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Planning for Qualified Retirement Plan Benefits and IRAs

Louis A. Mezzullo

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PLANNING FOR QUALIFIED RETIREMENT PLAN BENEFITS AND IRAS

Louis A. Mezzullo
Mezzullo & McCandlish
Richmond, Virginia

(September 1, 1999)
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TABLE OF CONTENTS

I. INTRODUCTION .................................................................................................................... 1
   A. Importance. .................................................................................................................. 1
   B. Client’s Objectives. ................................................................................................. 3
   C. Plan Provisions......................................................................................................... 4
   D. Spousal Rights. ......................................................................................................... 4

II. AVOIDING PENALTY TAXES.......................................................................................... 6
   A. Premature Distributions......................................................................................... 6
   B. Excess Retirement Distributions........................................................................... 10
   C. Excess Retirement Accumulations......................................................................... 11
   D. Minimum Distribution Rules................................................................................ 11
   E. Naming a Trust as a Beneficiary............................................................................ 20

III. DEFERRING OR REDUCING INCOME TAXES................................................................. 22
   A. General Considerations......................................................................................... 22
   B. Selecting a Preferred Method of Payment ............................................................ 24

IV. NAMING A QTIP TRUST AS BENEFICIARY ................................................................. 28
   A. Reason for Naming a QTIP Trust ....................................................................... 28
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>B.</td>
<td>Qualifying for the Marital Deduction</td>
<td>30</td>
</tr>
<tr>
<td>V.</td>
<td>OTHER ESTATE TAX CONSIDERATIONS</td>
<td>34</td>
</tr>
<tr>
<td>A.</td>
<td>Naming the Credit Shelter Trust as Beneficiary</td>
<td>34</td>
</tr>
<tr>
<td>B.</td>
<td>Payment of Estate Taxes</td>
<td>36</td>
</tr>
<tr>
<td>VI.</td>
<td>USING AN IRA FOR CHARITABLE GIVING</td>
<td>37</td>
</tr>
<tr>
<td>A.</td>
<td>Introduction</td>
<td>37</td>
</tr>
<tr>
<td>B.</td>
<td>Tax Consequences</td>
<td>37</td>
</tr>
<tr>
<td>C.</td>
<td>Naming a Charity as a Beneficiary Under the Minimum Distribution Rules</td>
<td>42</td>
</tr>
<tr>
<td>D.</td>
<td>Naming the Spouse as Primary Beneficiary, with Charity as Successor</td>
<td>44</td>
</tr>
<tr>
<td>E.</td>
<td>Naming a QTIP Trust as a Beneficiary</td>
<td>45</td>
</tr>
<tr>
<td>F.</td>
<td>Naming a Charitable Remainder Trust as Beneficiary</td>
<td>46</td>
</tr>
<tr>
<td>G.</td>
<td>Choosing the Appropriate Trust</td>
<td>47</td>
</tr>
<tr>
<td>H.</td>
<td>Providing for a Child</td>
<td>50</td>
</tr>
<tr>
<td>I.</td>
<td>Spousal Rights</td>
<td>51</td>
</tr>
<tr>
<td>J.</td>
<td>Withdrawals to Make Charitable Contributions</td>
<td>52</td>
</tr>
<tr>
<td>K.</td>
<td>Conclusion</td>
<td>52</td>
</tr>
<tr>
<td>VII.</td>
<td>IRAS: IN GENERAL</td>
<td>53</td>
</tr>
<tr>
<td>A.</td>
<td>Contribution Limitations</td>
<td>53</td>
</tr>
<tr>
<td>B.</td>
<td>Deductibility of Contributions</td>
<td>53</td>
</tr>
<tr>
<td>C.</td>
<td>Premature Withdrawals</td>
<td>56</td>
</tr>
<tr>
<td>VIII.</td>
<td>ROTH IRAS</td>
<td>56</td>
</tr>
<tr>
<td>A.</td>
<td>Introduction</td>
<td>56</td>
</tr>
</tbody>
</table>
PLANNING FOR QUALIFIED RETIREMENT PLAN BENEFITS AND IRAS

Louis A. Mezzullo
Mezzullo & McCandlish
Richmond, Virginia
(September 1, 1999)

I. INTRODUCTION

A. Importance.

1. Qualified retirement plan benefits and individual retirement accounts (IRAs) represent a substantial portion of the accumulated wealth of many Americans who seek estate planning advice.

