INCOME TAX ISSUES IN ESTATE ADMINISTRATION

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State Bar of Texas
35th ANNUAL
ESTATE PLANNING AND PROBATE COURSE
June 8-10, 2011
Fort Worth

CHAPTER 18

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I. Introduction. The administration of a decedent's estate can be compared to the yellow pages phonebook. It can involve a myriad of activities ranging from Admitting a will to probate to valuing the decedent's Zeppelin for federal estate tax purposes. Amidst all of the chaos lies a subset of responsibilities and issues that result in immediate and long-term income tax consequences to the estate, the beneficiaries of the estate, and those serving in related fiduciary positions. Though not as broad as the whole sphere of the estate administration process, this income tax subset has many parts which may or may not come into play depending upon the specific features of the estate in question.

The income tax issues that arise in the administration of an estate can be obvious, such as the need to file a final income tax return, and subtle, such as the timing and proper choice to make with respect to elections pertaining to qualified retirement plans and/or IRAs. In addition, there are many separate parties involved in the estate administration process, including the estate planning and probate lawyer, the tax return preparer and/or CPA, the personal representative, trustees, etc. In many cases, there is no clear identification of who is directly responsible for important income tax issues during this process, resulting in a failure of the whole to properly identify those issues and address them for the best outcome to the estate and the beneficiaries.

The purpose of this outline is to identify specific income tax issues that can arise in the administration of the estate and to provide an overview of those issues and means for addressing them as part of the overall estate administration process.

II. Duty to File/Pay Estate Income Taxes.

A. Overview. The personal representative of an estate has a duty to file the final income tax return for the estate and all income tax returns not filed for prior years. IRC 6012(b)(1). For this purpose, the "personal representative" of an estate is: the executor named in the Will and appointed by the probate court; or, if there is no Will or the executor named in the Will does not serve, then the administrator appointed by the probate court; or, if there is no executor or administrator, anyone who is in charge of the decedent's property.

The first order of business for a personal representative should be to complete and file a Form 56 giving written notice to the IRS that the personal representative has been appointed to act in a fiduciary capacity for the decedent. Upon such filing, the personal representative assumes the powers, rights, duties, and privileges of the decedent with respect to federal income taxes and the IRS will deal freely with such person with respect to all such matters (i.e., refund checks, notices of deficiency, etc.). Likewise, at the close of the estate administration process the personal representative should file Form 56 notifying the IRS of the termination of the fiduciary relationship.

The final income tax return for an estate covers the period beginning January 1st of the year in which the decedent died to the date of the decedent's death. That final return is due on April 15th of the year following the date of death. If the due date for the final income tax return is approaching and no personal representative has been appointed for the estate, then the surviving spouse may file a joint income tax return and sign on behalf of the estate by writing in the signature area "Filing as Surviving Spouse." (See B. below). If there is no surviving spouse, then, as noted above, the person(s) in charge of the decedent's property is required to file the final income tax return on a timely basis and sign that return on behalf of the estate as "personal representative."

Generally, the income tax liability of the estate is to be paid from the assets of the estate prior to the time that those assets are distributed out in the payment of other debts or in the form of distributions to beneficiaries. To the extent that the personal representative has distributed estate assets so that the estate has insufficient assets remaining to pay its federal income tax bill, then the personal representative can be personally liable for the payment of those income tax liabilities. This liability will attach to the personal representative if he or she had notice of the tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed. Treas. Reg. 1.641(b)-2.

Further, if the estate does not have enough assets remaining to pay the federal income tax liability, transferee liability may be imposed against those that have received distributions from the estate, including heirs, devisees, legatees, and distributees. IRC 6901;Treas.Reg. 1.641(b)-2.

If the personal representative elects to file a joint return with the decedent's spouse, joint and several liability is imposed on the estate and the spouse for the resulting income tax liability. IRC 6013(d). (See B. below).

B. Option to File Joint Return. The personal representative may elect, with the consent of the surviving spouse, to file the decedent's final income tax return as a joint return. The joint return option is only available if there is a surviving spouse, that spouse does not remarry before the close of the taxable year, and neither the husband or the wife was at any time during the taxable year a non-resident alien. IRC 6013(a)(1)-

(2). As noted above, if no personal representative has been appointed by the last day required for filing the return of the surviving spouse, then the surviving spouse may unilaterally file a joint return on behalf of that spouse and the estate. However, if thereafter a personal representative is appointed for the estate, then that personal representative may revoke the joint return by filing, within one year after the due date for filing the return of the surviving spouse, a separate return on behalf of the estate. IRC 6013(a)(3).

A decedent's final return filed as a joint return will report the decedent's income for the year up to the date of death and will report the surviving spouse's income for the full year. Both the decedent's estate and the surviving spouse will be jointly and severally liable for the income tax liability reported on a joint income tax return. IRC 6013(d)(3).

The personal representative should consider the possibility of filing a joint income tax return because of the opportunity to reduce the income tax liability. However, the risk assumed by filing a joint return is the fact that the estate is jointly and severally liable for all income taxes generated by that return. Thus, prior to making the decision to file a joint return the personal representative must exercise due diligence to determine the full tax liability that will be generated by the income, deductions, losses, and credits of both the decedent's estate and, most importantly, the surviving spouse.

In some cases, a spouse may seek relief for joint liability for taxes, interest, and penalties on a joint return that are related to items reported by the other spouse ("innocent spouse relief"). IRC 6015. A personal representative may pursue an existing request for innocent spouse relief, or initiate such request, so long as the decedent qualified for such relief while living.

C. <u>Income Tax Planning Opportunities</u>. The personal representative has a fiduciary responsibility to identify and claim opportunities to reduce the estate's income tax liability on the decedent's final income tax return. However, unlike some aspects of the estate administration process, the personal representative must move quickly to seize such tax reduction opportunities for the final return is due on April 15th of the year following the date of death (even if the date of death is late in the year) and, in some cases, the steps to reduce the income tax liability require working with and obtaining the consent of others.

The personal representative needs to determine whether the decedent has capital loss carryovers, net operating loss carryovers, or charitable deduction carryovers from prior years which would be deductible on the decedent's income tax return. If those carryover losses exist, then tax savings can be attained by accelerating income for recognition on the final return to be offset by those losses. This is important because any unused loss carryovers are lost. The remaining loss cannot be deducted by the estate on it's income tax return or by the beneficiaries. Rev.Rul.74-175, 1974-1 CB 52.

Accelerating or capturing income for the decedent's final return can be beneficial for reasons taking advantage of otherwise unused loss carryovers. In addition, the income tax liability reported on the decedent's final return is deductible on the decedent's estate tax return. The impact of this deduction is to reduce the effective tax rate imposed on the income reported on the final income tax return.

The personal representative has an opportunity to capture or move income to the final return by checking with partnerships and S corporations (both referred to herein as "entity") in which the decedent owned an interest. Basically, the income of an entity for the year in which an interest owner dies can be allocated between the owners by prorating that income on a daily basis or by "closing the books" as of the date of the owner's death.

In the event that the entity has a sizable portion of it's income occur after the decedent owner's death, then it would be beneficial to work with the other entity owners to have the entity's income for the year prorated amongst the partners on a daily basis in order to shift the decedent owner's portion of that large gain to the decedent's final return. Alternatively, the method of "closing the books" as of the date of the decedent's death would be the preferable method for capturing income for the decedent's final return if a disproportionate amount of the entity's income was earned prior to the date of the decedent's death.

Estate and trust distributions are another means of moving income to the final income tax return. Distributions that carry out distributable net income from a trust or an estate to the decedent or the surviving spouse can be captured for the final income tax return and used to offset available deductions or, if no such deductions are available but the estate will be filing a federal estate tax return, then the recognition of that income on the final return can be beneficial to the extent that the estate tax deduction for the income tax liability reduces the effective income tax rate imposed on that income.

D. <u>Tools Available to the Personal Representative</u>. As outlined above, the personal representative of a decedent's estate faces numerous responsibilities with respect to income tax matters pertaining to that estate.

There are, however, several tools available to the personal representative to allow him or her to meet those responsibilities and, consequently, protect himself or herself against potential liabilities that can otherwise result.

The personal representative is charged with not only filing the final income tax return but also any tax returns for prior years that have not been filed by the decedent. In addition, the personal representative is required to confirm that all taxes that the personal representative is or should be aware of have been properly paid. By completing and filing Form 4506, the personal representative can obtain copies of all prior income tax returns filed by the decedent. In addition, the personal representative can determine what income items have been reported to the IRS as having been received by the decedent (i.e., interest, dividends, capital gains) by sending a written request to the IRS for same.

Normally, the IRS has three years from the date an income tax return is filed to audit that return and assess additional tax due. As noted above, the personal representative must be aware of the fact that he or she can be personally liable for income taxes due from the estate. Thus, the personal representative can find himself or herself in a time crunch. On the one hand, he or she wants to hold sufficient assets in the estate to pay any additional income tax liability that may be assessed but, on the other hand, the beneficiaries are pressing for a distribution of assets and closing of the estate.

