IT SHOULD NOT BE THIS HARD:
A LOOK AT TRUSTS AS BENEFICIARIES OF RETIREMENT BENEFITS

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- B.B.A., The University of Texas (Major: Accounting) (1962)
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PUBLICATIONS & SPEAKING ENGAGEMENTS:

Extensive speaking in estate planning and employee benefits areas, including programs for University of Notre Dame, American Law Institute-American Bar Association (ALI-ABA), American Bar Association, New York University Institute on Federal Tax, New York University Estate Planning Institute, State Bar of Texas, Southwestern Legal Foundation, UCLA-CEB, University of Texas, American Institute on Federal Taxation, Texas Society of Certified Public Accountants, and the American College of Trust and Estate Counsel.

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Active in the legislative activities for the Real Estate, Probate & Trust Law Section and the Texas Academy of Probate Lawyers.

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Wife - Mary Ann Golden. Married February 5, 1966. Mary Ann has been active in the Austin Women's Symphony League, Laguna Gloria Art Guild, and the Women's Club. She is a breast cancer survivor.
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IT SHOULD NOT BE THIS HARD: A LOOK AT TRUSTS AS BENEFICIARIES OF RETIREMENT BENEFITS

I. SCOPE AND PURPOSE. This paper deals with the rules and uses of trusts and the seemingly unnecessary difficulties in doing so. A relatively complete discussion of many of the rules surrounding designated beneficiaries and the Retirement Equity Act of 1984 (REA) are included for the sake of completeness, although not all provisions are germane to the use of trusts as beneficiaries. No discussion will be had concerning Internal Revenue Code §403(b) plans or §457 governmental plans. And, even though funding of pecuniary bequests with IRD raises interesting issues, those isues are not limited to retirement benefits and thus are not discussed.[1]

A. SOME STATISTICS. Much of the wealth of our clients is invested in retirement plans. As of December 31, 2007, there were $17.6 trillion in retirement plans. Of that amount, $4.7 trillion was in IRAs, $4.5 trillion was in Defined Contribution Plans, and $2.4 trillion was in Defined Benefit plans. The balance was in government plans

B. FAILURE TO COORDINATE. One of the most frequent mistakes estate planners make is the failure to coordinate wills and trusts with retirement plans. The most carefully drafted wills and trusts may turn out to be virtually useless if the same care and attention is not paid to the beneficiary designation and the follow up to assure that it will be effective.

II. SOME GENERAL TERMS AND RULES. Unfortunately, some time must be spent on the arcane and non-intuitive rules and definitions which surround and encompass planning with retirement benefits.

A. THE PRIME DIRECTIVE – READ THE PLAN. Although it may be difficult for your client to understand why it is necessary for you to review the plan, such reading is vital, especially with qualified plans. All of the rules set out below – particularly those involving payment options and beneficiary designations – are statutory and represent options that may or may not be available under the plan itself. Because plan documents are lengthy and complex (and contain many provisions that are obviously irrelevant to the planner, a review of the current Summary Plan Description (SPD) should be sufficient.[2] If you review the IRA and it has unfavorable terms, you can always get a new custodian by a direct trustee-to trustee transfer.

B. THE SECOND PRIME DIRECTIVE – KEEP A COPY.

1. IRAs. Advise your client to keep a copy of the IRA Agreement. With all that is going on in the financial sector, it is highly likely that the custodian will not be able to find the agreement that your client signed. And that is the agreement which governs the IRA.

2. Beneficiary Designations. When you prepare a customized beneficiary designation, especially for an IRA, you must assure (or have your client assure) that the custodian or plan administrator signs off and accepts it. You and your client should then be sure to keep a copy for the reasons noted above.

3. Website Beneficiary Forms. A new problem has developed with respect to being able to create customized beneficiary designations. HR departments for many large organizations have begun posting beneficiary designation forms online with no way to complete them other than to fill in the names of the beneficiaries. Inquiries to HR are met with the response that the online form must be used.

C. OVERVIEW OF IRC §401(A)(9) Treas. Regs. §1.401(a)(9)-1. The rules concerning required distributions and designated beneficiaries are contained in §401(a(9)[3] and the Regulations thereunder. To understand those, it is necessary to understand the language and terms of these complex rules.

1. Participant or Owner. Technically the person who is an employee is a "participant" in a qualified plan, while the person who establishes the IRA is more correctly described as the "owner". These terms are often used interchangeably, and will be so used in this paper, unless otherwise specifically indicated.

2. Required Beginning Date ("RBD"). At some point (except for Roth IRAs), the rules require the owner or beneficiary to take the funds out of the tax deferred solution. Except for a less than 5% owner-participant in a qualified plan who is still employed, the RBD is April 1 in the year following the year in which the participant attains age 70-1/2. The RBD for the less than 5% owner who has not retired is April1 of the year following his retirement.

[1]Any other issue not discussed was also intentionally omitted.

[2]The cases go both ways on the issue as to whether the Plan or the SPD controls if they conflict.

[3]IRC §408(a)(6) makes the §401(a)(9) rules applicable to IRAs.

3. First Distribution Year. Even though the participant must begin taking distributions by April 1 of the year following the year in which she attains 70-1/2, that distribution relates to the year in which she actually attains age 70-1/2, so that if the first distribution is taken in the year containing the RBD, a second distribution is required for that year.

4. Required Minimum Distribution ("RMD"). The RMD is the minimum distribution required of the participant, determined by dividing the remaining life expectancy (determined under the appropriate table) of the participant into the value of the account (usually the December 31 of the year preceding the RMD. There is no RBD for 2009 under the Workers, Retirees and Employer's Relief Act of 2009, amending IRC §§401(a)(9)(H)(i).

5. Beneficiary Designation Date. The Beneficiary Designation Date is September 30 of the year following the year of the owner's or participant's death. The period between death and the Beneficiary Designation Date is sometimes referred to as the "shakeout period". This period allows some time for post-mortem planning to get rid of beneficiaries who might prevent a stretch-out of the benefits by causing there to be no Designated Beneficiary or a beneficiary with a shorter life expectancy.

6. Designated Beneficiary ("DB"). Designated Beneficiary is a term of art. The DB must be named either by beneficiary or by the plan document, and not under state law or by a dispositive document. ("as stated in wills" was determined not to create a designated beneficiary. PLR200849020.) Additionally, and most importantly, the DB need not be the only beneficiary, but rather the DB is the oldest beneficiary, *i.e., the DB is the measuring life for determining the period over which the RMD's will be taken.*

7. Rollovers. A true rollover is one in which the funds are distributed to the participant or beneficiary and that person deposits the fund to a different account which is qualified to receive tax deferred funds and maintain their tax deferred status. It must be completed within 60 days of the receipt of the funds. Only one rollover may occur within any 12 month period.

8. Direct Rollover or Trustee-to-Trustee Transfer. While "rollover" is also used to describe a transfer from one fiduciary to another, these type transfers are more accurately described by the title of this paragraph. In this transaction the funds never come into the hands of the participant or beneficiary.

D. SPEED OF DISTRIBUTION. During the participant's life, after the participant attains her RBD, the RMDs are paid out over the participant's life expectancy. However, after the participant's death, the payout period depends upon whether there is a designated beneficiary, and if not whether the participant dies before or after her RBD.

1. With a DB. If there is a DB, then the RMDs are paid out over the life expectancy of the DB. (There are special rules if the spouse is the DB, but those rules are beyond the scope of this paper.) IRC §401(a)(9)(A).

2. Without a DB. If there is no DB, then the payout period depends upon whether the participant died before or after her RBD.

a. *Death Before the RBD.* If the participant died before her RBD, and there is no DB, then the plan benefits must be distributed under the 5 year rule, *i.e.,* that is by December 31 of the fifth year following the year of death. IRC §401(a)(9)(B)(ii). If the five year period includes 2009, it is extended to six years. Workers, Retirees and Employer's Relief Act of 2009, amending §§401(a)(9)(H)(ii)(II).

b. *Death After the RBD.* Death after the RBD causes the benefits to be paid out under the"at least as rapidly rule", *i.e.,* over the remaining life expectancy of the deceased participant. IRC §401(a)(9)(B)(i).

E. TRUSTS AS BENEFICIARIES. As a general rule, only individuals can be DBs. However, individual beneficiaries of certain trusts can be treated as DBs, if the trust meets certain requirements. Tres. Regs. §1.401(a)(9)-4, A-5(b).

1. See Through Trusts. A trust which qualifies to have one of its beneficiaries treated as a DB is commonly known as a "See Through Trust". If the trust is not a conduit trust (see below), then the oldest beneficiary is treated as the DB if all beneficiaries of the trust are individuals. The requirements are as follows:

a. Must be valid under state law or would be except for having no corpus

b. Irrevocable on or before death – allows testamentary trusts or revocable I-V trusts that become irrevocable

c. Beneficiaries must be identifiable

(1) Class beneficiaries can be identifiable

(2) From the trust, not by operation of law

d. Documentation must be delivered to plan administrator or plan trustee by October 31 of the year following the year of death (31 days after Beneficiary Designation Date). This requirement can be satisfied by –

(1) Delivering a list of beneficiaries with a description of entitlements; OR

(2) A copy of the trust[4]

2. Conduit Trusts. A specific type of see through trust is the conduit trust. The distinctive feature of a conduit trust is that it must require that all distributions from the retirement plan or IRA must be distributed to a named beneficiary. In that case, the beneficiary receiving the distributions will be treated ass the DB. There may be more than one beneficiary of a conduit trust, in which case the oldest beneficiary is treated as the DB.