2. The estate planner must be familiar with the tax and nontax considerations associated with the receipt of qualified retirement plan benefits and IRAs by participants, account holders, and their beneficiaries.

3. Generally, the estate planner will be asked to give advice about distributions from qualified retirement plans and IRAs in at least five situations.

   a. An individual, upon becoming a participant in a qualified retirement plan or upon opening an IRA, will usually have an option to complete a beneficiary designation form naming someone to receive his or her plan benefit or IRA balance if he or

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In this outline, IRA refers to a traditional IRA. Roth individual retirement accounts, which were added to the Internal Revenue Code (I.R.C.) by the Taxpayer Relief Act of 1997 (TRA 97), are referred to as Roth IRAs. TRA 97 § 302(a), adding I.R.C. § 408A. See Section VIII of this outline for a brief discussion of Roth IRAs. This outline does not deal with education individual retirement accounts, which are described in I.R.C. § 530.
she dies before all the benefit or the account balance has been distributed.

(1) Failure to complete a beneficiary designation will result in the plan's or IRA's default mechanism determining the beneficiary.

(2) While it is unusual, a plan may be designed not to allow a participant any choice of his or her beneficiary.

(a) For example, the only death benefit under the plan may be a survivor annuity for the participant's surviving spouse.

b. A participant in a qualified retirement plan involved in a divorce will want to ensure that any benefits paid to his or her former spouse will be taxed to the former spouse and not to the participant, by having the payments made pursuant to a qualified domestic relations order (QDRO).

(1) Similarly, an account holder of an IRA will want to ensure that such payments are pursuant to a "divorce or separation instrument."

(2) Of course, the nonparticipant spouse's advisor will want to ensure that his or her rights to the benefit or account are protected.

c. The participant or account holder will seek advice about the appropriate method to receive benefits once he or she has retired or is otherwise required to receive the benefits.

(1) Even if the participant or account holder does not need the plan benefits or IRAs for his or her living needs, he or she will be required to begin withdrawing plan benefits or IRA balances by the participant's required beginning date (RBD) which is April 1 of the year following the year in which he or she reaches age 70½ (or, if later, retires in the case of a participant in a qualified retirement plan who does not own more than five percent of the sponsoring employer). I.R.C. § 401(a)(9)(A) and (C).

(2) The identity of the designated beneficiary (and hence his or her life expectancy) and the decision whether to recalculate or not recalculate the life expectancies of a participant and
his or her spouse become irrevocable at the RBD. Treas. Reg. § 1.401(a)(9)-1, Q&A D-3(a) and E-7(c).

d. If there are plan benefits or IRA balances remaining to the credit of an individual after his or her death, the deceased individual's personal representative or beneficiaries of his or her plan benefits or IRAs may seek advice concerning various options that may be available to reduce taxes or to defer the payment of taxes.

e. At any time during an individual's life, the estate planner may be asked to advise the individual on his or her eligibility for converting the individual's traditional IRA balances into a Roth IRA and the wisdom of doing so.

B. Client's Objectives.

1. Perhaps the most important considerations are the client's wishes and needs.

   a. The client may, or may not, need distributions of the plan benefit or withdrawals from his or her IRA for current living needs.

   b. The client should determine whom he or she wants to receive any remaining plan benefits or IRAs at his or her death, taking into account his or her other assets and his or her overall estate plan.

2. The client will be required to decide:

   a. When he or she should begin receiving payments;

   b. What method of benefit payment he or she should select; e.g., lump sum, period certain, life annuity, or joint and survivor annuity; and

   c. Whom to name as the beneficiary of any plan benefits or IRA balances remaining at his or her death.