The personal representative has some tools available for addressing this problem. First, Form 4810 allows the personal representative to request a prompt assessment of the income tax after the return has been filed. This reduces the IRS period of time for making the assessment of income taxes to 18 months from the normal three year period, with that 18 month period beginning to run on the date that Form 4810 is received by the IRS. In addition, the personal representative is responsible for the payment of all taxes that may be owing from the decedent's estate, including those triggered by tax returns filed before the decedent's death. In this regard, the personal representative may file Form 4810 requesting a prompt assessment for tax returns for any year for which a statutory period of assessment is still open.

It is important to note that the filing of a Form 4810 will not reduce the period of assessment for a return in which there was a failure to report substantial amounts of gross income (more than 25% of the gross income) or for which a false or fraudulent return was filed. However, in these circumstances the personal representative is not personally responsible for those taxes to the extent that he or she did not have (or should have had) knowledge of the unpaid tax liability.

As also noted above, the personal representative can be personally responsible for income taxes owing from the estate to the extent that the estate's assets have been depleted by distributions and are not available to fully cover that tax liability. To bring this liability exposure to a close, the personal representative may file Form 5495 that requires the IRS to notify the personal representative within nine months of receipt of that filing of the amount of any taxes due. Upon payment of those taxes, if any, the personal representative will be discharged from any personal liability for same.

III. <u>The Section 754 Election.</u>

A. <u>Background</u>. Upon the death of a partner, the basis of the partner's partnership interest is adjusted to its fair market value as of the partner's date of death or the alternate valuation date, if applicable, reduced by any income in respect of a decedent attributable to the partnership interest (referred to herein as the "outside basis"). Additionally, the holding period in the partner's partnership interest is long-term for the estate or successor partner. But this only effects the decedent's or his successor's partnership interest and has no effect on the basis of the underlying partnership property (referred to herein as the "inside basis"). Thus, if the partnership sells an asset immediately after a partner dies, the partner's estate or successor partner will report gain as if no basis adjustment occurred as a result of the partner's death.

However, if the partnership makes a § 754 election, the estate or successor partner adjusts his share of the inside basis of the partnership assets to equal its outside basis. The successor partner acquires a basis in his share of the underlaying partnership assets as if he had purchased an undivided interest in them at market value on the date of death. It has no effect on the holding period, nor does it affect the basis of any other partner.

When the partnership sells the assets on hand at the decedent's date of death, the inside basis increase allows the successor partner to recognize a smaller share of a gain or a larger share of loss than his fellow partner. This allows the successor partner to claim higher depreciation deductions than his partners based his higher inside depreciable basis. Any applicable recovery period and method may be used.

B. <u>The Double-Edged Sword</u>. The § 754 election can be a double-edged sword. First, the record-keeping can be a burden. Second, it causes a step-down in basis for the successor partner if the partnership assets are worth less than their tax basis on the date of the transfer. For example, a § 754 election is not desirable when discounts on the outside partnership interest would reduce the decedent's share of inside basis of partnership assets to below his share of their cost basis. Third, the election is irrevocable without the consent of the IRS. Thus, it causes inside basis adjustments at each subsequent partner's death whether the partners desire it or not. And fourth, it requires the partnership to adjust the basis of its assets when it makes certain types of distributions.

C. Hypothetical Sale. The outside basis in the decedent's partnership interest is adjusted to its fair market value on the partner's date of death, or the alternative valuation date, if applicable, regardless of whether a § 754 election is made. The basis increase will eventually provide a tax savings for the successor when the partnership interest is sold or liquidated. However, wanting to reap the tax benefits of a basis step-up sooner, many partnerships make the § 754 election. This pushes the outside step-up or step-down to the inside basis of the partnership assets with respect to the decedent partner's interest. Thus, sales of property occurring fairly soon after death will result in little or no gain to the successor partner due to the § 754 basis adjustment.

The regulations provide how to allocate the transferee's basis in his partnership interest among his share of the underlying partnership assets when the partnership makes a § 754 election. The § 754 election helps to achieve uniformity between the inside and outside basis when there has been a transfer of a partnership interest upon the death of a partner. The regulations provide a three-step process to make the basis adjustment.

Step One - Determine the difference between the partner's outside basis (i.e., the basis of his partnership interest) and his inside basis (i.e., his share of the adjusted basis of partnership property). This difference is the § 743 adjustment. This basis of a purchased interest is its cost. The basis of an interest acquired from a decedent is the fair market value at the date of death or the alternative valuation date.

Step Two - Separate the adjustment into two classes - ordinary income and capital gain property. Apply the adjustment first to the ordinary income property in an amount equal to the income that would be allocated on sale of that asset at fair market value. Apply the remaining balance of the adjustment to the capital gain class. One class may get a step-up in basis and another class may be allocated a step-down.

Step Three - Allocate the step-up or down for each class among the assets within each class on an asset to asset basis based on the taxable gain or loss that would be allocated to the transferee from the "hypothetical sale" of each item.

For Example: Mr. X died with an interest in Partnership A and the only assets owned by the partnership are marketable securities. His partnership interest is valued at $14,000 based on the fair market value of his share of the underlying assets (ignoring any partnership discounts). His share of the basis in those assets is $8,000. The § 743 adjustment is $6,000 ($14,000 - 8,000) and is allocated as follows:

	Basis before 743 Adj.	FMV	§ 743 Adj.
Stock 1	500	2,000	+1,500
Stock 2	4,000	3,300	- 700
Stock 3	2,500	8,500	+6,000
Stock 4	1,000	200	- 800
	$8,000	$14,000	$6,000

D. Filing Requirements When Making the Election.

1. The § 754 Election. The § 754 election is made by the partnership on a written statement submitted with a timely filed Form 1065 for the tax year in which the transfer occurs. For the election to be valid, the return must be filed on time, including extensions. The statement must include the name and address of the partnership, be signed by one of the partners, and state that the partnership elects under § 754 to apply § 743(b). If the election cannot be made with the return, a partner or the partnership can request an automatic extension of 12 months to make the election.

Once a valid election has been made, it applies in succeeding years until it is revoked. Generally, the election can be revoked only with the approval of the IRS. The IRS will not approve an application to revoke the election if its primary purpose is to avoid decreasing the basis of partnership assets upon a transfer of assets. Examples of sufficient grounds for approving the application include the following: (i) a change in the nature of the business, (ii) a substantial increase in assets, (iii) a change in the character of the assets, and (iv) an increased frequency of retirements or shifts of partnership interests.

2. The § 743(b) Election. The § 743(b) computation and allocation of adjustments to the basis of partnership property must be reported on the partnership's Schedule K and the transferee partner's Schedule K-1. The adjustments should be reported on an attached statement to the K-1 using the codes for “Other Income or Other Deductions.” The partnership item being adjusted and the amount of the adjustment should be reflected on the statement. The adjustment will either (i) increase the basis in partnership assets by the excess of the partner’s outside basis (i.e., his basis in his partnership interest) over the inside basis (i.e., his proportionate share of the partnership property’s adjusted tax basis), or (ii) decrease the basis in partnership assets by the excess of inside basis over outside basis

E. When Not to Make the Election. If the discounted value of the partnership interest is less than the partnership’s cost basis in the underlying assets, the partnership should not make the § 754 election. If made, the election will reduce the decedent partner’s share of the cost basis of the partnership assets to the discounted amount.

For Example: Assume that Partnership B has marketable securities with a cost basis of $200,000 and a market value of $300,000. However, an appraisal applies a 50 percent discount, valuing the partnership at only $150,000. Partner Y, a 20 percent partner, dies and Partnership B makes a § 754 election. Partner Y’s new basis in his partnership interest on his date of death is $30,000, or 20% of $150,000. Shortly after his death, the partnership sells all of the stock for $300,000. The tax consequences to D, Partner Y’s successor in interest, are:

	With § 754 Election	Without § 754 Election
Sales Proceeds Allocable to D (20% x $300,000)	60,000	60,000
D’s Stock Basis (20% x $150,000)	-30,000	
(20% x $200,000)		-40,000
Gain Recognized	$30,000	$20,000

In the above example, the § 754 election brings the valuation discounts inside the partnership causing Partner Y’s successor to report an extra $10,000 in gain. But keep in mind this is only a timing difference. Partner Y’s successor adds the gain reported to his outside basis and reports less gain when he ultimately sells or liquidates his interest.

	With § 754 Election	Without § 754 Election
Partner Y’s Basis in the Partnership	30,000	30,000
Gain Recognized	30,000	20,000
Liquidating Distribution	-60,000	-60,000
Liquidating Gain	$0	$10,000

Timing differences become less important if the partnership does not plan to cash out the successor partner right away.

F. Mandatory Basis Adjustment for “Substantial Built in Loss Property.” Basis adjustments under § 743 are mandatory when a partner dies and the partnership has a “substantial built-in loss.” A substantial built-in loss exists if the adjusted basis of partnership property exceeds the property’s market value by more than $250,000 on the date of death. If the partnership is required to make a mandatory basis adjustment because of a substantial built-in loss, it must disclose the adjustment on Form 1065 and attach a statement showing the computation and allocation of the basis adjustment.

Note that the $250,000 is the difference between the cost and market value of the partnership property, not the partnership interest. But once this threshold is met, the required adjustment is the difference between the cost of the partnership property and the discounted value of the partnership interest, which could be significantly larger than the spread between the cost and market value of the partnership assets.

