulation Trust "Testing Rule"

When testing an accumulation trust to determine if all trust beneficiaries are human beings and, if so, which trust beneficiary (or potential trust beneficiary) is the oldest, you can stop at the point where the trust assets will definitely be distributed outright and free of trust to a human being. All beneficiaries after that are "mere successor beneficiaries." Please note: the "life expectancy theory" is dead!

Income Tax Problems/Issues

- If trust does not qualify for DB treatment, result is acceleration of MRDs: 5 year rule if P dies before RBD *or* P's remaining single life expectancy (not recalculated) if P dies after RBD
- If transfer an inherited plan/IRA to a different (maybe "better") beneficiary than the named beneficiary, risk immediate acceleration of *all* income taxes due to IRC Section 691(a)(2)

Married Couples with Taxable Estates: Income Tax-Estate Tax Tradeoff

If allocate plan/IRA to a Bypass Trust to avoid estate taxes when surviving spouse dies on amounts remaining in plan/IRA (and, if trust is an accumulation trust, to avoid estate taxes on MRDs accumulated in the trust), even if trust qualifies as a see-through trust, MRDs after surviving spouse's death must continue based on spouse's single life expectancy**—no "stretch IRA" for children***

Two Options for dealing with Estate Tax-Income Tax Tradeoff

- Portability: now permanent per American Taxpayer Relief Act of 2012 (passed in January 2013)
- Non pro rata distribution by Trustee of joint revocable trust to which plan/IRA passes at death (assuming trust has after-tax assets sufficient in value for the "swap")

Use of Joint Revocable Trust to Facilitate Non Pro Rata Distribution

Assets of Jack and Helen Johnson (all community property)

Home (no mortgage)	$1,000,000
Joint Money Market Act	$250,000
Joint Investment Acct	$4,000,000
IRA in Husband's name	$4,000,000
Household furnishings, Personal effects, etc.	$100,000
TOTAL	$9,350,000

Assumptions and Pre-Death Planning

- No prior marriages (i.e., mutual children)
- All assets, including husband's IRA rollover, are community property
- Joint revocable trust creates a Bypass Trust on death of first spouse
- Joint investment account (at least) is titled in name of joint revocable trust before death of first spouse (this is better way to do this versus waiting until first spouse’s death)

Assumptions and Pre-Death Planning, continued

- Trust instrument specifically gives Trustee power to make non pro rata distributions*
- IRA beneficiary designation is set up with joint revocable trust as primary beneficiary *or* set up with wife as primary beneficiary and, if she disclaims husband's community interest in IRA, that interest will pass to Trustee of the joint revocable trust due to disclaimer/contingent beneficiary wording in beneficiary designation form

Assume Husband Dies First: Post-Death Steps—1st Case

If joint revocable trust *is* 100% primary beneficiary of husband's IRA, Trustee "distributes" (i.e., allocates) *all* of IRA to wife and distributes *all* of investment account to Bypass Trust in a non pro rata distribution (in this example, husband's CP ½ interest in IRA is equal to wife's CP ½ interest in investment account)

Assume Husband Dies First: Post-Death Steps—2nd Case

- If joint revocable trust is *not* primary beneficiary of husband's IRA, then wife disclaims husband's CP ½ interest in IRA, with result that disclaimed IRA interest "passes to" Trustee of joint revocable trust per beneficiary designation form (retaining its character as husband's CP ½ interest in IRA)
- Per specific n.p.r. authority in trust instrument, Trustee distributes husband's CP ½ interest in IRA to wife (wife already owns her ½ of IRA) and distributes wife's CP ½ interest in investment account to Bypass Trust (Bypass Trust already entitled to husband's ½ of investment account)*