F. SEPARATE ACCOUNTS. The beneficiary designation, and only the beneficiary designation[5], can create separate accounts so that each account can have its own DB.

1. Multiple Individual Beneficiaries. A beneficiary designation which provides that the benefits are to be paid in equal shares to A, B, and C automatically creates separate accounts, assuming that the accounts are set up in a timely manner, by December 31 of the year following the year of death of the participant and all income and expense are allocated pro-rata among the accounts.

2. Single Trust as Named Beneficiary. On the other hand, if a trust is named as the beneficiary, and the trustee is directed to divide the trust into three separate trusts, one for A, one for B, and one for C, the trustee cannot create separate accounts because they are not created by the beneficiary designation.

3. Multiple Trusts. If the beneficiary designation names separate trusts, then separate accounts can be established.

G. TRUSTEED IRAS. Although most IRAs are custodial IRAs, it is possible to have an IRA which is in itself a trust. Thus, an instruction to the trustee to create separate trusts will also allow the creation of separate shares.

1. Why Not More Frequently Used? There are really three primary reasons that trusteed IRAs are not used. One is that practitioners are somewhat leery of creating them even though the IRS has promulgated Form 5305 which incorporates the language required and gives lawyers the ability to augment those terms. (Many of the administrative provisions you always put in your trust instruments are omitted from the Form 5305. Second it is hard to find a trustee who will let you alter their prototype plan. (A somewhat bureaucratic approach because of the flexibility of Form 5305.) However, the main reason that practitioners do not do more of these is that clients are reluctant to pay the cost of drafting since the custodian will provide the plan documents without cost.

2. Creditor Protection. The trust may be creditor protected under the spendthrift trust rules rather than relying on state IRA statutes or the Bankruptcy Act, as the case may be.

III. USE OF TRUST AS BENEFICIARY GENERALLY.

The IRS seems to have a general suspicion of trusts as a beneficiary, and seems determined to make them difficult to use as a beneficiary. Except in the case discussed in the community property section below, either the beneficiary designation or the document establishing the trust or trusts as beneficiary should give the trustee instructions as to how to allocate the retirement benefits.

A. CAVEATS. If the trust is not a conduit trust, care must be taken in naming the beneficiaries of the trust to be certain that the primary beneficiary is the designated beneficiary so that the distributions can be made over the life expectancy of that person.

1. Powers of Appointment. A general power of appointment in the primary beneficiary will result in no DB because the oldest beneficiary cannot be identified. A special power of appointment must be limited to takers younger than the primary beneficiary or the oldest possible appointee will be the DB for purposes of determining the measuring life. A charity cannot be the designated be a possible appointee or there will be no DB.

2. Remote Takers. As discussed below, care must be taken in naming beneficiaries who have only a remote chance of taking. They may still be counted. In PLR 200208025, the beneficiaries were two minor grandchildren in trust, until each attained age 30, but if they both died before attaining age 30, then to the 67 year old uncle. The IRS ruled the 67 year old uncle was the DB as a contingent beneficiary.

B. CONTINGENT BENEFICIARIES. Contingent beneficiaries are taken into account in determining the identity of the DB, even though. Trust lawyers would not describe all such beneficiaries as contingent. For example, in a beneficiary designation which provides "to my wife for life, then to my children, and at the death of my last child to The University of Texas", the charity is treated as a contingent beneficiary and thus prevents the trust from having a DB because a charity cannot qualify. There seems to the author to

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[4]The author is at a loss to understand why anyone would deliver a list rather than the trust. Privacy notwithstanding, there is always the chance for an error in the preparation of the list.

[5]It is possible that the plan could create separate accounts if the default beneficiary was, for example, the children of the participant, but in almost every case, the default beneficiary is the estate of the decedent.

nothing "contingent" about the charity's interest. Treas. Regs. §1.401(a)(9)-5, A7(a)(1).

C. SUCCESSOR BENEFICIARY. A successor beneficiary, on the other hand is one whose right to receive benefits depend upon surviving the person(s) who would take if all benefits were to be distributed. Treas. Regs. §1.401(a)(9)-5, A7(c)(1). For example: "To my spouse for life and then outright to my children. And if none of my children are surviving, to The University of Texas" makes the charity a "successor beneficiary", one who is not counted in determining the identity of the DB. This gift sounds a lot more "contingent" than the Service's definition of "contingent beneficiary". The distinction between "contingent" and "successor" beneficiaries would appear to be that in the case of a successor beneficiary, someone is named as an outright taker, and, only by surviving that outright taker, is a beneficiary a mere successor. But, as long as there is a contingency of survival before taking (and isn't there always?) the ultimate taker is a contingent beneficiary.

D. A REAL LIFE EXAMPLE. It is very easy to create problems when trusts are drafted without understanding the DB rules and their subtleties.. For example, participant dies and designates her RMT as the beneficiary of her IRA. The terms of the trust provide that the trust shall continue for the life of the son, who is 15 at the date of her death. Income and principal is to be distributed on a HEMS standard. At son's death, trust goes to his issue in trust until they are 21. (Obviously there is no issue now, and no guarantee that there will be any.) If son dies without issue, then the trust terminates in favor of an inter-vivos trust established for decedent's brother during his life, and at his death to his issue, per stirpes. Presently the brother has two children ages 13 and 15, neither of whom have children. Because the beneficiaries of the brother's trust are contingent beneficiaries as defined above, they must be counted in determining the DB. Assuming that the brother's trust is a see-through trust, the brother (age 52) is the DB.

E. RETIREMENT EQUITY ACT. Before a married participant in a qualified plan can name a trust as the beneficiary of the plan, the participant must waive the prescribed statutory benefit of a qualified pre-retirement survivor annuity or a qualified joint and survivor annuity, and the spouse of the participant must consent to such waiver. *See* discussion at Article VIII, below.

IV. QTIP TRUST. Although, for convenience if nothing else, the IRA is often left outright to the surviving spouse, there are planning situations in which the use of a QTIP trust is preferable. For example, if the IRA is a major asset of the estate, a QTIP trust might be used in a second marriage situation, if the surviving spouse is a spendthrift, or to assure that, even if the surviving spouse remarries, the remaining assets will descend to the children of the marriage.

A. CONSIDERATIONS IN USING QTIP TRUSTS. In addition to the complexities brought about by IRS rules and the drafting issues, both of which are discussed below, there are several other considerations in choosing a QTIP trust.

1. Choice of Trustee. If the purpose of the trust is to avoid the surviving spouse having control of the trust, a third party trustee must be used. This gives the trustee the ability to make principal distributions in accord with a standard (or maybe even totally discretionary) so that the spouse can be provided for without being in control. Even if a conduit trust is used, a third party trustee will avoid the issue of the spouse making withdrawals in excess of the RMD (or all the income, as the case may be.)

2. Income tax Considerations. If the spouse is in a lower income tax bracket, then the use of the QTIP may cause a higher income tax if it is not a conduit trust, because all distributions from the IRA will be income to the trust.

3. Estate Tax and Creditor Protection. There is no estate tax benefit nor any creditor protection in using a QTIP trust in Texas.

4. Spousal Consent. If benefits are in a qualified retirement plan, the participant must waive the required annuity under the Retirement Equity Act and the spouse must consent to such waiver.

B. RULES SURROUNDING QUALIFICATION OF QTIP. If the beneficiary of the retirement benefit is a QTIP trust, a myriad of special rules surround that trust, primarily those surrounding qualification. The Internal Revenue Service issued Rev. Rul 2006-26, 2006-22 I.R.B. 939 (5/30/2006), to deal with marital deduction issues raised (at least in the Service's view) by the adoption of the Uniform Principal and Income Act. In actuality, the Ruling does nothing more than reiterate the Service's long-standing position first set forth in Rev. Rul. 89-89, 1989-2 C.B. 231, obsoleted by Rev. Rul 2002-2, that the IRA and the QTIP trust are separate trusts and that both must meet the all income requirements.

C. A LITTLE HISTORY.

1. Revenue Ruling 89-89. In Rev. Rul 89-89, the Service postulated an irrevocable beneficiary designation which required that the account balance as of decedent's death must be distributed to the trust in equal annual installments over the surviving spouse's life expectancy. The income earned on the undistributed portion of the account balance received during the calendar year was required to be distributed to the trust annually, by the close of the calendar year. On the surviving spouse's death, any undistributed balance

of the IRA was required to be distributed to the trust. Under this set of facts, the Service ruled that both the IRA and the QTIP Trust qualified for the marital deduction since all of the income on both the undistributed portion of the IRA and the distributed portion were payable to the surviving spouse. There was no comment about the provision which required that the IRA be paid to the trust at the surviving spouse's death.