IV. The Section 645 Election.

A. Background. A qualified revocable trust typically allows the grantor, but no one else, to revoke it and thus becomes irrevocable at the grantor’s death. The income, deductions, and credits attributable to such a trust prior to the grantor’s death will be reflected on the deceased grantor’s final Form 1040. A revocable living trust becomes a different taxpayer after the grantor dies. It must obtain a new taxpayer identification number and start filing Form 1041 trust income tax returns under such new number on income earned after the grantor’s death.

Historically, post-death revocable trusts suffered several minor disadvantages when contrasted with an estate for income tax purposes. Theses included, for example, fiscal year-end selection, waiver of active participation for passive losses, use of the $600.00 allowance in lieu of personal exemption, holding periods for S stock, income tax deductions for charitable set asides, avoidance of estimated tax payment requirements for two years, etc.

B. <u>Election Under Section 645</u>. For decedents dying after August 5, 1997, the trustee and the executor (if any) may irrevocably elect to treat a "qualified revocable trust" as part of the estate for income tax purposes. The term "qualified revocable trust" means any trust that was treated under § 676 as owned by the decedent by reason of a power in the decedent to revoke.

The election must be made on the estate's first timely income tax return (including extensions), and, once made, is irrevocable. The election applies until "the date which is 6 months after the date of the final determination of the liability for tax imposed by chapter 11," or if no estate tax return is due, two years after the date of death. The final regulations provided that the date of final determination of liability is the date that is six months after the date the closing letter is issued. Therefore, the § 645 election will terminate twelve months after issuance of the closing letter. The regulations further provide that the election period terminates earlier if both the electing trust and the related estate, if any, have distributed all their assets. If an executor has been appointed, the executor and trustee of the trust make the election by signing and filing Form 8855, "Election to Treat Qualified Revocable Trust as Part of an Estate." If there is no executor, the trustee of the trust files the election form.

C. <u>Advantages of the Election</u>. If the estate (if any) and the revocable trust make the election, a number of tax benefits may result to the trust, including-

1. Availability of an estate to choose fiscal year income tax reporting under § 644 (whereas a revocable living trust must utilize a calendar year for reporting income after the grantor's death),
2. Avoiding the need to make estimated tax payments for two years after the decedent's death because estates are not required to make estimated income tax payments,
3. Use of the $600 personal exemption available to an estate rather than either a $300 or $100 exemption available to trusts (depending on whether the trust is a simple or complex trust),
4. The ability to hold S corporation stock for the duration of the administration of the estate, without meeting special trust rules (estate exception applies for the reasonable period of estate administration),
5. Medical expenses of the decedent paid out of the estate within one year after date of death may be deducted if elected,
6. The ability to obtain a charitable deduction for amounts permanently set aside for an ultimate distribution to charity (under Section 642(c)(2)),
7. Allowing certain losses for income tax purposes (i.e., losses resulting from the funding of pecuniary bequests under Section 267(b)(13)),
8. Avoidance of the passive loss active participation requirement under Section 469 of the Code for rental real estate for two years after death,
9. Simplifying the number of tax returns, and
10. Deferral of payment of income tax on income earned after the date of death until the due date of the estate's fiduciary return (which could result in up to eleven months of additional deferral).

V. <u>IRC 691(c).</u>

NOTE: For ease of reference, the term "participant" is used in this presentation to refer to both an employee who has an interest in a qualified retirement plan account offered by his/her employer and an owner/creator of an IRA, as applicable. Also, whenever the term "qualified retirement account" is used, it should be interpreted as a reference to both an IRA and a qualified retirement plan account offered by an employer.

A. <u>Overview</u>. Income in respect of a decedent ("IRD") is defined as "amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income from the taxable year ending with the date of his death or for a previous year...." Treas. Reg. 1.691(a)-1(b). Death benefits under qualified plans, IRAs, and 403(b) plans are IRD. Rev. Rul. 92-47, 1992-1 C.B. 198; Treas. Reg. 1.663(c)-5, Example 9.

Generally, the same income tax rules that applied with regard to a qualified retirement account during the participant's lifetime also apply to beneficiaries of the account after death. Consequently, IRD is only taxable when received by the beneficiary entitled to the IRD item. IRD is generally taxed as ordinary income, unless excepted otherwise by the IRC (e.g., recovery of basis, spousal rollover, etc.). IRC 691(a)(1).

IRD does not qualify for a new basis at death. IRC 1014(c). Instead, the recipient of IRD takes a carryover basis (i.e., the decedent's basis).

The federal estate tax paid on IRD is deductible for federal income tax purposes by the recipient as the IRD is received, even if the estate tax has yet to be paid and even if the IRD recipient is not the party responsible for payment of the estate tax. IRC 691(c); PLR 200011023. There is also a limited deduction for any GST tax due. IRC 691(c)(3). Note, however, that IRC 691(c) does not provide an income tax deduction for whatever state inheritance/estate tax may be paid on IRD.

To calculate the IRC 691(c) deduction, first you calculate the estate tax due on the entire estate. Then you calculate the net value of all IRD included in the estate. The estate tax attributable to the IRD is the difference between the actual federal estate tax paid and the federal estate that would have been paid had the IRD been excluded. Consequently, the IRC 691(c) deduction is computed at the marginal rate rather than an average rate, a result generally beneficial to the recipient entitled to the deduction.

B. <u>Situations Complicating Calculation of the IRC 691(c) Deduction</u>. The 691(c) calculation is easy for a recipient taking a lump sum distribution of IRD. The calculation becomes more complicated with other payment arrangements. If the IRD is received via an extended payout (e.g., over the recipient's life expectancy, or a "stretch-out" payment), there will be a need to determine the portion of a distribution attributable to the estate taxed IRD and the portion of the distribution reflecting post-death income earned.

The answer is a relatively easy one for the surviving spouse in receipt of a joint and survivor annuity (provided the decedent died after the annuity start date), since IRC 691(d) requires that the deduction be apportioned equally to the annuity payments received over the surviving spouse's life expectancy.

While there is no authority requiring a specific allocation of the deduction with nonannuity payments (e.g., installment payments), it is common to treat all post-death distributions as first coming from IRD (and not post-death earnings) until the IRC 691(c) deduction is exhausted. In doing so, the deductible amount will be equal to a percentage of each payment (or portion thereof considered IRD) for which the numerator is the total IRC 691(c) deduction amount and the denominator is the federal estate tax value of the IRD item. Again, however, there is no official confirmation of the legitimacy of that approach.

The 691(c) deduction can also be complicated when there are multiple recipients. In that event, the deduction is to be apportioned among the recipients based upon the manner in which they shared in the IRD item. IRC 691(c)(1)(A).

Again, the deduction is intended to reflect the estate tax attributable to the inclusion of the IRD in the gross estate. Consequently, the IRC 691(c) deduction in any year should be limited to the estate tax attributable to the IRD portion of the benefits received during the year. In light of this, it is certainly not appropriate to treat the IRC 691(c) deduction as a dollar-for-dollar deduction until exhaustion with regard to benefits initially received from the IRD account, though some do advocate for that treatment.

C. <u>Interaction With IRC 67 and IRC 68</u>. The IRC 691(c) deduction is not subject to the 2% floor otherwise applicable with regard to certain miscellaneous itemized deductions. IRC 67(b)(7). Consequently, the deduction is allowed in computing AMT. IRC 56(b)(1)(A)(i). The IRC 691(c) deduction has traditionally been subject to IRC 68, but IRC 68 is repealed for 2011 and 2012 (and does not apply in any event to trusts or estates).

VI. <u>Post-Death Minimum Required Distributions ("MRDs") and Associated Tax Consequences.</u> While a detailed discussion of such is beyond the scope of this presentation, here are a few key points to keep in mind in evaluating the available payout options applicable with regard to a qualified retirement account to determine which is preferable for a recipient's circumstances.

A. <u>The Decedent's MRD for the Year of Death</u>. An individual is required to begin taking MRDs from a qualified retirement account by April 1st of the year following the year in which he/she turns 70.5 (or for an employer provided qualified retirement plan, if later, the year in which the decedent retired from employment).[1] For purposes of this outline, the applicable date will be referred to as the required beginning date, or "RBD" for short.

If the decedent died on or after his/her RBD and had not taken the MRD for the year of death, the recipient of the account at death (not the decedent's executor, unless the estate is the recipient of the account), is responsible for ensuring the balance of the MRD is taken in full by December 31st of that year. Treas. Reg. 1.401(a)(9)-5, A-4(a).[2]

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[1] This assumes the decedent was not a "5-percent owner." IRC 401(a)(9)(C)(ii)(I); Treas. Reg. 1.401(a)(9)-2, A-2(c). This also assumes the employer provided plan allows for the later RBD since the plan is not required to do so under the IRC. If the plan requires that each plan participant (whether employed or retired) have a RBD of April 1st following the year in which he/she turns 70.5, the distributions received by an employed participant are eligible for rollover until he/she reaches his/her *statutory* RBD. Notice 97-75, 1997-2 C.B. 337, A-10(c).