Assume Husband Dies First: Post-Death Steps, continued

- Wife does spousal IRA rollover of *entire* IRA
  - Better income tax result for wife during life
  - Much better income tax result for children on wife's death ("stretch IRA")
- Bypass Trust is funded with 100% of the after-tax assets that just got a step up in basis
- More assets, overall, are protected from creditors' claims
- Trustee should not do this if wife objects (even if Trustee has the power to do it)

Assume Husband Dies First: Post-Death Steps, continued

- Trustee should document the non pro rata distribution—i.e., prepare a written document summarizing the transaction (it's part of post-death trust funding)
- Income Tax Issues:
  - Is this a taxable sale or exchange for federal income tax purposes?
  - Does this accelerate the income taxes with respect to the IRA per Section 691(a)(2)?

Supportive Rulings: No Adverse Income Tax Consequences

- PLR 8037124 (June 23, 1980)
- PLR 8016050 (January 23, 1980)
- PLR 9422052 (March 9, 1994)
- PLR 199912040 (March 29, 1999)
- PLR 199925033 (June 28, 1999)

There are other rulings, too

Note that some Texas attorneys believe that Texas' version of community property law poses a problem

Another Option:
Make the Portability Election

For estates of married decedents with a combined value greater than $5.43 million, instead of either (i) allocating P's plan/IRA to a qualified see-through Bypass Trust or (ii) making a non pro rata distribution after P's death, P should consider naming his spouse as the 100% primary beneficiary of his plan/IRA and, upon P's death, the surviving spouse, as executor of P's estate, should make the portability election

Benefits of Portability Election

- Transports deceased spouse's unused estate tax exclusion amount (DSUE Amount) to surviving spouse, so P's interest in plan/IRA passing to spouse is "covered"
- Simpler for surviving spouse (no trust)
- Surviving spouse can do spousal IRA rollover
  - Better income tax result for spouse during life
  - Preserves "stretch IRA" for children when spouse dies

Disadvantages of Portability

- Additional post-death expense to prepare and file a Form 706 for a decedent's estate with a value under the filing requirement (many executor clients don't want to do it*)
- If surviving spouse remarries, DSUE Amount transported to surviving spouse can be lost if new spouse also predeceases P's surviving spouse with less unused exemption amount*
- No remarriage protection for P's IRA
- No portability of GST exemption

Minor/Incapacitated Beneficiaries

- At a minimum: Name a custodian for the minor child under TUTMA
- Better: Name a qualified see-through trust for the minor or disabled child
- In choosing type of trust and trust structure, don't cut out older sibling(s) as remainder beneficiaries of younger siblings' trusts—*see* divisors in Single Life Table and Ann Smith example, above

867 Trusts

- If minor is named as a direct beneficiary of plan/IRA, legal guardian appointed for minor can take MRDs based on minor's life expectancy (DB treatment is clear)
- Can a Section 867 Trust* be created to be recipient of plan/IRA where minor child is named as direct beneficiary of plan/IRA? If so, is that a transfer that accelerates the income taxes? No cases involving 867 Trusts, per se, but *see* PLR 200620025

867 Trusts, continued

Issues:

- Does the “deemed transfer” from the minor beneficiary to the Trustee of the 867 Trust cause income tax acceleration per Section 691(a)(2)?
- Should the 867 Trust be custom drafted in order to be a “qualified see-through trust”?
- If the inherited plan/IRA passes to a *standard* 867 Trust, can MRDs be taken based on the minor child’s life expectancy?

SNT for Disabled Child Created *After* P's Death: PLR 200620025

- P died before RBD, naming his 4 sons as equal beneficiaries of his IRA
- One son, "B", was disabled and receiving government benefits at time of P's death
- Guardian of disabled son petitioned state court for creation of standard SNT for B
- Court created standard SNT for B, with guardian as trustee

PLR 200620025, continued

- On B's death, amounts remaining in SNT up to total benefits received by B during life payable to state Medicaid department and balance payable to B's "heirs"
- Guardian disclaimed any interest in trust as an heir of B under state law
- Guardian wants to transfer B's ¼ of P's IRA to SNT created by court for B

PLR 200620025: Tax Issues

- Will "transfer" of B's share of P's IRA to SNT be a transfer under Code Section 691(a)(2) (which would accelerate all the income taxes)?
- Will the transaction be a deemed *distribution* of the entire IRA to B, followed by B contributing the IRA proceeds to the SNT, which would make the entire amount taxable income to B in one year?
- Can MRDs from the IRA payable to B's SNT be calculated using B's life expectancy instead of the 5 year rule (since standard SNT created by court is not a qualified see-through trust per Regs)?