2. Revenue Ruling 2002-2. Rev. Rul. 89-89 was obsoleted by Rev. Rul. 2002-2, 2000-3 I.R.B. 305 (1/18/2000). In that Ruling, the decedent's IRA was payable to the trustee of a QTIP trust over the life expectancy of the surviving spouse in accordance with the Treas. Regs. §1.401(a)(9). The trust also met the requirements of the Regulations to make the QTIP trust a "designated beneficiary".[6] The spouse had the ability to compel the trustee to withdraw from the IRA any amount of income in excess of the required minimum distribution and to pay such amount to her. The Service states its conclusion as follows:

> Under the terms of the testamentary trust, [spouse] is given the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all the income earned on the assets held in the IRA and pay that amount to [spouse]. If [spouse] exercises this power, the trustee must withdraw from the IRA the greater of the amount of income earned on the IRA assets during the year or the annual minimum required distribution. Nothing in the IRA instrument prohibits the trustee from withdrawing such amount from the IRA. If [spouse] does not exercise this power, the trustee must withdraw from the IRA only the annual minimum required distribution.
>
> [Spouse's] power to compel the trustee's action meets the standard set forth in section20.2056(b)-5(f)(8) for the surviving spouse to be entitled to all the income for life payable annually. Thus, [spouse] has a qualifying income interest for life within the meaning of section 2056(b)(7) in both the IRA and the testamentary trust. Furthermore, [spouse] has a qualifying income interest for life in the IRA and the testamentary trust for purposes of sections 2519 and 2044 . Because the trust is a conduit for payments equal to income from the IRA to [spouse], decedent's executor needs to make the QTIP election under section 2056(b)(7) for both the IRA and the testamentary trust

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D. THE PRESENT RULES. In Rev. Rul. 2006-26, modifying and superseding Rev. Rul. 2002-2, the Service still clings tenaciously to the concept of the IRA as a "trust" separate from the QTIP trust and that the IRA must itself qualify as a QTIP trust which requires a separate election. This ruling postulates three different situations and then determines the effect of each of them.

1. Facts. *A* dies, survived by spouse *B* with an IRA which names the trustee of a testamentary trust designed to qualify as a QTIP trust as beneficiary of the IRA. *B* is the income beneficiary of the trust, with children as remainder beneficiaries.[7] The trust meets all the technical requirements of Treas. Regs. §1.401(a)(9)-4, Q&A- 4 and 5. The spouse has a power, as in Rev. Rul. 2002-2, to compel the trustee to withdraw all the income from the IRA and to distribute such income to *B*. If the required minimum distribution exceeds the income of the IRA, any excess is allocated to principal, so that the trust in this ruling is not a conduit trust.

2. Situation 1 - Authorized Adjustment Between Principal and Income. The trust in this situation is governed by the laws of a state which has adopted the Uniform Principal and Income Act (UPIA) as well as the Uniform Prudent Investor Act.

a. *Facts.* The state's version of UPIA contains §104(a) allowing the trustee to make adjustments between principal and income, if such adjustments are necessary to fulfill the trustee's duty of impartiality. The state's UPIA also incorporate §409(c) which provides that required distributions from an IRA to a trust which are not characterized as interest,

[6]The Ruling states that the remainder beneficiaries under the trust were the children of the decedent, and that "no other person had a beneficial interest in the trust." That would seem irrelevant to the trust's status as a designated beneficiary since the trust is a "conduit" trust.

[7]Once again, the Service asserts that no person other than *B* and the children have an interest in the trust adding "(including any contingent beneficial interest)". My unconfirmed suspicion is that the gift to the children is on a *per stirpes* basis. At least in this Ruling, the trust is not a conduit, so that may be a relevant fact in determining whether the trust can have a designated beneficiary and who is the measuring life.

dividends or rent[8] are to be allocated 10% to income and the balance to principal. UPIA also directs in §409(d) that, if additional allocations of income are required to qualify the trust for the marital deduction, such excess allocation shall be made.[9] For each tax year, the trustee determines the income of the trust without regard to the income of or the distributions from the IRA.

b. *Analysis.* Because the trustee determines the income of the QTIP separately and in accordance with state law and distributes all such income to the spouse, the Ruling determines that the trust qualifies for the marital deduction. Similarly, since the spouse has the authority to require the trustee to withdraw and distribute the income of the IRA (determined separately) to *B*, the IRA also qualifies for QTIP treatment. In brief, state law provisions, coupled with the power of the spouse to compel distributions of the IRA "income", create a situation in which the marital deduction is available.

c. *Caveat.* The Service cautions, however, that, if the trust does not direct that the income of the IRA must be distributed if the spouse compels withdrawal from the IRA, then the requirements for the marital deduction "*may* not be satisfied" (emphasis added) unless the trust waives the application of UPIA §409(c).

AUTHOR'S NOTE: Texas did not adopt §409(c) of the Uniform Principal and Income Act, but rather maintained its approach under prior law (although clarified) of using a 4% unitrust approach to determine income; *i.e.*, 4% of the value of the IRA as of the last valuation date (in most cases) is treated as income with respect to any required payment. *See* Texas Trust Code §116.072(c) and (d). Thus, only if the internal income (however that may be determined) of the IRA is greater than the required payment (or the required payment is less than 4% of the value of the IRA) is there any necessity for the application of Texas Trust Code §116.072(h).[10] The unitrust approach under the statute satisfies the all income test under the §643(b) regulations if the RMD equals or exceeds the unitrust amount. *See* Situation 2 discussed below.

3. Situation 2 – Unitrust Income Determination. Under state law, if the instrument so provides or all beneficiaries agree, income of a trust may be 4% of the value of the assets in a trust, determined annually.

a. *Facts.* In this situation, the trust is a 4% unitrust. The trustee determines 4% of the value of the assets of the trust without regard to the value of the IRA assets. If *B* exercise *B*'s withdrawal right, the trustee will withdraw the greater of 4% of the value of the IRA or the minimum required distribution and distribute at least 4% unitrust amount to *B*.

b. *Analysis.* The state law unitrust amount satisfies the all income requirement of Treas. Regs. §20.2056(b)-5(f)(1) and the reasonable apportionment requirement of Treas. Regs. §1.643(b)-1. Thus, both the IRA and the marital trust qualify as QTIPs. The Service goes on to note that if the state also had the right to adjust in UPIA §104(a), and if the income of the trust were determined under that standard while the income of the IRA were determined under the unitrust standard, or *vice-versa*, each would still qualify.

4. Situation 3 – "Traditional" Definition of Income. The state law in this situation does not include UPIA. The right of withdrawal in *B* and the income of the trust and the IRA are separately determined.

a. *Facts.* The income of both the IRA and the trust are determined based upon a reasonable allocation between income and principal under state law. If *B* exercise *B*'s withdrawal right, the trustee will withdraw the greater of the income of the IRA or the minimum required distribution and distribute at least the income of the IRA to *B*.

b. *Analysis.* Since income is determined under state law, and since *B* has an unfettered right to access the income of the IRA, both the IRA and the trust qualify for QTIP treatment. The Service notes that the same would be true even if the

[8]Minimum required distributions from a custodial IRA are never characterized as to source.

[9]The Ruling characterizes UPIA §409(d) as a "savings clause" and questions whether it would be effective absent the requirement in the Ruling that the income of the IRA be separately determined so that allocation to principal or interest of the amount distributed by the IRA is irrelevant in determining the income to which the spouse is entitled. Ironically, Example 5 of §104 of UPIA contemplates that the power to adjust will be exercised taking into consideration the overall return of the trust, treating the IRA as an asset of the trust and not a separate trust. *See also* official comment to UPIA §409(d). The Uniform Laws Commission (formerly the National Conference of Commissioners on Uniform State Laws) has proposed an amendment to §409(d) to try to meet the IRS's objections. There is a Bill pending in the Legislature this session to amend Texas Trust Code §116.072(h) in conformity with the recommended amendment. See Author's Note, below.

[10]This is a highly unlikely scenario, but could occur, for example, if the surviving spouse were very young so that the RMD was less than 4% of the value of the trust and thus the spouse would be required to withdraw an amount in excess of the RMD.

state law incorporated UPIA §104(a) and the trustee determined not to make the adjustments allowed by such provision.

5. Other Observations.

a. *By the IRS.* The IRS also notes that the result would be the same if the trustee were required to withdraw and distribute all income of the IRA rather than the spouse having a power to compel such action. The same rules apply to defined contribution qualified retirement plans (*e.g.,* a 401(k) plan). At the end of the PLR, the Service reiterates that if distributions from the IRA or qualified plan are accumulated in the trust (*i.e.,* the excess of the minimum required distribution over the income of the trust no matter how determined), then the spouse is not the sole beneficiary, and remainder beneficiaries must be taken into account in determining the oldest beneficiary and whether all beneficiaries are individuals.

b. *By the Author.* For two decades, since Rev. Rul. 89-89, the Service has maintained that the IRA is to be treated as a separate trust from the QTIP rather than an asset of the QTIP. This position makes no more sense today than when it was first promulgated. Perhaps the biggest flaw in the "logic" of this position is that the vast majority of IRAs are custodial accounts, and the custodians do not allocate receipts and disbursements between income and principal, thereby making it difficult if not impossible for the trustee to know what to withdraw. Is it the trustee or custodian's duty to determine the income of the IRA? Additionally, the Service "neatly" solves the problem of taking remainder beneficiaries into account by reciting as a fact that "no other person has an interest in the trust." Those of us who draft trusts or beneficiary designations would have provided for what happens if a child predeceases the surviving spouse.