[2] There are other factors regarding a qualified retirement account that the deceased participant's executor will want to address that are beyond the scope of this presentation. Those factors include determining (i) whether

If the participant died during the year of his/her RBD but before the actual RBD (April 1st), it does not appear that the recipients of the qualified retirement account are required to take the accrued MRDs for the year of death and the prior year. While there is no express provision of the Code or Treas. Reg. to this effect, this result is implied by IRC 401(a)(9)(B)(i); Treas. Reg. 1.401(a)(9)-2, A-6; Treas. Reg. 1.401(a)(9)-5, A-4(a); Treas. Reg. 1.408-8, A-5(a); Treas. Reg. 1.401(a)(9)-3, A-1.

If there are multiple beneficiaries, it appears that the participant's MRD for the year of death need not be distributed pro rata to them, and in fact, may be distributed to only one of the beneficiaries. Treas. Reg. 1.401(a)(9)-5, A-4(a); Treas. Reg. 1.401(a)(9)-8, A-2(a)(2); Rev. Rul. 2005-36 2005-1 C.B. 1368.

B. Surviving Spouse's Options.

1. Spousal Rollover/Election to Treat IRA as Own. Note that the surviving spouse has the greatest income tax deferral options when named as a beneficiary of a qualified retirement account, either directly in the beneficiary designation or through an estate or trust. To secure the greatest benefits, the surviving spouse should elect to rollover the retirement account (except an MRD) to a traditional or Roth IRA (or if he/she is the sole Designated Beneficiary of the participant's IRA, he/she may elect to treat the deceased spouse's IRA as his/her own).[3]

If the surviving spouse elects to treat the participant's IRA as her own, that election is given effect as of January 1st of the election year, resulting in the MRD for that election year and future years being calculated with the surviving spouse as the participant. Treas. Reg. 1.408-8, A-5(a). As a caveat, the MRDs for the year of the participant's death will in any event be based upon the rules applicable to the participant.

2. MRDs. If the surviving spouse elects either to rollover a qualified retirement account to his/her own IRA or to treat the participant's IRA as his/her own, then he/she may take MRDs from the subject account over his/her own lifetime based upon a life expectancy (i) determined under the advantageous Uniform Life Table (as opposed to the Single Life Table, applicable for determining the life expectancy for any other recipient (including the surviving spouse if he/she elects to take the participant's retirement account as a "beneficiary") and (ii) recalculated annually (as opposed to the "less 1" method applicable for all other recipients).[4] Note, in either event, the surviving spouse's MRDs will not be required to begin until April 1st of the year following the year in which the surviving spouse reaches age 70.5.

3. Ability to Name New Designated Beneficiaries. Of perhaps even greater benefit is the ability of a surviving spouse to name his/her own Designated Beneficiaries for the subject IRA in either event and, consequently, give each of them the option of electing a "stretch-out" payment of his/her share of the IRA over his/her own life expectancy. In contrast, the recipients of a qualified retirement account held by the surviving spouse as a beneficiary will generally be required to take MRDs over the surviving spouse's remaining life expectancy.

4. Spousal Rollover Available Even if Not Sole Beneficiary. There is no requirement that the surviving

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to "recharacterize" the deceased participant's Roth conversion (if possible), (ii) whether to complete a rollover of retirement funds for the deceased participant, and (iii) whether MRDs for years prior to the participant's death have been properly taken (and if not, addressing whether any excise taxes are due and the potential for relief from them).

[3] Spousal rollovers to a nonIRA may also permitted under certain circumstances but are not discussed in this presentation. Note, the surviving spouse's election to treat the deceased participant's IRA as his/her own IRA provides virtually the same benefits as a rollover of that IRA to the spouse's IRA. However, to treat the deceased participant's IRA as the surviving spouse's IRA, the surviving spouse must be the sole beneficiary of the IRA by September 30th of the year following the decedent's death (or be the sole beneficiary of a separate account established by December 31st of the year following the participant's death).

Of course, there may be unique circumstances that make a spousal rollover inappropriate, such as if the surviving spouse is older than the deceased spouse (particularly if the participant dies before his/her RBD) or if the surviving spouse is under age 59.5 and wants to preserve the ability to take penalty-free distributions from the account by taking the benefits as beneficiary (i.e., the 10% penalty on early distributions does not apply to death benefits). In light of that possibility, the prudent practitioner will want to considered carefully the applicable facts and only proceed with the generally favorable spousal rollover if the circumstances warrant. The rules applicable in the event a surviving spouse elects to hold a qualified retirement account as the beneficiary are generally not covered in this presentation.

[4] A surviving spouse who is the sole Designated Beneficiary of a qualified retirement account and takes it as a beneficiary may also recalculate his/her life expectancy annually for purposes of determining MRDs.

spouse be the sole beneficiary of a retirement account to be entitled to the spousal rollover. A surviving spouse can be one of multiple beneficiaries and still be permitted to roll over a distribution made to him/her. T.D. 8987, 2002-1 C.B. 852; PLRs 200449041; Preamble to final minimum distribution Regulations (T.D. 9897, 67 F.R. 18987 (4/17/02). The determination of whether a distribution is an "eligible rollover distribution" and other rollover rules applicable during the participant's lifetime also apply with regard to a spousal rollover. However, the surviving spouse must be the sole beneficiary of an IRA as of the Beneficiary Finalization Date in order to be permitted to treat it as his/her own IRA.

Though there is no express authority for it in the Code, Treasury Regulations or caselaw, the IRS has ruled that if the participant leave benefits to the estate or a trust (e.g., a revocable management trust) as beneficiary, the surviving spouse can roll over benefits that are paid to him/her as a beneficiary of the estate/trust, provided the spouse has and exercises the right to demand that the benefits be paid to him/her. The IRS's position in this regard has been set out in dozens of PLRs. PLRs 200935045, 200950053, 200405017, 200406048. Again, it is key that the surviving spouse have the right to the benefits, either because he/she is the sole beneficiary of the estate/trust (and thus the retirement benefits payable to it) or because he/she can direct (as sole trustee/executor) that the benefits fund a trust over which he/she has an unlimited withdrawal right.

For example, if benefits are payable to a revocable management trust that is divided upon the participant's death between a Bypass Trust and a General Power of Appointment Trust (i.e., a Trust described in IRC 2056(b)(5)), the IRS has permitted the surviving spouse to exercise the spousal rollover option if (i) the qualified retirement account is directed in the trust instrument to be used to fund the General Power of Appointment Trust subject to the surviving spouse's unfettered withdrawal right <u>or</u> is allocated to the Trust by the surviving spouse as the sole trustee <u>and</u> (ii) the withdrawn funds are rolled over by the surviving spouse within 60 days into another qualified retirement account. If only a portion of benefits are subject to this type of control, then only that portion is eligible for a spousal roll over.

The PLRs addressing the availability of a spousal rollover for retirement funds paid to the estate or a revocable management trust indicate it will not be available if either (i) the surviving spouse's rights under the recipient Trust are limited by a distribution standard (e.g., a HEMS standard) or (ii) the General Power of Appointment Trust will only receive the qualified retirement account at a third party's discretion (e.g., the surviving spouse is not the sole executor/trustee). However, see PLR 200705032, in which the surviving spouse was permitted to rollover funds directed to the General Power of Appointment Trust by a third party Trustee.

5. <u>No Deadline For Spousal Rollover/Election to Treat Participant's IRA as Own.</u> There is no deadline for a spousal rollover or election to treat the deceased participant's IRA as the surviving spouse's own IRA (with the exception of the requirement that distributed funds be rolled over within 60 days of their receipt). However, as discussed below, a qualified employee retirement plan with the 5-year rule as the default payout could cause a surviving spouse who defaulted into that 5-year payout to lose the rollover ability if the spouse fails to exercise it before December 31st of the year in which the 4th anniversary of the participant's death falls because the entire account becomes an MRD in the following year. Also, if the surviving spouse is the sole beneficiary of the participant's IRA, his/her failure to take MRDs will be deemed an election to treat the IRA as his/her own.

6. <u>Withholding</u>. If the rollover regards a qualified retirement plan subject to IRC 401(a)(9) (and, consequently, a 20% withholding), the surviving spouse can roll over the withheld money by substituting other funds. PLR 200344024. Alternatively, the surviving spouse has the option of a trustee-to-trustee transfer of a retirement account, if he/she would prefer to avoid the withholding altogether. PLR 200950058.

C. <u>Options for a Nonspouse Beneficiary.</u>

1. <u>The Ideal: the "Stretch-Out" Method</u>. The payout options available to a recipient of a retirement account at the participant's death who is not the surviving spouse depend upon the identity of the recipient and, under certain circumstances, whether the participant died before or after his/her RBD.[5]

a. <u>Overview of the "Stretch-Out Method".</u> Ideally, from an income tax deferral perspective, the participant will have provided for the retirement benefits to be paid to a "Designated Beneficiary." Treas. Reg. 1.401(a)(9)-4, A-1 provides that a designated beneficiary "is an individual who is designated as a beneficiary under the plan. An individual may be designated as a beneficiary

[5] Death on the RBD is treated as death after the RBD. Treas. Reg. 1.401(a)(9)-2, A-6(a).

under the plan either by the terms of the plan or, if the plan so provides, by an affirmative election by the employee (or the employee's surviving spouse) specifying the beneficiary. A beneficiary designated as such under the plan is an individual who is entitled to a portion of an employee's benefit, contingent on the employee's death or another specified event. For example, if a distribution is in the form of a joint and survivor annuity over the life of the employee and another individual, the plan does not satisfy section 401(a)(9) unless such other individual is a designated beneficiary under the plan. A designated beneficiary need not be specified by name in the plan or by the employee to the plan in order to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan. The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible, to identify the class member with the shortest life expectancy. The fact that an employee's interest under the plan passes to a certain individual under a will or otherwise under applicable state law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan."