PLR 200620025: Favorable Result

- SNT is a grantor trust and ∴ no sale or other disposition under Section 691(a)(2) when B's share of P's IRA was transferred to inherited IRA for the benefit of B's SNT
- Not treated as a distribution to B of entire IRA
- In this case, B was named as beneficiary as of P's date of death and separate accounts were created, so distributions from inherited IRA to SNT (a grantor trust as to B) can be based on B's life expectancy

What does PLR 200620025 mean?

- Does it mean that it's not necessary to draft an SNT that will receive a plan/IRA as a "qualified see-through trust"?
- Does this ruling answer the question about 867 Trusts?
- A PLR can only be relied on by the taxpayer who obtained it
- Better practice: All trusts that will be beneficiaries of P's plan/IRA should be drafted as "qualified see-through trusts"

Special Needs Trusts

- SNT that will receive a share of P's plan/IRA should not be a "standard" SNT
- SNT should usually *not* be in the form of a Conduit Trust (because MRDs have to be distributed out of a conduit SNT to the special needs beneficiary)—better to use an SNT that is an Accumulation Trust
- Consider Using a Roth IRA SNT Accumulation Trust for disabled beneficiary

Charitable Planning Issues

- Qualified Plans and IRAs: great assets to leave to charity at death (no income taxes and no estate taxes)
- But, charity is not a “designated beneficiary”
- If *entire* plan/IRA passes to charity, so what?
- If only a portion of plan/IRA to charity, draft beneficiary designation so that charity can easily be cashed out in full by “DB Determination date,” leaving human beings*

Charitable Planning Issues, continued

- Do not name “estate” as beneficiary and then make charitable gifts in Will—name charities *directly* in beneficiary designation form (or in attachment to form)
- Some PLRs allow Estate named as beneficiary to *assign* IRAs to charities that are named as residuary Will beneficiaries without accelerating all income taxes per Code Section 691(c)(2) (but this won’t work if charity is receiving a specific bequest in the Will)
- Beware of Section 642(c) “independent economic effect” regulations

Creditor Protection Issues

- Qualified plans are protected from attachment by ERISA
- IRAs are protected from attachment per Texas Property Code Section 42.0021*
- Issue: Is there a difference between a participant-owned IRA and an inherited IRA for federal bankruptcy purposes? Yes! *See Clark v. Rameker*
- A non-exempt IRA can be left to a spendthrift trust for the benefit of the beneficiary (designed as a "qualified see-through trust")

Ex-Spouse is (Still) Named as Beneficiary on B.D. Form for P's Qualified Plan When P Dies, but Ex-Spouse Waived Right to Plan Benefits in Divorce: **"Plan Documents Rule"**

- *Kennedy* case (US S Ct 2009)
- Divorce documents—no QDRO
- State law waiver of retirement benefits by ex-wife
- P dies with ex-wife still named as beneficiary of plan
- Plan administrator MUST pay plan benefits to ex-wife as named beneficiary of P's qualified plan—"Plan Documents Rule"

ISSUE: Whether ERISA preempts a civil action against a designated plan beneficiary who has previously waived the right to retain ERISA benefits once they have been paid out by the ERISA plan and are no longer subject to the control of the plan administrator?