6. Other State Laws. Not all states that have adopted UPIA have adopted §409(c) as it exists in the Uniform Act. Pennsylvania has adopted a statute which looks at income inside the IRA to determine what portion of a distribution is income. 20 PA. C.S. §8149(c). This would be irrelevant under the Ruling's approach which requires that all income of the IRA, whether distributed by the IRA custodian or not, be available to the spouse. And, this approach does not solve the problems that the custodian does not allocate between income and principal.

a. *Prospective Application.* The Ruling provides that it will be applied prospectively only for taxable years beginning after May 30, 2006 with respect to Situations 1 and 2. It is strange that the effective date is couched in terms of taxable years when the issue is not an income tax issue, but rather qualification as a QTIP trust

E. DRAFTING CONSIDERATIONS. A draftsman should take care that the following provisions are included in the QTIP trust provisions if a qualified plan or IRA is to be paid to the trustee of the QTIP:

1. Withdrawal of Income. The QTIP must direct the trustee to withdraw all the income from the retirement benefit and distribute same to the beneficiary spouse, or, alternatively authorize the spouse to compel the trustee to withdraw and distribute all income from the IRA or plan. To be on the safe side, income should be determined in accordance with the state law governing trusts. (This is the problem, as noted before, with the approach of treating the IRA as a separate "trust".)

a. *Decision as to "Conduit" Approach.* The trustee will be obligated to withdraw the required minimum distribution from the IRA or plan whether it exceeds the income or not. If all the distributions from the IRA or plan are payable to the spouse, then the identity of remainder beneficiaries is irrelevant in determining the qualification of the spouse as a designated beneficiary. If the amount of the required minimum distribution is not to be distributed, care must be taken identifying the remainder beneficiaries, and particular care must be given to any special power of appointment by the surviving spouse so that it is limited to persons younger than the spouse.

b. *Unitrust.* If a conduit trust is not desired, defining the income of an IRA in terms of a unitrust amount, if permitted by state law, could solve several issues. First, it obviates the problem of trying to figure out the income. Second, if only income is to be distributed to the spouse, a 3% unitrust limits the amount of income required to be distributed. (A 5% unitrust would, of course, be more generous.)

2. Spouse as Sole Beneficiary. If the spouse is the "sole beneficiary" of the QTIP (*i.e.,* it is a conduit trust), then the spouse may wait until the participant would have attained 70-1/2 before taking RMDs. But, the spouse must still have the right to take all the income of the retirement plan to qualify for the marital deduction.

3. Separate election on 706. A QTIP election on the 706 must be made for *both* the QTIP Trust and the retirement benefit.

PRACTICE POINT: IF A QTIP TRUST IS UTILIZED, NOTE THAT THE SPOUSE WILL CONTINUE TO BE THE MEASURING LIFE AFTER THE SPOUSE'S DEATH, WHEREAS WITH AN OUTRIGHT BEQUEST AND ROLLOVER, THE CHILDREN CAN TAKE DISTRIBUTIONS OVER THEIR LIFE EXPECTANCY IF NAMED AS THE SPOUSE'S BENEFICIARY.

V. BYPASS TRUST AS BENEFICIARY. In many estates, the IRA or qualified plan is the only (or at least most) substantial asset of the estate. Thus, it is often the only asset available to complete the funding of the Bypass Trust.

A. MOST COMMON PLAN. Rather than naming the Bypass Trust as the outright beneficiary, the more common beneficiary designation if the participant dies first is outright to the spouse with a right to disclaim to the Bypass Trust.

1. Advantages. The primary advantage to this plan is the ability to make the decision at the death of the participant rather than at the time the plan is made. The importance of this can be seen in the recent change in the Applicable Exemption Amount from $2,000,000 to $3,500,000. Assume a community estate of $4,000,000 consisting of an IRA of $2,000,000, a house worth $500,000, and $1,500,000 of securities and cash. Outside of the IRA, there is only $750,000 to fund the Bypass Trust, leaving the SS with an estate of $3,250,00 (the $2,000,000 IRA, the $500,000 house and $750,000 worth of securities). Under prior law, the SS might consider disclaiming the decedent's community one-half of the IRA to fund the Bypass Trust to avoid a taxable estate of $1,250,000.[11] Under current law, the SS would not have a taxable estate, and thus probably would not disclaim.

2. Potential Disadvantage. Of course, the SS might not disclaim, but that should be acceptable because the decedent was willing to leave the SS with that ability. Alternatively, if the disclaimer is made, the benefits of a spousal rollover are lost so that the souse cannot name a beneficiary who will be treated as a designated beneficiary, nor can the spouse wait until the SS attains 70 ½ before taking RMDs. And, the SS must use a less favorable table for determining RMDs.

B. NOT TAX EFFICIENT. Whether the Bypass Trust is funded by a beneficiary designation or by disclaimer, use of the retirement benefit does not ever fully fund the Bypass Trust due to the built in tax liability. It is especially inefficient if a conduit trust is used because there is no chance for accumulation in a transfer tax sheltered environment. And, lastly, because RMDs are required, there may be no funds from the plan left in the IRA.

VI. SPECIAL NEEDS TRUSTS. If a beneficiary is entitled to or may become entitled to government benefits due to a physical or mental incapacity, then obviously such person cannot be the beneficiary of the plan or IRA so that a trust must be used. A special needs trust ("SNT"), by definition, may only be used to provide supplemental benefits to the beneficiary without causing the beneficiary to fail to meet either the asset test or the income test, or both. Thus, SNTs are almost always drafted as totally discretionary trusts, with proper language so that the trustee has guidance as to the purposes for which distributions may be made. If the trust is the beneficiary of retirement benefits, the trust must be an accumulation and not a conduit trust. In PLR PLR 200620025, the Service allowed a court to direct that the IRA benefits payable to a beneficiary on government benefits be paid to a first person SNT, with appropriate terms to preserve the beneficiary's eligibility.[12] Although the beneficiary was not the DB because his sibling, the remainder beneficiary, was older, a stretch-out was achieved.

VII. A COUPLE OF BRIEF WORDS. One cannot discuss trusts as beneficiaries without discussing rollovers and reformations. An in depth discussion is beyond the scope of this paper, but a brief discussion is necessary because trusts are where most of these problems occur.

A. SPOUSAL ROLLOVERS. If a trust (or an estate) is the named beneficiary, and the desire is for the spouse to be able to roll the benefits over into the SS's own IRA, the Service has been very generous in allowing the spouse to do so, if the spouse is the sole beneficiary and is in control of the trust or estate as trustee or executor. *See* PLR 8927042, PLR 9247035, PLR 9515042 (spouse could rollover because trust revocable); PLR 9302022, PLR 9416039, PLR 200052041(spouse had unlimited withdrawal right); and PLR 9426049 (spouse allowed to rollover even though not trustee because spouse had the unfettered right to remove and replace trustee. (Evidently the IRS still does not believe in *Estate of Wall.*)

B. NON-SPOUSAL ROLLOVERS. There is no way a non-spousal beneficiary, can rollover the benefit to his or her own IRA. However, a trust can be a beneficiary of the plan benefits if named as the beneficiary in the beneficiary designation. Notice 2007-7, A-16.

C. REFORMATIONS AND MODIFICATIONS. The IRS has been fairly generous in

[11] Note that the disclaimer can be only as to the decedent's one-half. There cannot be a disclaimer as to the SS's community one-half.

[12] A first party SNT is one created by the disabled person and requires that there be a payback to medicaid for any benefits received during the terms of the trust to the extent that there are assets remaining in the trust. A SNT created by a third party does not need to contain a payback (although I have seen those done for no reason).

allowing post mortem reformations and modifications. The Service has even allowed a reformation of a beneficiary designation. While PLR 200742026 denied a reformation, the facts in that ruling indicated that the failure to have a DB was the fault of the participant. *See* PLRs 200616039, 200616040, and 200616041 (beneficiary designation modified) and PLR 200608032 (court allowed post mortem amendment).

D. DISCLAIMERS. Disclaimers may be used to fix a flawed beneficiary designation by getting rid of older beneficiaries or charities (if their interest is remote enough). Disclaimers may provide a solution to the real life problem in III.D. above.

VIII. THE RETIREMENT EQUITY ACT OF 1984 (REA). It is beyond the scope of this paper to discuss the political and social implications of the Retirement Equity Act of 1984. Suffice it to say that its announced purpose was to protect the interest of the non-employee spouse (in most cases the wife) from disposition of a principal asset of the marital community (not used in a community property context) in a way which would deprive the non-participant spouse of the benefits of that asset. It achieves this purpose by mandating the forms of benefits and the beneficiary, and permitting a change of either form or beneficiary only with the consent of the non-participant spouse. REA applies to the defined benefit plans and defined contribution plans to which the minimum funding standards of §412 apply. The estate planner must be aware of these rules so that he can determine whether the beneficiary designation, if other than that mandated by the statute, is valid. The estate planner should be able to rely on the plan administrator to determine the amount of the benefit.