An estate cannot be a Designated Beneficiary. Treas. Reg. 1.401(a)(9)-4, A-3. (See Section C.2.b.ii below for the ramifications of a participant's failing to provide for a Designated Beneficiary.) However, see the discussion in Section B.4 above of instances in which the IRS has informally ruled that the surviving spouse may nevertheless be treated as the sole beneficiary of the qualified retirement account passing to the estate and consequently be permitted a spousal rollover of the account.

A Designated Beneficiary is permitted pursuant to Treas. Reg. 1.401(a)(9)-5, A-5 to take MRDs from a qualified retirement account (or his/her separate account) over the course of the Designated Beneficiary's own life expectancy.[6] Consequently, payment of the associated income tax obligation may be postponed for as long as legally permitted. Typically, the Designated Beneficiary is not limited to the stretch-out and may elect a more accelerated payout of the account, unless the participant provided for the Designated Beneficiary to receive the benefits in a format that limits the Designated Beneficiary's discretion in that regard.[7] Note, that if there is only one Designated Beneficiary and the Designated Beneficiary is subject to the life expectancy rule of Treas. Reg. 1.401(a)(9)-3 (i.e., the participant died before his/her RBD) but the Designated Beneficiary misses one or more MRDs, then he/she can avoid the penalties for missed MRDs by withdrawing the entire account by December 31st of the year of the 5th anniversary of the participant's death. Treas. Reg. 54.4974-2, A-7(b).

b. <u>Potential For Election Between the "Stretch-Out Method" and 5-Year Payout.</u> As a caveat, if the participant's death occurred before his/her RBD, the Designated Beneficiary may be put to an election between the 5-year payout (see Section C.1.c below) and the "stretch-out" payout, with the plan potentially providing for a default option if a timely election is not made. If the plan does not provide for a default option, the default payout will be the "stretch-out" payout over the Designated Beneficiary's life expectancy. Treas. Reg. 1.401(a)(9)-3, A-4(c). Treas. Reg. 1.401(a)(9)-3, A-1.[8] Generally, the deadline is the earlier of December 31st of the calendar year in which distributions would be required to commence to satisfy IRC 401(a)(9)(B)(iii) and (iv) or December 31st of the year in which the 5th anniversary of the participant's death occurs. Treas. 1.401(a)(9)-3, A-4(c).

For a nonspouse Designated Beneficiary, that would mean December 31st of the year following the participant's death. However, this rule could create a trap for an unwary surviving spouse of a young deceased participant under a qualified employee retirement plan who elects to take the retirement funds as a beneficiary (as opposed to electing a spousal rollover) if the plan provides for the 5-year payout by default. If the surviving spouse were not subject to the 5-year payout, he/she would have until the year in which the participant would have reached 70.5 to begin MRDs. However, under the default 5-year payout, he/she would be required to take a distribution of the entire account in the

[6] Of course, if the deceased employee had reached his/her Required Beginning Date and had a longer life expectancy than the Designated Beneficiary, the Designated Beneficiary would likely prefer to take MRDs over the deceased employee's remaining life expectancy. Treas. Reg. 1.401(a)(9)-5, A-5(a)(1).

[7] For example, the participant can arrange for the qualified retirement account to pass to a conduit trust for a child and appoint a third party as trustee with instructions to elect the "stretch-out" payment option.

[8] Note, any reference in this presentation to the "5-year payout" should be read as the "6-year payout" if the subject death occurred during years 2004-2009 due to the 1-year suspension of MRDs in 2009 and the direction in IRC 401(a)(9)(H)(ii)(II) that the 5-year period be determined without regard to calendar year 2009.

year in which the 5th anniversary of the participant's death falls, since the entire account becomes an MRD during that year. Consequently, the surviving spouse otherwise subject to those circumstances would want to pursue a rollover in a prior year to avoid that result.

However, if the qualified retirement account is an IRA, the surviving spouse's failure to take a distribution of the entire account by the December 31st following the 5th anniversary of the participant's death would be deemed an election to treat the IRA as his/her own and would thereby avoid a required distribution of the entire account.

c. Options in the Event the Plan Does Not Offer the "Stretch-Out Method". Note, sometimes a stretch-out payment election is not available even if the participant provided for a Designated Beneficiary to receive the retirement funds. Although IRAs commonly allow for the stretch-out payment election, many qualified retirement plans limit a Designated Beneficiary to a lump sum payout, or potentially a 5-year payout. This used to be limiting for participants who preferred to leave their retirement benefits in a form that allowed for a "stretch-out" payment but did not have the opportunity to roll over their employer sponsored retirement benefits into an IRA before death.

However, beginning in 2007, the administrator of a qualified retirement plan subject to those self-imposed limitations is required to permit the Designated Beneficiary (but not a beneficiary who fails to qualify as a Designated Beneficiary) to elect a trustee-to-trustee transfer of the funds held in the qualified plan for the participant at death (minus any MRDs) to an inherited traditional or Roth IRA (not a Designated Beneficiary's own traditional or Roth IRA) that will accommodate the participant's existing beneficiary designation (e.g., to accommodate a "stretch-out" payment format). IRC 401(a)(31); Notice 2008-30, 2008-12 IRB 638, A-4. Per Notice 2007-7, A-17(c)(2), the trustee-to-trustee transfer must occur by no later than December 31st of the year following the year of participant's death to obtain the benefit of a favorable payout consistent with the beneficiary designation form. 2007-5 I.R.B. 395.

Again, the transfer must be in the form of a trustee-to-trustee transfer. If funds are distributed to a nonspouse beneficiary (even accidentally), they will be immediately taxable since nonspouse beneficiaries cannot roll over a distribution. PLR 200513032.

Of course the surviving spouse has always been able to accomplish that result with a spousal rollover.

2. Qualification for the Stretch Out-Method. The IRC permits retirement plan death benefits to be distributed in annual installments over the life expectancy of a "Designated Beneficiary" named by the participant.

a. Individual(s) as Designated Beneficiary/Designated Beneficiaries. Typically, one or more individuals will be selected as the "Designated Beneficiary" or "Designated Beneficiaries" of a qualified retirement account. Consequently, an individual may take his/her share of the account over his/her life expectancy (i.e., his/her MRDs will be calculated so that the account will be exhausted by the end of his/her life expectancy), provided separate accounts are timely created if multiples beneficiaries are named, as discussed in Section C.4 below. See Section C.1.c above for a discussion of how the Designated Beneficiary may opt for a trustee-to-trustee transfer of qualified retirement plan funds if the plan does not allow for the "stretch-out" payout. Also keep in mind that some plans may require the Designated Beneficiary to elect between the 5-year rule and the life expectancy payout and may provide for either to serve as the default selection.

b. Trusts as Designated Beneficiaries. The participant may name a trust as a beneficiary and still have a "Designated Beneficiary," provided that the following five requirements are met. See Treas. Reg. 1.401(a)(9)-4, A-5(b). If a trust meets Requirements 1-5, it will be considered a "see-through trust" and the IRS will generally treat the Trust's beneficiaries as though they had been directly named as beneficiaries of the retirement account benefits, with the result that the Trust may take MRDs over the oldest beneficiary's life expectancy.

i. Trust Rules.

• **Requirement #1 - Trust Must Be a Valid Trust.** The trust must be valid under state law. However, there is no requirement that the Trust be funded at the time of the participant's death.

• **Requirement #2 - Trust Must Be Irrevocable.** The trust must be irrevocable or must by its terms become irrevocable upon the participant's death.

• **Requirement #3 - Trust Beneficiaries Must Be Identifiable.**[9] The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the retirement account must be "identifiable" from the

[9] See discussion in Section VI.C.2.b.iii below for determining which beneficiaries "count" for this Rule.

instrument. A designation of beneficiaries by class is permitted so long as it is possible to identify the beneficiary in the class with the shortest life expectancy. Note, permitted appointees under a power of appointment count as "beneficiaries" for this purpose, as do the takers in default, unless they are disregarded under Treas. Reg. 1.401(a)(9)-5, A-7(c). Be careful that the definition of "adoption" is sufficiently limited so that older adopted issue will not cause the oldest beneficiary at the participant's date of death to be unidentifiable.

Even if the Trust "flunks" Requirement #3 at the participant's death, it may be possible to cure the problem by timely disclaimers and distributions to problematic beneficiaries by the Beneficiary Finalization Date (e.g., disclaimers of problematic powers of appointment). See Treas. Reg. 1.401(a)(9)-4, A-4(a).