- *Kensinger* case (3rd Circuit 2012)--same facts as Kennedy
- Per **Plan Documents Rule**, on P's death, administrator MUST pay P's qualified plan benefits to ex-wife as beneficiary named on P's b.d. form
- **BUT** P's estate may sue ex-wife in state court to enforce waiver and recover benefits *after* plan benefits are distributed out of plan
- *See also Andochik v. Byrd* (4th Circuit 2013)—petition for cert. denied, Oct. 7, 2013—US S Ct: no conflict in circuits

Post-Divorce Cases: Conflict between Texas law and Federal law: Federal law wins

Assume no QDRO and no post-divorce change of beneficiary:

- Texas Family Code Sections 9.301 and 9.302, attempting to negate pre-divorce beneficiary designation in favor of ex-spouse and imposing liability on company for paying death benefits to ex-spouse, **not valid** as to federally qualified benefits per *Kennedy* case (US Supreme Court case that established the "Plan Documents Rule")
- *After* the qualified benefits are paid to the ex-spouse, decedent's estate may sue ex-spouse to recover benefits based on written waiver in divorce settlement and/or Family Code provisions based on theory in *Kensinger* case

Plan Documents Rule, continued

- Rule has also been applied in creditors' rights cases (in addition to ex-spouse cases)
- Some Plan Administrators are taking the Plan Documents Rule too far—they won't recognize Qualified Disclaimers that meet applicable state and federal law requirements (even though IRS has ruled in GCM 39858 that disclaimers do not violate ERISA)

Pension Protection Act (PPA)

- Problem before PPA: Many qualified plans *require* a lump sum distribution to P's non-spouse beneficiary on P's death (or require a more rapid distribution than allowed under the federal minimum distribution rules)
- PPA Fix: By creating an "inherited IRA" via a direct rollover (i.e., trustee to trustee transfer) from P's qualified plan, P's DB will be able to use a life expectancy distribution under the MRD rules

Bobrow v. Comm'r and IRS Announcement 2014-15

- Only one, tax-free, "60-day" IRA rollover per year
- Effective 1/1/2015
- Contrary provisions in Publication 590 are withdrawn
- Same rule applies to Roth IRAs, but Roth IRAs counted separately
- Not applicable to **direct** rollovers

Trust or Estate Named as Beneficiary But Surviving Spouse Desires to do Spousal IRA Rollover

- Dozens and dozens of PLRs allow spousal IRA rollover in this situation--where spouse is sole fiduciary and sole beneficiary and can allocate plan/IRA to herself
- New PLRs on this issue every quarter
- We need a Revenue Ruling!

Roth IRA Conversion

- As of 1/1/2010, no longer a modified AGI limit to convert a traditional IRA (and certain qualified plans) to a Roth IRA
- This may be a good year to do a Roth conversion because of 35% top income tax rate (rates likely to go up in the future)
- Have a long time to "recharacterize" (undo) a Roth conversion if it doesn't work out (October 15th of the year following the year of the conversion)—i.e., can use hindsight

Roth IRAs

- Neither P nor P's spouse have to take MRDs from Roth IRA during life
- A Roth IRA in which decedent owned an interest at death (whether P or NPS) is included in decedent's estate for federal estate tax purposes (but has a lower value compared to traditional IRA)
- Easier to do estate planning with Roth IRA versus traditional IRA

Roth IRAs, continued

- "Qualified Distributions" from a Roth IRA are income tax free
- To be a "Qualified Distribution," Two Tests must be met:
  - 5 Year Test
  - Type of Distribution Test
- For more info, see Exhibit 18 attached to outline

Self-Directed IRAs

- Self-directed IRAs are high risk--prone to violating the “prohibited transaction” rules
- Tax result of violating the prohibited transaction rules is severe
- Peek-Fleck Case—cannot guarantee a loan relating to business operated inside IRA
- Peek-Fleck Case—can only pay reasonable compensation from IRA for handling pure IRA matters (and not the business matters)

THE END