A. MANDATORY FORMS OF BENEFITS. Subject to the exception is Paragraph 3, below, REA mandates that any plan, to be a qualified plan, must provide a mandatory form of benefit which will be paid to a married participant or his or her beneficiary absent a waiver of such form of benefit by the participant and a consent to such waiver by the participant's spouse.

1. Qualified Joint and Survivor Annuity (QJSA). Section 401(a)(11)(A)(i) mandates that the accrued benefit payable to a participant who does not die before the annuity starting date must be paid in the form of a QJSA. A QJSA is one in which the survivor's annuity is not less than 50% and not more than 100% of the annuity payable during the joint lives of the participant and his spouse. §417(b). A joint and survivor annuity with a minimum term certain should meet these requirements, and the consent of the non-participant spouse should not be required to name an alternate beneficiary for any remaining benefits after the death of the surviving spouse.

2. Qualified Pre-Retirement Survivor Annuity (QPSA). A QPSA is mandated by §401(a)(11)(A)(ii) if the participant dies before the annuity starting date. In a defined benefit plan, the QPSA must be no less than the amount that would be payable as a survivor annuity under the plan's provisions for a QJSA. §417(c)(1). In the case of a defined contribution plan, a QPSA is an annuity for the life of the surviving spouse, which is not less than 50% of the portion of the account balance of the participant (as of the date of death) to which the participant had a nonforfeitable right. §417(c)(2). This means that unless the plan provides a QPSA of a greater amount, only one-half of the participant's vested accrued benefit is subject to the waiver and spousal consent rules. The other one-half may be disposed of by the participant as he or she sees fit. See, e.g. Q&A 4 of Regs. §1.401(a)-20. In determining one-half of the vested accrued benefit, the face value of life insurance is taken into account if the plan is a defined contribution plan. This is true regardless of the amount of the cash surrender value of the policy. Regs. §1.401(a)-20, Q&A 12(b). To the extent that the benefits to which a beneficiary becomes entitled as a result of the employee's death exceed the present value of the non-forfeitable interest of the employee prior to his death, §401(a)(1) and §417 do not apply. Regs. §1.401(a)-20, Q&A 12(a).

3. Exception for Certain Defined Contribution Plans. As noted above, REA applies to defined benefit plans and defined contribution plans. However, certain defined contribution plans are not subject to these rules. §401(a)(11)(B)(iii). If a defined contribution plan provides that the participant's non-forfeitable accrued benefit is payable in full on the death of the participant to the participant's surviving spouse, if such participant does not elect the payment of benefits in the form of a life annuity, and if the plan has not been the recipient of a transfer from a plan which does not qualify for these exceptions (unless such transferred funds are separately accounted for) then the QPSA and QJSA rules do not apply. This leaves the participant free to choose any form of lifetime benefit the participant selects. This would include the right of the participant to select a lump sum distribution with a rollover to an IRA. Since IRAs are not subject to REA, the participant could then designate any beneficiary and any sort of payout (assuming such payout were permitted by the minimum distribution rules) without the consent of the participant spouse. Many, if not most, defined contribution plans (particularly in closely held businesses) are drafted to meet this exception.

4. Plan Loans. Since many technical problems may arise with respect to loans from a participant's account secured by the participant's vested benefits in a plan subject to the QPSA and QJSA requirements, spousal consent is required. §417(a)(4). This consent must be given within 90 days of the "date on which the loan is to be so secured." The requirements of informed consent under §417(a)(2) must also be met. Spousal consent is not required for setoff once the consent to the loan has been obtained or if spousal consent to the loan was not required. This is true even if the consenting spouse is no longer the spouse of the employee. Regs. §1.104(a)-20, Q&A 24(b). Any renegotiation of the loan is treated as a new loan. Regs. §1.104(a)-20, Q&A 24(c).

B. RECIPIENTS OF BENEFITS. REA not only mandates the form of benefits which may be paid, but also directs that such benefits must be paid to a spouse of a participant if one exists. In PLR 8908063, however, the Internal Revenue Service held that no benefit was payable to a spouse who had murdered the participant in the face of a state law prohibiting a murderer from collecting any benefits as a result of the death of the victim. An exception to §§401(a)(11) and 417 was found to exist.

1. Who is a "Spouse." One of the wonderful things about dealing with qualified plans, is that as noted by a character in Alice in Wonderland, "A word means precisely what I say it means, nothing more, nothing less."

a. *Waiting Period.* The plan may define a spouse as one who has been married throughout the one-year period ending on the earlier of the participant's annuity starting date or the date of the participant's death. Absent this provision in a plan, a spouse for purposes of the Retirement Equity Act is a person who was married to the participant on the annuity starting date or the date of the participant's death. §417(d)(1).

b. *Exception.* Despite the one-year waiting period in the plan, if a participant marries within one year of the annuity starting date and is still married to the same spouse for at least one year prior to the date of death, then the participant is treated as having been married throughout the one-year period ending on the participant's annuity starting date. §417(d)(2). If the participant is not married during that one year period, the spouse may lose all benefits. See Regs. §1.401(a)-20, Q&A 25 and 26.

2. Elections by Participants. As noted above, the plans covered by REA must provide a benefit in the form of a QJSA or a QPSA, but unless the plan is fully subsidized, the participant must be given the right to elect other benefits. However, REA circumscribes rather carefully the time in which such elections may be made.

a. *QJSA.* The election date for a QJSA must be within the 90-day period ending on the annuity starting date. The annuity starting date means the first day of the first period for which an amount is payable as an annuity or, if benefits are not payable in the form of an annuity, the first day on which all events have occurred which entitle the participant to such benefit. §417(f)(2). Note that under this definition if the annuity is to be paid quarterly at the end of each calendar quarter, then the annuity starting date is the first day of that quarter because that is the first day of the first period for which an amount is payable.

b. *QPSA.* The period for electing out of a QPSA is after the participant attains age 35. No valid election may be had prior to that time, except that a beneficiary may elect out of a QPSA if he will turn 35 within the plan year even though he is not 35 at the time of the election.

3. Consent by Spouse. Even if the participant elects out of QJSA or QPSA, if the plan is covered by REA, then that election is not effective unless the spouse consents to it. The act imposes several qualifications on spousal consent.

a. *Informed Consent.* In order for the spousal consent to be effective, it must be in writing and must acknowledge the effect of such election. It must also be witnessed by a plan representative or notary public. Further, each plan, within time limits set out in REA, must provide written explanations to the plan participant setting out the terms and conditions of the QJSA and the QPSA provided by the plan, and the effect of spousal consents to any elections out. Prudence would seem to dictate that this same information be provided to the spouse in order to insure informed consent.

b. *Revocability of Consent and Election.* A plan may be written to allow revocation of a spousal consent, but that is not required. Regs. §401(a)-20, Q&A 30. While some commentators would argue that revocation should be allowed to protect the plan administrator from a claim by this non-participant spouse that inadequate information was provided, it is my feeling that revocation should not be permitted so that the participant may rely upon the arrangements that were made.

c. *Requirement of Future Spousal Consent.* The spouse may execute a general consent to the change of beneficiary or form of benefit and thereafter the participant may alter either the beneficiary or form of benefit, or both, without further consent. No such general consent is valid unless it "acknowledges that the spouse has the right to limit consent to a specific beneficiary and a specific optional form of benefit, where applicable, and that the spouse voluntarily elects to relinquish both of such rights." A consent need not be general as to both form and beneficiary. Regs. §1.401(a)-20, Q&A 31(c). Absent a general consent, a spousal consent as to one beneficiary will not operate to permit the participant to change the beneficiary to someone else (other than the spouse). Regs. §1.401(a)-20, Q&A 31(a). The same would be true of a participant's waiver of a QJSA wherein the participant is required to specify the optional form of benefit. [Id., Q&A 31(b)(1)], but not of a waiver of a QPSA [Id., Q&A 31(b)(2)]. Note that general consents prior to October 22, 1986, need not meet the specifics of the Regulations. See §417(a)(2)(A)(i). Further, a waiver of a QJSA (and the spousal consent thereto), is not required to specify the optional form of benefit if executed prior to the first plan year beginning after December 31, 1986.

C. DOMESTIC RELATIONS ORDERS. Recognizing that in modern days, spouses and marital relationships change, REA provides a way in which qualified plan benefits may be allocated between the spouses on divorce. If the plan administrator does not choose to recognize a pre-REA order under REA §303(d)(2), then the domestic relations order must be treated as a QDRO only if the plan is already in pay status. If the administrator refuses to treat the order as qualified, then it will either remain a non-qualified order, bringing state law rights in head to head conflict with federal law, or the parties must return to court and gain an amendment to the order so that it may be qualified as a QDRO.

1. Domestic Relations Order. For a court order to qualify as a qualified domestic order it must first be a domestic relations order as defined in IRC §414(p) and ERISA §206(d)(3).

a. *Identifies Alternate Payee.* The purpose of a domestic relations order in the REA context is to identify the person who is to receive all or a portion of the participant's benefits. In fact, this order creates the right to receive the benefits, assigns the right to those benefits, and sets forth the amount or percentage of benefits to be paid to the alternate payee.

b. *Any Judgment or Order.* A domestic relations order does not need to be an order incident to divorce, but rather is any judgment or order of a court of competent jurisdiction which relates to the provision of child support, alimony payments, or marital property rights with respect to a spouse, former spouse, child or other dependent of a participant and is made pursuant to a State domestic relations law (including community property law). IRC §414(p)(1) and ERISA §206(d)(3)(B). Thus, it can be seen that perhaps a QDRO has application well beyond a divorce or legal separation.