- **Requirement #4 - Timely Delivery of Trust Instrument/Will or Certification of Beneficiaries to Administrator.** The Trustee must deliver to the plan administrator by October 31st of the year following the participant's death either (i) the trust instrument/Will or (ii) a final list of all trust beneficiaries as of the Beneficiary Finalization Date (including contingent and remainder beneficiaries), along with a description of the conditions under which they would receive benefits and a certification from the Trustee that to the best of his/her knowledge (A) the list is a correct and complete accounting of the beneficiaries, (B) the other rules for a Trust named as a beneficiary are satisfied, and (C) the Trustee will provide a copy of the trust instrument upon request. Treas. Reg. 1.401(a)(9)-4, A-6(b).

- **Requirement #5 - All Trust Beneficiaries Must Be Individuals.**[10] The next step is to ensure all of the Trust's beneficiaries as of the Beneficiary Finalization Date are individuals.

ii. Consequence of a Nonindividual Trust Beneficiary. If any part of the Trust's interest in a retirement account could pass to a nonindividual, then there is a risk that the participant will be deemed to have no Designated Beneficiary unless the problematic nonindividual beneficiary can be eliminated by the Beneficiary Finalization Date. For example, if a Trust designated as the beneficiary of the deceased participant's retirement account provides that its assets maybe used to pay the deceased participant's debts, expenses, and taxes at death (and retirement funds are not specifically excluded for such purpose), then the estate (a nonindividual) is considered a beneficiary of the Trust.

The IRS has privately ruled that distributing sufficient funds from the Trust to the estate by the Beneficiary Finalization Date to defray all debts, expenses, and taxes at death may be sufficient to remove the estate as a beneficiary. See PLR 200432027 in which the IRS noted the Trust's contingent liability for paying additional estate taxes but nevertheless found the estate had been sufficiently "removed" as a problematic nonindividual beneficiary by the Beneficiary Finalization Date. The IRS's generosity in this situation is indicative of its reluctance to date to find an estate to be a nonindividual of a Trust in receipt of retirement funds due solely to the potential payment (or even actual payment) of retirement funds for an estate's debts, expenses, and taxes.[11]

See the discussion in Section C.2.c below for ways in which a nonindividual beneficiary may be "eliminated" by the Beneficiary Finalization Date.

If there is a nonindividual beneficiary of the Trust designated as beneficiary that cannot be eliminated by September 30th of the year following death, then the participant will be deemed to have failed to provide for a Designated Beneficiary for the retirement account. In that event, the account funds will be payable over the deceased participant's remaining actuarial lifetime (if he/she died after his/her RBD) or over the 5-year period (if he/she died before his/her RBD).

iii. Which Trust Beneficiaries Count?

- **Only Count Beneficiaries of the Trust Entitled to Receive the Qualified Retirement Account.** Clearly, if the beneficiary designation directs that the qualified retirement account be payable to a specific Trust created upon the participant's death under a revocable management trust/Will, then only the beneficiaries of that specific Trust "count" for purposes of the trust rules.

The same result should occur if the revocable management trust/Wwill itself requires the Trustee to allocate retirement benefits to a particular Trust or effectively provides for that result via a prohibition on the benefits being paid to other beneficiaries/Trusts. See PLR 200620026 and Treas. Reg. 1.401(a)(9)-4, A-5(a), Treas. Reg. 1.401(a)(9)-4, Q-5; A-5(b)(3), (c), Treas. Reg. 1.401(a)(9)-8, A-11 (last sentence). However, given the lack of authority on point, it is preferable for certainty purposes to name the desired Trust directly as

10 See discussion in Section VI.C.2.b.iii below for determining which beneficiaries "count" for this Rule.

11 Note, a 645 Election is not problematic in this regard. See TD 8987, 2002-1 CB 852, 857.

the beneficiary of the retirement benefits in the beneficiary designation form.

However, there is no authority on point for a situation in which the beneficiary designation directs that the retirement account be payable to the Trustee of the revocable management trust/participant's estate but leaves it to the trustee's/executor's discretion as to which of the Trusts created at the participant's death is to receive the retirement account. Presumably, the IRS would require that the beneficiaries of all Trusts that could be funded with the qualified retirement account "count" for purposes of the trust rules.

Along those lines, see PLR 200528031, in which pursuant to state law an IRA was used to fund one but not both of the successor Trusts created upon the Trustor's death to receive his estate. The IRS disregarded the state law requirement that only the one successor Trust receive the IRA and consequently required that the beneficiaries of both Trusts be considered in determining which beneficiary's life expectancy was to be used in establishing MRDs.

However, see PLR 200221061, in which the IRS concluded that the pre-residuary beneficiaries (including charities) could be ignored for purposes of calculating the MRDs even though their bequests could have been (but were not) satisfied using the retirement benefits.[12]

• **Disregarding "Mere Potential Successors."** Treas. Reg. 1.401(a)(9)-5, A-7(c) provides that certain trust beneficiaries may be disregarded for purposes of applying the trust rules. Treas. Reg. 1.401(a)(9)-5, A-7(c) provides that "a person will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy under paragraph (a) of this A-7, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death. However, the preceding sentence does not apply to a person who has any right (including a contingent right) to an employee's benefit beyond being a mere potential successor to the interest of one of the employee's beneficiaries upon that beneficiary's death."

For purposes of applying the "mere potential successor" test, there are two types of trusts: "conduit trusts" and "accumulation trusts."

• **Conduit Trusts.** Conduit Trusts are a type of "see-through" trust under which the trustee has no power to accumulate in the Trust any retirement benefits it receives (whether MRDs or other withdrawals). Instead, the Trustee of a Conduit Trust is required by the Trust's terms to distribute immediately to the current beneficiary/beneficiaries any amounts received from the retirement account. The IRS considers the current beneficiary or beneficiaries as the sole beneficiary/beneficiaries of the trust, thus meeting the "all individual beneficiaries" test.

All other beneficiaries are considered mere potential successors and are consequently disregarded. Thus, a Conduit Trust beneficiary can be given a broad special (or even general) testamentary power of appointment exercisable in favor of charities or other nonindividuals (including the beneficiary's own estate) without impairing the ability of the Conduit Trust current beneficiary to use his/her own life expectancy for purposes of calculating MRDs. See Treas. Reg. 1.401(a)(9)-5, A-7(c)(3), Example 2.

The IRS has privately ruled that payment of normal trust administration expenses will not prevent a Conduit Trust from being treated as though it has only individual beneficiaries even though payments of administration expenses could be interpreted as benefitting a nonindividual. PLR 200432027.

• **Accumulation Trusts.** An Accumulation Trust is any type of Trust in which distributions from the qualified retirement account received by the Trust may be held for later distribution. Consequently, some or all of the potential remainder beneficiaries of an Accumulation Trust "count" for purposes of the MRD rules. A conventional dynasty trust providing a beneficiary or beneficiaries with distributions for health, education, maintenance, and support purposes would be classified as an Accumulation Trust.

The rules in this regard are by no means clear, and the Regulations provide only one example of an Accumulation Trust that passes the trust rules. See Treas. Reg. 1.401(a)(9)-5, A-7(c)(3), Example 1 in which the Trust designated as the beneficiary of the retirement account otherwise passed Requirements #1-4 of the trust rules and further provided that (i) all trust income is to be payable annually to the surviving spouse, (ii) no one has the power to appoint trust principal to any person other than the surviving spouse, and (iii) the children of the decedent and the surviving spouse are the sole remainder beneficiaries of the Trust. The example specifically notes that "no other person has a beneficial interest in" the Trust and goes on to conclude that the surviving spouse and the children are to be considered

[12] Also note herein for a discussion of the IRS's generosity in permitted spousal rollovers in like situations when the surviving spouse is the trustee/executor with the discretion to allocate the retirement account to a General Power of Appointment Trust.

the only beneficiaries of the Trust. As a result, the Example concludes that the life expectancy of the surviving spouse (i.e., the oldest beneficiary) is to be used in calculating the MRDs for the account.

Note, the Example is overly simplistic in that it does not address the possibility of a child's predeceasing the surviving spouse and the resulting possibility of that child's share of the retirement benefits passing to other individuals or nonindividuals. Thus, we are left to wonder whether we are entitled to safely assume that the takers in that event are "mere potential successors" not to be considered in establishing MRDs, or whether the Example was insufficiently developed.

The PLRs interpreting the Example indicate that the former interpretation of the Example is the correct one. In those PLRs, the IRS concludes that because the children were outright takers upon the surviving spouse's death, the alternate takers in the event of a child's death are "mere potential successors."

Based upon that approach, for an accumulation trust you "count" as of the participant's death all (i) beneficiaries who could potentially take "in trust" (i.e., potential beneficiaries of successor Trusts, if any) and (ii) the beneficiaries who will ultimately receive the trust property outright upon termination of the last existing Trust. Note, if a remainder interest is subject to a power of appointment, all potential appointees (as well as the takers in default) are considered beneficiaries unless they can be eliminated by a disclaimer or otherwise disregarded.[13] Any individual or nonindividual who might receive benefits as a result of the death of an individual described in (ii) is ignored as a "mere potential successor." To ensure an Accumulation Trust "passes" under this test, there needs to be at least one individual described in (ii) living at the time of the participant's death, which is the point at which these tests are applied (as though all of the takers in trust died immediately after the participant).

If all of the individuals described in (i) and (ii) are individuals, then the Trust qualifies as a "see-through trust," and the life expectancy of the oldest member of the group will be used in calculating MRDs. Again, Treas. Reg. 1.401(a)(9)-5, A-7(c), Example 1 is not entirely clear in "blessing" this analysis. However, PLRs 200522012 and 200608032 have interpreted the Regulation to provide for this approach. The cautious practitioner may want to request a PLR for his/her client to achieve certainty.

c. <u>"Removal" of Problematic Beneficiaries By the Beneficiary Finalization Date</u>. Even if the beneficiary designation provides for a nonindividual to share in the qualified retirement account at the participant's death, it may be possible to cure that problem by the Beneficiary Finalization Date. See Treas. Reg. 1.401(a)(9)-4, A-4(a). A nonindividual beneficiary may be "removed" by a (i) distribution to the nonindividual beneficiary of his/her/its interest in the account, (ii) a disclaimer by the nonindividual beneficiary of his/her/its interest in the account, or (iii) certain other actions, possibly such as beneficiary designation reformations (although a reformation may or may not be given retroactive effect by the IRS). These solutions are discussed in more detail below.

A "problematic" beneficiary could be a significantly older beneficiary whose interest in the qualified retirement account could prevent a younger beneficiary from ultimately being able to use his/her life expectancy for purposes of calculating MRDs. Note, the death of a problematic beneficiary before the Beneficiary Finalization Date may also cause him/her to no longer be a problem (depending upon the manner in which the affected share of the benefits passes in that event), though death should obviously not be considered a "solution."

i. <u>Distribution Of Problematic Beneficiary's Share By the Beneficiary Finalization Date</u>. If the retirement benefits are to be divided among beneficiaries that include a nonindividual, then no individual beneficiary will be able to use his/her own life expectancy in calculating MRDs from his/her share of the account because the participant will have failed to provide a "Designated Beneficiary" for the account. Fortunately, it may be possible to "eliminate" the nonindividual beneficiary by distributing his/her/its share of the benefits prior to the Beneficiary Finalization Date.

Similarly, if the retirement benefits are to be divided among beneficiaries that include a significantly older individual, then that could prevent a younger beneficiary from being able to use his/her own life expectancy in calculating MRDs from his/her share of the account if the creation of separate accounts is not permitted (e.g., the older beneficiary is to receive a dollar amount that does not share pro rata in gains/losses).

Fortunately, it may be easy to "eliminate" the nonindividual or older beneficiary by distributing his/her/its share of the benefits prior to the Beneficiary Finalization Date.

ii. <u>Disclaimers By the Beneficiary Finalization Date</u>. If the nonindividual/older beneficiary disclaims his/her

[13] Consequently, they should be (i) identifiable, (ii) individuals, and (iii) younger than the beneficiary whose life expectancy is to be used to calculate MRDs.

share of the benefits by the Beneficiary Finalization Date, then he/she/it will no longer "count" as a beneficiary. Treas. Reg. 1.401(a)(9)-4, A-4(a), PLR 200444033. A disclaimer of a problematic power of appointment may also "solve" a potential problem with trust Rules 3 and 5. Note, it appears that the elimination of problematic beneficiaries (and appointees) via a disclaimer must occur by the earlier of (i) the last day on which a qualified disclaimer under IRC 2518 and applicable state law may occur and (ii) the Beneficiary Finalization Date, even though a disclaimer after the Beneficiary Finalization Date (but within the otherwise applicable disclaimer period) is considered effective as of the participant's date of death for transfer tax and state law purposes. Treas. Reg. 1.409(a)(9)-4, A-4(a).

iii. Other Means of "Removing" a Problematic Nonindividual/Older Beneficiary. Treas. Regulation 1.401(a)(9)-4, A-4(a) suggest that there are other means of removing a problematic nonindividual/older beneficiary by the Beneficiary Finalization Date, although distributions and disclaimers are the only means specifically noted. However, certain post-death trust amendments have been treated as effective for this purpose. PLR 200537044.

3. If No Designated Beneficiary. If the participant designates his/her estate, a charity, a Trust that fails to qualify as a "see through trust," or any other nonindividual as the beneficiary of part or all of the retirement account (and that problematic beneficiary's interest is not "eliminated" by the Beneficiary Finalization Date), then the participant will be deemed to have failed to name a "Designated Beneficiary" for the account. Consequently, the retirement funds must be must be entirely withdrawn by December 31st of the year in which the 5th anniversary of the participant's death occurs (if the participant died prior to his/her Required Beginning Date) or over the remaining life expectancy of the deceased participant (if he/she died after his/her Required Beginning Date).[14] Typically, this results in a more accelerated payout than would be applicable if there were a Designated Beneficiary entitled to elect a payout of the retirement account (or his/her share of it) over his/her own life expectancy.

4. Separate Accounts Rule. If the participant provides in the beneficiary designation for multiple beneficiaries to receive the qualified retirement account at death, it is generally a good idea for the retirement account to be divided into separate accounts by December 31st of the year following the year of the participant's death (in which event the separate accounts will be deemed created as of January 1st of the year following the participant's death).[15] In doing so, each beneficiary may calculate the MRDs from his/her share of the account using his/her own life expectancy. If the surviving spouse is the sole beneficiary of a separate account payable to her created from the deceased participant's IRA, then her separate account will be subject to the same special minimum distributions rules that would have been applicable in the event she had been the sole beneficiary of the participant's IRA at death. 1.401(a)(9)-8, A-2(a)(2).

In contrast, if separate accounts are not established by December 31st of the year following the participant's death, then all MRDs (even if separate accounts are later established) will be calculated based upon the life expectancy of the oldest of the Designated Beneficiaries.[16]

Note, separate accounts may only be created if there is a required pro rata sharing of gains/losses/contributions/forfeitures by the Designated Beneficiaries' interests in the account prior to division. See Treas. Reg. 1.401(a)(9)-8, A-2(a)(2), A-3 for details. This should be the case if the Designated Beneficiaries' interests are defined in terms of fractions or percentages. This would not typically be the case for a recipient of a pecuniary gift, unless the beneficiary designation provides for the pecuniary gift to share in gains/losses, or state law provides for that effect. If that is not the case,

[14] Under the 5-year payout, there are no MRDs until that final year, in which the entire account is an MRD. Treas. Reg. 1.401(a)(9)-3, A-1(a), 54.4974-2, A-3(c).

[15] The election to create separate accounts is generally effective for the following years. Treas. Reg. 1.401(a)(9)-8, A-2(a)(2). However, if the election is made either in the year of the participant's death or the following year, then the election will be effective as of January 1st of the year following the participant's death. T.D. 9130, 2004-26 IRB 1082.

[16] This assumes that there is no beneficiary whose interest in the qualified retirement account would deem the participant to have failed to provide for a Designated Beneficiary, with the result of MRDs for all beneficiaries being based upon the participant's own life expectancy (if his/her death occurred after his/her RBD) or the 5-year rule (if his/her death occurred before his/her RBD). To ensure that will not be the case, it is vital that (i) interests of nonindividuals (including a Trust that does not qualify as a "see-through" trust) and (ii) pecuniary gifts that do not share pro rata in pre-division gains/losses be eliminated by distribution or disclaimer before the Beneficiary Finalization Date.

the pecuniary gift must be satisfied by Beneficiary Finalization Date in order for the remaining recipients to be entitled to create separate accounts.

Note, multiple beneficiaries who receive their shares of the qualified retirement account via a revocable management trust/estate can establish separate accounts for all MRD purposes, except that an individual beneficiary will not be able to use his/her own life expectancy for purposes of calculating MRDs for his/her share of the account unless he/she is the oldest beneficiary of a "see-through" trust whose life expectancy is used for determining MRDs. Treas. Reg. 1.401(a)(9)-4, A-5(c); PLRs 200317041. Consequently, if the participant wants to provide for separate individuals or "see-through trusts" created under the revocable management trust/Will to share in the qualified retirement account and give each individual (or trust beneficiary) the ability to calculate MRDs for his/her (or his/her Trust's) share of the account using his/her life expectancy, then the division of the account among those individuals (or Trusts) should be set out in the beneficiary designation.

VII. Income Taxation of Retirement Benefits Paid to Trust.[17] Generally, benefits distributed from a retirement account (considered "income in respect of a decedent" or "IRD") are taxable to a Trust when received and are taxed as ordinary income (except to the extent of a nontaxable recovery of basis), unless the Trustee subsequently distributes the benefits to an individual or charity and receives a deduction in the process.[18] This will be the case, regardless of whether the Trust qualifies as a "see through Trust," which only has significance for determining how MRDs are to be calculated.

Since Trusts and estates reach the highest marginal rate of 35% quickly (at $11,200 for 2011), it is may be preferable to arrange for a beneficiary to pay the associated deferred income taxes. This may be done in several ways.[19]

A. Distribution of Benefits to an Individual Beneficiary. The Trustee may be able to distribute out the benefits to a beneficiary either under a mandatory provision (e.g, a conduit trust) or a discretionary distribution (under a met HEMS standard). This is often a beneficial arrangement since individuals only reach the top marginal rate in 2011 with taxable income of $373,650.