2. May Not Alter Amount of Benefit. Although a great deal can be accomplished with a QDRO, it cannot alter the amount of the benefit ultimately payable under the plan, nor may it alter the form of benefit payable under the plan. Regs. §1.401(a)-13(g)(4)(iii). But see IRC §414(p)(4) and ERISA §206(d)(3)(E).

3. Not Applicable to Certain Plans. A QDRO does not apply to plans which do not meet the anti-alienation provisions of IRC §401(a)(13) and ERISA §206(d)(4). IRC §414(p)(9) and ERISA §206(d)(3)(L). This is stating the obvious in that if there is no prohibition against alienation, it would not be necessary to meet the requirements of a qualified domestic relations order since benefits could be alienated by the participant without the benefit of a court order.

IX. COMMUNITY PROPERTY ISSUES. As we know all too well, community property issues form an overlay to an already complex set of rules. Except where noted, the discussion assumes that the IRA was community property. With respect to qualified plans, the U. S. Supreme Court has determined that ERISA preempts at least the community property rights of the non-participant spouse ("NPS"). *Boggs v. Boggs,* 520 U.S. 833 (1997). There are issues regardless of which spouse dies first, but the greater complexities are produced when the NPS predeceases, so let's begin with the simpler case. The use of revocable trusts in the community property planning context is discussed below.

A. PARTICIPANT SPOUSE PREDECEASES. If the participant predeceases, then, as noted above, the most frequent beneficiary designation is all to the spouse outright with the ability to disclaim into the Bypass Trust. However, this designation will not always be the client's choice. For example, in a second marriage situation, the participant may prefer that the benefits be paid to the Bypass Trust or QTIP Trust, or perhaps solely to a third party, such as the children of the participant by a prior marriage.

1. As to IRAs. There is no federal preemption with respect to IRAs, and REA rights do not apply (even though some custodians wrongly require spousal consent). Therefore, subject to the fraud on the community doctrine, the participant is free to dispose of his or her entire interest in the IRA because the IRA is clearly the sole management community of the participant.

2. As to Qualified Plans ("QP"). QPs are subject to REA, so that, ordinarily, spousal consent must be obtained if anyone other than the spouse

is to be named as the beneficiary, subject to the §401(a)(11) exception noted above. Because §401(k) plans are now the most common plans, and because most §401(k) plans meet such exception, most participants can rollover to an IRA without waiver and spousal consent, and then can execute a beneficiary designation without spousal consent. However, until such rollover occurs, the spouse must be the sole beneficiary of the QP benefit.

B. NPS PREDECEASES. If the NPS predeceases, then a host of problems are presented if the NPS does not leave the NPS's interest to the surviving participant.

1. Boggs and the Questions It Raises. In *Boggs v. Boggs,* above, the NPS predeceased the participant in several plans and left the surviving spouse only a usufruct interest (the Louisiana version of a life estate) in her estate. The participant remarried, and his second wife, to whom he left the plan benefits, survived. The children by the prior marriage sued, claiming the first wife's community interest in the plans.[13] The Supreme Court held that ERISA preempted state community property law and that the NPS had no interest of which she could dispose. The Court further stated that the plaintiffs could not recover an equivalent amount from the other assets of Mr. Boggs's estate, holding that they could not do indirectly what they could not do directly. However, *Boggs* left one issue specifically unresolved and did not even deal with another issue.

a. *Application to Rollover IRAs*. It is still uncertain whether the *Boggs* opinion would apply to an interest rolled over to an IRA before the death of the non-participant spouse. While the opinion talks in terms of "undistributed" benefits, it is not at all clear that such benefits suddenly transmute to community property upon distribution. In fact, the Court itself specifically declines to deal with this issue:

> Both parties agree that the ERISA benefits at issue here were paid after Dorothy's death, and thus this case does not present the question whether ERISA would permit a non-participant spouse to obtain a devisable community interest in benefits paid out during the existence of the community between the participant and that spouse.

Boggs, 520 U.S. at 845. Further, the Court, as noted earlier, concludes its opinion with this comment:

> It does not matter that respondents have sought to enforce their rights only after the retirement benefits have been distributed **since their asserted rights are based on the theory that they *had* an interest in the undistributed pension plan benefits.** (emphasis added)

Id., at 854.

The Court could arguably be saying that if the benefits can be traced to the qualified plan, the non-participant never had a community interest in those assets and thus one could not suddenly arise. The result depends upon the view taken of the meaning of "pre-empted."

One viewpoint (and I suspect that this is the one of majority of community property lawyers) is that the essential character of the property as community property inside the plan is unchanged, and that what was pre-empted was only the non-participant spouse's ability to dispose of the assets at such spouse's death while they remained in QP solution. Thus, when the assets emerge from the plan, they are community property freed of the restriction on the non-participant spouse's right to transfer.

The other argument, somewhat supported by the above quoted language from the Supreme Court's opinion, is that the community character of the property itself is pre-empted. Thus, when classic community property analysis is applied, if the asset was not community property inside the plan, it cannot suddenly "transmute" (absent an agreement in those states which permit such agreements) to community property. In other words, If it was not community property inside the plan, how can it be community property when it comes out of the plan? And this would seem to apply even if the assets were distributed outright (rather than in an IRA) so long as the proceeds can be traced.

While a literal reading of the statutes and *Boggs* might favor the construction that distributions from the plan are not community property, the result is likely to be that the distributed property will be treated as community property. One argument is that the federal purpose has been satisfied once the assets are distributed. The response to that is that the same policy should apply whether the assets are in the plan or not. The more persuasive argument, however, comes after some reflection. Since IRAs are not covered by ERISA, then the character of property, once distributed (whether in an IRA or not) is a state law question. The state courts are

[13] This factual recitation and summary of the opinion are grossly oversimplified. For a complete discussion of *Boggs*, see the earlier outlines of the author for this course.

very likely to protect the state community property law, and to hold that the assets, outside the plan, are community property.

Of course, even if the assets themselves are not community property, the earnings on the assets, will be community property in Texas and Idaho. This would include assets distributed to a rollover IRA unless IRC §408(g)[14] applies. I have long believed that the purpose of this income tax section is to prevent couples in a community property state from double-dipping, by attributing one-half the earnings of the working spouse to the non-working spouse so that two IRAs could be established. (This belief has been confirmed by one Treasury staffer who was responsible for drafting this provision.) *See* discussion of 2009 PLR above.

b. *Reporting Issue and Inclusion in Gross Estate.* After *Boggs,* what is to be reported on the federal estate tax return of the predeceasing NPS? Since the federal estate tax is an excise tax on the privilege of transferring property, it would seem that if the non-participant has no right to transfer, then there is nothing to report on the return.[15] My present view is that the non-participant's interest should not be included in the gross estate, but should be disclosed on the return. A more interesting issue is presented if the participant dies first. Is 100% included in the participant's estate? Logically, it should be if no interest is to be reported on the non-participant's return. Shortly after *Boggs* was decided, Treasury indicated that it was strongly considering promulgating a position that comports with the above -- No inclusion on the non-participant's spouse's return but 100% inclusion on the participant's return. However, Treasury has never provided such guidance.

Is this entire question as to the non-participant spouse's interest academic? After all, even if the non-participant's interest is included in the gross estate, surely it qualifies for the marital deduction because it "passes" by operation of law to the participant. But the non-participant's interest is a classic terminable interest.[16] Even if true, the Service has not been disallowing the marital deduction in a case like this. IRC §2056(b)(7)(C) was amended by inserting the parenthetical phrase "(or in the case of an interest in an annuity arising under the community property laws of a State, included in the gross estate of the decedent under section 2033)" to make clear that the non-participant's interest, if passing to the participant, qualifies for the marital deduction. While some consideration was given to deleting this provision from the Bill in light of *Boggs,* it was decided that there may still be situations in which this problem exists; *e.g.*, §403(b) plans and individual retirement annuities. The committee reports were to make clear that this section is not intended to override *Boggs,* but no such provision was inserted.

2. <u>NPS Disposition of Rollover IRA</u>. Non-rollover IRAs funded during marriage are clearly community property, but except in extremely unusual circumstances, such IRAs are not generally large enough to generate serious tax issues. Therefore, the following discussion assumes a rollover IRA, and also assumes that the rollover is community property, the uncertainty of such characterization of *Boggs* notwithstanding.

a. *Gift in Will to Participant***.** It seems well settled that the NPS can leave the NPS's interest in the participant's IRA to the participant by Will. *Allard v. Frech*, 754 S.W.2d 111 (Tex. 1988), *cert. den.* 488 U.S. 1006, 109 S. Ct. 788 (1989). This resolves any issues as to treatment of the beneficiary since the participant becomes the only one with any interest in the IRA. It is doubtful that a gift to a QTIP trust would accomplish the same thing even if the participant is the trustee.

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[14]§408(g) states: "This section will be applied without regard to community property laws." See discussion of this section below.

[15]*See* Treas. Regs. §20.2033-1(a) which, while noting that federal government bonds which are exempt from income tax are not necessarily exempt from the estate tax, state, "...since such tax is an excise on the transfer of property at death and is not a tax on the property transferred."

[16]IRC § 2039(c), prior to its repeal by the Tax Reform Act of 1986, provided that any interest of a non-participant spouse in a retirement plan, which interest was obtained solely as a result of community property law, was not includable in the estate of the non-employee spouse upon such spouse's death. The result of the repeal of this section prior to *Boggs* was thought to be that the one-half community interest of the non-employee spouse is includable in that spouse's estate if the non-participant spouse predeceases the participant. The Senate explanation of the repeal states, "However, the bill clarifies that, if a transfer is made to an employee spouse by a non-employee spouse in a community property state, the amount transferred is eligible for the unlimited marital deduction (§§2056 and 2523)." No such provision was to be found anywhere in the statutes and no subsequent tax law (of which there have been many) corrects this oversight, except TAMRA's amendment to §2056(b)(7) which is limited to joint and survivor annuities.

b. *Gift to Other than Participant*. It also follows from the holding in *Allard*, that someone other than the participant can be the beneficiary of the NPS's interest. If someone other than the spouse is the beneficiary, then there are many problems and few answers. One would think that there would be clear authority as to the taxation of distributions to the NPS's beneficiaries other than the participant.

c. *Still Unanswered Questions*. If the NPS disposes of the IRA to other than the participant spouse, then there are huge, but answered questions: (1) When must distributions begin to the alternate takers; (2) the flip side of that, when can alternate takers demand distributions; (3) who is the measuring life for such distributions; and (4) who pays tax on such distributions?

3. PLR 8040101. The only direct authority dealing with the passage of an IRA at death is a 1980 private letter ruling, PLR 8040101 (7/15/1980). In that PLR, the Service ruled that the NPS's community interest was transferable to the NPS's beneficiaries and that the distribution was taxable to the beneficiaries. Even though that PLR has stood a long time without challenge, it cannot be fairly assumed that it is the law, if only because of the statutory directive that PLRs are not precedent and do not bind the Service. The ruling does not answer serious questions as to the NPS's beneficiaries: Can they take distributions over their life expectancy, over the participant's life expectancy, under the 5 year rule, or only as a lump sum. Additionally, the §72(t) penalty should not apply because the interest was acquired at death, but there is no real answer.

4. Indirect Contradictory Authority. In *Bunney v. Commissioner,* 114 T.C. 259 (2000), an IRA was divided in a divorce settlement as permitted by Code §408(d)(6). However, instead of delivering one-half of the IRA account to his wife, husband withdrew money and delivered part of that to his wife. The court held that the amount withdrawn was taxable on husband's return (and subject to the §72(t) penalty). In analyzing the case, the court discussed Code §408(g) and determined that the fact that the distribution was community property made no difference – it was nonetheless taxable to the husband-distributee. While there is language indicating that the Tax Court would treat payment to the NPS's beneficiaries the same way, they were not faced with such issue directly. In PLR 9439020, the IRS recognized the community character of an IRA, but stated that a distribution of the NPS's interest to other than the owner, may be a prohibited transaction under IRC §4975(c). *See also* PLR 199937055, discussed below.

5. A Recent Example of How to Plan (Or Perhaps Not). In PLR 200826039 (6/27/2008), the decedent, a participant in two qualified plans, had not reached his RBD. His wife was the executor and testamentary trustee under his Will and was named as beneficiary in her capacity as trustee. The will provided that if Wife had an ownership interest in the qualified plans, then such interest was to be paid to her to the extent it did not pass to her under the beneficiary designation, and the balance was to pass to the Bypass Trust, over which wife had power to make distributions of income and principal for health support and maintenance. The Service ruled that the wife had a community property interest which passed to her under the provisions of the Will and was eligible for a rollover to her IRA.

a. *Some Unanswered Questions*. Under the analysis of *Boggs,* there would seem to be a serious question as to whether the wife had an ownership interest in the qualified plan. However, that seemed to be of no concern to the IRS, raising the question as to whether *Boggs* has any application in the absence of a dispute as to the rights of the NPS.

b. *Why Make It so Hard?* Decedent could have named his spouse as beneficiary with a power to disclaim and achieved the same result much more easily and directly or, at the very least, name the spouse as the beneficiary of one-half, name the Bypass Trust as the next beneficiary,with any excess going to the Marital Trust.

C. AGGREGATE VS. ENTITY THEORY. There has been an ongoing discussion for many years concerning whether the community was a collection of assets which could, under certain circumstances, be rearranged between the spouses at death much as they can be at divorce (the entity theory). Those circumstances would require an agreement between the spouses and a provision in the will allowing the executor to divide the community on a non-prorata basis. This approach is fraught with difficulties if the surviving spouse is not the executor, and with all sorts of fiduciary duties if there are other beneficiaries. The aggregate theory would hold that each asset must be divided between the spouses, and the deceased spouse can only dispose of one-half of each asset.[17] Under the current state of Texas law, the author believes that the aggregate

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[17]Even though Texas Probate Code §177(b) gives the executor control over both halves of the decedent's sole management community property and the joint community, the NPS's community interest in the IRA is not controlled by the executor and the participant's interest is not a probate asset.

theory is the correct approach, although there are some very fine lawyers who take the other view.

X. A (NOT SO NEW) PROPOSED SOLUTION.

If, as would seem to be the majority of cases, the spouses wish for the other spouse to control the IRA after the first death, it would be very convenient in estates with large IRAs if the IRA could be allocated to the surviving NPS as part of the division of the community property so that the Bypass Trust could be fully funded with other assets. One solution is a funded revocable trust which is named as the beneficiary of the IRA, with a specific provision allowing non-prorata in kind distributions. This differs from the estate situation described above in that there is a specific vehicle which vests the control over all the assets in one person with an agreement allowing that person to divide the assets as they see fit because the assets are trust assets and not the property of each spouse in undivided interests.[18]

A. The 1999 PLRs. Three PLRs in 1999 demonstrated that the IRS would approve this technique, although apparently none of them dealt with Texas law because they each recite that there was an agreement between the spouses that all their property was community property, and such an agreement was not allowed under Texas law at that time.[19] The facts in the first two of these rulings are very similar.

1. PLR 199912040. In this ruling, decedent died at the age of 72, with a pourover Will and a revocable trust as the primary dispositive vehicle. All property was community property. There is no statement in the PLR as to how the IRA became subject to the trust, but the language used indicates that decedent owned it at his death. One can only assume then, that the trust was the named beneficiary. The surviving spouse was the trustee of the trust and the executor of the estate. The trust specifically provided for non-prorata distributions in kind. The trust was a standard trust with an irrevocable Bypass Trust and Survivor's trust which contained all of the SS's property and the decedent's community property in excess of that required to fund the Bypass Trust. SS proposed to allocate 100% of the IRA to the Survivor's Trust, which she could revoke and over which she had complete control. It was represented to the IRS that state law allowed non-prorata distributions, but gives no further guidance as to whether it is statutory or common law, and cites no authority.

a. *The* Cottage Savings *Issue.* The first ruling requested was whether this non-prorata funding would be treated as a pro-rata funding followed by an exchange, which would bring it within the ambit of *Cottage Savings Association v. Commissioner*, 499U.S. 554 (1991), causing it to be treated as a sale or exchange and therefore taxable. The IRS determines that the non-prorata funding will not "differ materially" from the required funding of the two trusts, and thus did not constitute a taxable exchange. This was distinguished from the situation in Rev. Rul. 69-486, 1969-2 CB 159, in which the IRS held that non-prorata funding by the trustee based upon the agreement of the two beneficiaries created a taxable event because neither the trust nor state law permitted non-prorata funding.

b. *Tax Free Rollover.* The SS then sought a ruling that the IRA could be distributed from the Survivor's Trust to her, in which case she would rollover the proceeds within 60 days . Because SS was in complete control, the Service, in keeping with other PLRs cited above, held that the rollover (after she took the RMD) would be tax free. The Service held also that the distribution of the IRA to the trust and the subsequent transfer to SS was not a transfer under §691(a)(2).

c. *Unanswered Questions.* The PLR does not tell us what state is involved or whether both the instrument and state law must permit the non-prorata funding or whether the instrument alone is sufficient so long as state law does not prohibit it. Conversely, if state law permits such allocations but the instrument is silent, can this result be achieved? In the former case, I would think so, but in the latter I would think not. The contract between the spouses would seem to be the essential element of this kind of planning.

2. PLR 199925033. This PLR is factually almost identical except that it deals with the rollover rules from a qualified plan, which were not in controversy and as to which no ruling was sought.[20] The result was the same – the transfer of the proceeds to the trustee and the subsequent distribution to the SS was free from income tax so long as the rollover was timely completed. This ruling never cited *Cottage Savings,* but solved the sale and exchange problem by analogizing this transaction to a division on divorce, which had specifically been held to be tax free in Rev. Rul. 76-83.

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[18] California statutorily authorizes this technique, but their statute is less than clear, and the author does not believe statutory authority is necessary, and that Texas law permits this approach.

[19] *See* Texas Family Code, §§4.201, *et seq.*, effective January 1, 2000.