A Trust will commonly be entitled to an income tax deduction under IRC 651 and 661 if the following six requirements are met and the retirement account distributions consequently become part of the Trust's distributable net income (or "DNI"). IRC 643(a), Treas. Reg. 1.663(c)-5. Examples 6 and 9. In that event, the recipient will include the distributed benefits in his/her taxable income pursuant to IRC 652/662.

There are six requirements that must be met in order for a Trust's distribution of retirement benefits to carry out the income tax burden to the recipient beneficiary as DNI:

1. Trust must authorize the distribution. The beneficiary must be entitled to receive the funds in accordance with the trust instrument/Will. Consequently, if distributions are permitted under a HEMS standard, some of the benefits may still be taxed to the Trust if the Trustee cannot justify distribution under the HEMS standard of all the received benefits. See Texas Trust Code Section 116.172 for the rules applicable in determining how funds received from a retirement account are to be divided between income and principal and consider the impact on the applicable distribution standard (e.g., if a beneficiary is entitled to only distributions of income, part or all of the IRD received by the Trust may be taxed solely to it if allocable in part or entirely to principal).[20]

2. Income Required to be Distributed/Actually Distributed in the Year of Receipt. The DNI deduction is available only for gross income required to be distributed, or actually distributed, to the recipient in the same year the benefits were received by the Trust (or within 65 days subsequent to the end of the year of receipt, if the Trustee makes the IRC 663(b) election). If distributions are discretionary, this means the Trustee

[17] The income taxation of benefits paid to an estate is generally the same as the treatment of benefits paid to a trust.

[18] For purposes of this outline, it is assumed that an IRA or employee benefit plan holds only pre-tax money so that the account will be entirely taxable when it is distributed.

[19] The recipient will get the benefit of the IRC 691(c) deduction to the extent IRD is carried out. To the extent IRD is retained by the Trust, it will retain a proportionate benefit of the IRC 691(c) deduction. See Section V.A above for a discussion of the IRC 691(c) deduction.

[20] Generally, under Texas Trust Code 116.172 the portion of an MRD from an IRA allocated to income is equal to 4% of the IRA's value as of December 31st of the prior year. The rest of the MRD is allocated to principal. Other distributions from the IRA (i.e., an amount voluntarily withdrawn by the Trustee/not MRDs) are generally allocated entirely to principal. Of course, the trust agreement can provide to the contrary, and the Trustee may exercise the power of adjustment to the contrary.

must take action before the deadline.

3. <u>DNI Allocation When Separate Share Rules Applicable</u>. Treas. Reg. 1.663(c)-2(b)(3) provides that it "governs the allocation of the portion of gross income includible in distributable net income that is income in respect of a decedent within the meaning of section 691(a) and is not income within the meaning of section 643(b). Such gross income is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts."

Treas. Reg. 1.663(c)-2(b)(3) has generally been interpreted to mean that discretionary non pro rata funding of distributions of the trust that are made in "substantially the same manner as if separate trusts had been created" (and thus are considered separate shares) will produce the same result as mandatory pro rata funding. See Treas. Reg. 1.663(c)-3(a). So, for example, if a revocable management trust (i) holds $4,000,000 in nonretirement accounts, (ii) is the Designated Beneficiary of a $2,000,000 IRA, and (iii) is to terminate at the Trustor's death and distribute equally to the Trustor's two children, it is likely that an attempt to partially satisfy one child's share with the entire IRA will only result in the revocable management trust receiving a $1,000,000 DNI deduction.

This result is easily avoided by either transferring the retirement account itself to the child to whom the Trustee wishes to allocate the account, with the result that no gross income is triggered at the revocable management trust level and, consequently, DNI is never created. Alternatively, the other child's share could be satisfied first with the nonretirement account assets so that the revocable management trust will receive a full DNI deduction when retirement funds are transferred by necessity to the child to whom the Trustee wishes to allocate the account.

Note, if the beneficiary of a specific share is required under the trust instrument/Will to receive IRD, then the entire IRD amount distributed to the beneficiary will carry out an equivalent amount of DNI. Treas. Reg. 1.663(c)-5, Example 9.

4. <u>No Carry out of DNI When Retirement Account Transferred To Recipient of Specific or Residuary Bequest</u>. Typically, when the right to receive IRD is transferred to another it will be immediately taxable to the transferor. IRC 691(a)(2). However, a Trust's or estate's transfer of the qualified retirement account itself to a beneficiary in satisfaction of a specific bequest of the account or to the residuary beneficiary does not generally carry out DNI. The beneficiary will be taxable upon IRD as benefits are received from the account. IRC 691(a)(2); Treas. Reg. 1.691(a)-2(a)(3), (b), Example 1; 1.691(a)-4(b)(2), (3).[21]

5. <u>No DNI Deduction for Charitable Distribution</u>. A Trust generally does not receive a DNI deduction for distributions to charity, although the Trust may be entitled to a deduction under IRC 642(c).

6. <u>No DNI Deduction for Certain Pecuniary Bequests</u>. A DNI deduction is not available for distributions in satisfaction of a specific bequest (as opposed to a pecuniary bequest) unless the trust instrument/Will requires that the distribution be paid in more than three installments. IRC 663(a)(1), Treas. Reg. 1.663(a)-1.

As noted above, there is the possibility of a transfer of a retirement account in satisfaction of a pecuniary bequest (e.g., a gift of the deceased spouse's unused estate tax exemption amount to the Bypass Trust) resulting in an immediate recognition of the associated deferred income.

B. <u>Distribution of Benefits to a Charitable Beneficiary</u>. A Trust may also be able to avoid taxation of retirement benefits at the top marginal rate by distributions to charity, if permitted under the trust instrument/Will. IRC 642(c).

C. <u>Income Tax Implications of Funding Bequests With an Assignment of Income in Respect of a Decedent ("IRD").</u>

1. <u>Chief Counsel Advice 2006-44020</u>. Generally, if a person/entity in receipt of IRD transfers it to another, the IRD is immediately taxable to the transferor, unless it was transferred in "transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent." IRC 691(a)(2).

In Chief Counsel Advice 2006-44020, the IRS takes the position that a transfer of an interest in an IRA to a beneficiary by a Trustee in satisfaction of a pecuniary

[21] Similarly, the transfer of a retirement account by an estate to the residuary beneficiary or a beneficiary who is the recipient of a specific bequest of the account is a nontaxable transfer.

bequest triggered realization by the Trust of income under IRC 691(a)(2). The IRS's citing of Kenan v. Comm'r, 114 F.2d 217 (2d Cir. 1940) in support of its position is questionable since Kenan involved a transfer of appreciated property (not IRD) in fulfillment of a pecuniary bequest and, consequently, regarded IRC 663.

2. PLRs Seeming Inconsistent with Chief Counsel Advice 2006-44020. Natalie Choate, a noted expert on retirement benefits planning, believes the IRS is incorrect in its conclusions in Chief Counsel Advice 2006-44020. Choate believes there are at least two situations in which IRC 691(a)(2) requires that the funding of a pecuniary bequest under a revocable management trust/Will by the Trustee/executor via a transfer of a retirement account not result in an immediate recognition of IRD. Scenario #1 concerns a trust instrument that requires that the retirement account be used to satisfy the subject pecuniary bequest. Scenario #2 involves a situation in which the fiduciary must use the retirement account to satisfy the pecuniary bequest because no other asset is available (effectively making the distribution of the retirement account a bequest from the decedent).[22]

Choate cites several instances in which the IRS has permitted surviving spouses to roll over benefits paid to them in satisfaction of a pecuniary bequest as evidence of the IRS having applied IRC 691(a)(2) in a manner consistent with her interpretation of it (although IRC 691(a)(2) was not mentioned in the rulings). See 9608036, 9623056, 200940031, 200943046 (none of which mention IRC 691(a)(2)). Choate reasons that if the transfer of retirement accounts in the PLRs had been treated as "sales" consistent with Chief Counsel Advice 2006-44020, the transfers would have resulted in immediate recognition of income and, consequently, would have left nothing for the surviving spouse to roll over.

3. Discretionary Funding of Pecuniary Bequest With IRD Likely Results in Income Recognition. Choate concedes that a discretionary transfer of a retirement account in satisfaction of a pecuniary bequest may result in income being realized immediately under 691(a)(2), although there are still many practitioners who feel otherwise. If you face this situation, tread carefully.

NOTE: The scope of this presentation makes it necessary to omit any discussion of (i) nontaxable distributions from a retirement account, (ii) a Trust's distributions to charity and the IRC 642(c) deduction, (iii) deemed distributions of retirement accounts resulting in taxation of the affected benefits to the account beneficiary (e.g., use of an IRA for a loan or investment of it in collectibles), (iv) special averaging of "Lump Sum Distributions" from qualified retirement plans, (v) death benefits payable in the form of life insurance, (vi) taxation of annuities, (vii) rules applicable solely to IRC 403(b) accounts, (viii) TEFRA 242(b) elections, (ix) the 50% penalty for failure to take timely MRDs and possible remedies, (x) rules applicable solely to Roth IRAs, and (xi) MRDs or any other aspects of defined benefit plans or defined contribution plans that have been annuitized.

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[22] Note, there is no 691(a)(2) issue if the pecuniary bequest is provided for in the beneficiary designation for the retirement account.