[20] The Service gratuitously cited *Boggs* for the doctrine that state law was preempted but it did not matter because the spouses executed the necessary waivers and consents.

1976-1 C.B. 213. Additionally, the Service found that the Survivor Trust was a grantor trust (SS had a power to revoke) and that a transaction between the Grantor and herself was not recognized as a sale under Rev. Rul 85-13, 1985-1 C.B. 184. Note that this PLR was issued 3 months after the earlier PLR, yet their reasoning is substantially different.

a. *State Law.* This Ruling does not mention whether state law allows this kind of distribution or not.

b. *Spousal Agreement.* This PLR also mentions that the spouse had executed an agreement making all their property community property.

3. PLR 199937065. The taxpayers in this PLR pushed the envelope just a tad too far. H and W did an estate plan which involved H's 2 IRAs and a marital property agreement that both IRAs were community property. The plan was to divide the two IRAs into equal shares. One-half of each IRA would then be transferred to a new IRA which would be W's "individual" property. The other one half of the two IRAs would be H's "individual" property. W's IRA would then be distributed without regard to H's life expectancy. The Service went along with the idea that state law would permit the treatment of the IRAs as community property and that the IRAs could be divided. However, the Service drew the line at allowing one-half the IRAs to be transferred into an IRA in W's name. It stated that the transfer to W's IRA would be a distribution, indicated that it would be taxed to H.

The Service, in answering the requested ruling as to W's community interest then went off on a complete tangent, perceiving somehow that there was an issue as to whether IRC §408(g), which mandates that §408 is to be applied without regard to community property laws, preempts state community property law. In analyzing this non-issue, the Service traces the legislative history of 408(g) and finds that the House Committee Report "provides that community property laws are not to apply *with respect to deductions* taken for contributions made to IRAs."[21] (Emphasis added) The Service then goes on to note that §408(g) applies only to deductions under §§219 and 220, giving the example that a husband in a community property state who is the sole wage earner may count all his earnings in determining his deductible contribution, even though such earning are community property belonging half to the wife. The Ruling then reasons that §408(d)(6) allowing a division of IRAs on divorce demonstrates that the Congress "recognized the effect of State domestic relations laws on IRAs". Therefore, the Service concluded, that there is "no specific language on what effect Congress intended Code §408(g) to have," and therefore it should not be applied to preempt state community property law. Thus, the parties to the marriage could agree that the IRAs would be community property, and could even partition them, so long as they stayed in the name of H.

B. THE 2009 PLR. This PLR is not yet published and numbered as of the date of this writing. (And I would not spend too much time looking for it unless you intend to cite it in a paper or article.) The facts are substantially identical to the first two 1999 PLRs, except that the Revocable Trust divides into a marital share, a bypass share and a survivor's share. SS is still in control of the survivor's share, has the right to allocate non-prorata and intends to allocate the IRA to the survivor's share.

1. The Fiduciary Duty Twist. This PLR contains some very strange representation's from the taxpayer's authorized representative. In the first instance the PLR says:

> Your authorized representative has submitted a representation that under State C fiduciary law, the trustee of Trust T is bound to act in the best interests of the current and future beneficiaries of Trust T and that in this instance an allocation of IRA X to any other Subtrust [[other than the survivor's trust] could subject the trustee to a financial surcharge for breach of her fiduciary responsibilities.

Later in the ruling, the following is found:

> In this case, your authorized representative has submitted that Surviving Spouse A is not only permitted to demand a single sum distribution of IRA X, and allocate the IRA X proceeds to Subtrust A by the terms of Trust T, but she is compelled to do so as a fiduciary for the benefit of the beneficiaries of Trust T under State C law. It is further represented that an allocation of IRA X to any other Subtrust could subject the trustee to a financial surcharge for breach of her fiduciary responsibilities under State C law.

The author finds himself unable to understand how any state law (even California) could require SS to "demand"

[21] H.R. Rep. No. 93-779, 93rd Congress, 2nd Session, 1974-3 C.B. 244, 363.

a lump sum distribution and require her to allocate it to the survivor's trust. It is equally puzzling to comprehend how it could be a breach of fiduciary duty under state law to allocate the IRA differently. (The PLR is silent as to the exact terms of the trust, but there is nothing to indicate the trust dictates this allocation.) What is most disturbing is the implication that this allocation is bottomed on the SS's lack of discretion, when the trust instrument probably gives her ample discretion.

2. The Detailed §408(g) Analysis. "Additionally, with respect to any Code section 408(g) implications, the Service notes that under the property laws of State C, IRA X constituted community property at the death of Decedent A. As such, the language of Trust T required that it be allocated to Subtrust A. Thus, the trustee of Trust T, Surviving Spouse A, had no discretion with respect as to which of the three Trust T subtrusts to allocate Surviving Spouse A's community property interest in IRA X. The Service notes that determining if IRA X was/is community property and, as such, which of the three subtrusts was/is to receive said IRA X lies outside the scope of Code section 408." The Service's conclusion is obviously correct that the value of SS's community interest in the trust's assets must be allocated to the survivor's trust under Trust's terms. However, they also seem to be saying that §408(g) is just irrelevant in determining community property issues, with no analysis whatsoever.

3. The Author's Take. This Ruling is a little disturbing because of the fiduciary duty language quoted above. However, it sheds NO new light whatsoever, and I am curious as to why it was sought in light of the taxpayer's representative's apparent need to (only slightly) probably misrepresent the laws of State C. As a colleague noted upon reading it, "My guess is that the ruling is a result of the Service not understanding community property law and desperately trying to stay out of it, *so a reading of the ruling as if they meant what they said is unwarranted.*" A perfect summary.

C. SO, WHAT TO DO? It is clear from the above cited rulings that if the NPS survives and the Revocable Trust is the beneficiary, whether fully funded or funded by a pourover Will, the NPS can allocate all of the IRA (to the extent the assets of the estate or trust permit) to a trust over which the NPS has complete control.

1. The Mechanics. For this technique to work under existing authority, the SS should be the trustee of the trust (and probably the executor under the Will), the trust must contain a totally discretionary power to make non-prorata distributions (the 2009 PLR discussed below notwithstanding), and the SS must have the power to revoke (or at least demand distributions) from the Survivor's Trust.

2. Trust Should Be Fully Funded. A fully funded joint management trust would seem to work best because, after the participant's death, the NPS would have not only the participant's one of the community property which has poured over to the trust, but also his or her one-half of the community property to work with. For example, the community estate consists of an IRA of $2,000,000 and other community assets of $2,000,000. If the trust is named as beneficiary of the IRA with a pourover Will, then the trust consists of only $3,000,000 (the IRA and one-half of the deceased spouse's community property) and only $1,500,000 can be allocated to the survivor's trust. If, however, the trust is fully funded, then the entire $2,000,000 IRA can be allocated to the survivor's trust and the other $2,000,000 of assets can be placed in the Bypass Trust.

3. What if NPS Dies First? If the NPS dies first, then the beneficiary designation of the owner does not come into play. There are two easy solutions to this issue and one rather exotic one.

a. *NPS Leaves Interest by Will to SS.* Because under this plan, the parties are apparently happy to have the SS, no matter which spouse that is, be the sole owner of the IRA, a simple bequest of the NPS interest to the SS would get the desired result. If the IRA is the principal asset of the estate, then the Bypass Trust cannot be fully funded.

b. *NPS Interest Transferred to Trust by Will.* If somehow the NPS interest end up in the trust, assuming the trust has been funded, then SS's other assets could be allocated to the Bypass Trust and NPS's share of the IRA can be allocated to the survivor's trust. If the trust is not funded, the same issues exist as if the Will had left the IRA interest to a third party. Note that the NPS can only leave his or her interest to the trust, but this helps in funding the Bypass Trust, if it does not produce an adverse tax effect, A possible solution to this problem is having the participant spouse assign one-half of the distributions (less income tax) to the Bypass Trust without actually transferring the IRA.

4. Can IRA Be an Asset of the Trust? Can you list the IRA on Schedule A and thereby transfer it to the trust? If so, then the non-prorata allocation of 100% of the IRA to the survivor's trust might be achievable. Since the trust is a wholly grantor trust while both spouses are alive, would it be disregarded? Do the grantor trust rules jibe with the 408 rules which require the IRA to be owned by one person? This technique is a Dirty Harry approach: "Ask yourself, do you feel lucky?" And, there would be almost no chance that the Service would rule (at least favorably) on this one.

5. Can There Be a Third Party Trustee? As to the Marital and Bypass, perhaps the decedent desire that all assets other than the IRA be subject to third party management. Can this be done and still achieve the desired result? There is no authority, but why could a third party trustee could not be given the power to allocate non-prorata and in kind so long as SS has the ability to demand distribution of the IRA proceeds? This is a little worrisome, however, in that the Service might contend did not have sufficient control and acquired the right to the IRA from someone other than the decedent. If 3rd party management is desired, the safer course would seem to be to have the spouse removed as trustee of the Bypass and Marital once the allocation is made.

XI. CONCLUSION. As noted in the title, it should not be this hard. But, so long as the rules surrounding trusts continue to be drawn by people who do not really understand trusts and regard them with suspicion, it will stay difficult. When community property opportunities are overlaid with the trust rules, it can get really hard. And the sad thing is, it is easier and simpler now than it once was.