3. The client's tax objectives will, usually, be to:

   a. Defer the receipt of the benefits in order to postpone paying income tax (but, see the traditional IRA to Roth IRA conversion decision discussed below);

   b. Reduce the amount of income tax on benefits distributed;
c. Defer or reduce the payment of transfer taxes; and

d. Avoid penalty taxes.

4. A participant's desires will be restricted by the provisions in the plan or IRA and by spousal rights created by I.R.C. §§ 401(a)(11) and 417, and the Employee Retirement Income Security Act of 1974 (ERISA) § 205.

C. Plan Provisions.

1. In many cases, particularly in plans sponsored by larger employers, the plan document may restrict the method and timing of receiving plan benefits.

   a. Similarly, all legally allowable options may not be available in every IRA document.

2. The participant may not be entitled to a lump sum distribution under the plan, or, alternatively, may not be entitled to payments in the form of an annuity.

3. Also, forms of annuity payments at retirement may be limited to a joint and survivor annuity or to payments over no more than ten years.

4. The plan may require that payments to a terminated employee begin at the later of the plan's normal retirement date or when the employee reaches age 62.

D. Spousal Rights.

1. In addition to provisions in the plan, a married participant's choices concerning benefit payments from a qualified retirement plan may be limited by his or her spouse's rights under I.R.C. §§ 401(a)(11) and 417, and ERISA § 205.

2. Generally speaking, those provisions require that the participant's spouse be entitled to some (at least 50 percent) or all of the participant's remaining plan benefits at the participant's death unless the spouse has consented to the designation of someone else as the beneficiary.

3. In addition, under all types of qualified retirement plans except those profit sharing plans and stock bonus plans that meet certain requirements specified in the I.R.C., the participant must receive his or her benefits in the form of a qualified joint and survivor annuity when he or she reaches his or her annuity starting date (which is generally whenever the
participant commences to receive benefits from the plan), unless the spouse consents to another form of distribution.

a. Under a qualified joint and survivor annuity, the participant receives his or her plan benefit in the form of a life annuity, and, if the spouse survives the participant, the spouse receives a life annuity which is not less than 50 percent of (and is not greater than 100 percent of) the amount of the annuity which is payable during the joint lives of the participant and the spouse. I.R.C. § 417(b).

4. According to the Treasury Regulations, a participant about to marry cannot obtain a valid consent from his or her future spouse. Treas. Reg. § 1.401(a)-20, Q&A 28.

a. Because the regulations state that an individual may only consent after marriage to waive his or her right to some or all of the participant's vested accrued benefit at the participant's death, a premarital agreement cannot qualify as a valid consent.

b. While most of the cases support the position taken in the regulations, in an unpublished decision, Callahan v. Hutsell, et al., 14 F.3d 600 (6th Cir. 1993), remanding 813 F. Supp. 541 (WDKY 1992), the Sixth Circuit Court of Appeals indicated that a premarital agreement that included a spousal consent waiving rights to the participant's qualified retirement plan benefits could serve as a valid consent if it satisfied the requirements of the I.R.C., ERISA and the plan and even if the premarital agreement did not satisfy those requirements, it might be enforceable under state contract law.

5. In addition, a valid consent to a waiver of the qualified joint and survivor annuity can only be made within 90 days of the date payments to the participant are to commence. I.R.C. § 417(a)(3)(A) and (6)(A).

6. A profit sharing plan or a stock bonus plan that satisfies the following three requirements is not subject to the qualified preretirement survivor or qualified joint and survivor annuity rules, allowing a participant to take his or her accrued benefit out of the plan or have it transferred to an IRA without the spouse's consent.

a. The plan must provide that the participant's entire vested accrued benefit is payable to the spouse upon the participant's death unless the spouse consents to another designation.

b. The participant must not elect to receive his or her benefit in the form of an annuity.
c. The plan must not have received a direct or indirect transfer of amounts from another plan that was subject to the qualified joint and survivor annuity rules.

(1) Because the participant's spouse would have to consent to the distribution from a prior plan subject to the annuity rules, a rollover or a direct rollover is not treated as a transfer for this purpose. Rev. Rul. 94-76, 1994-2 C.B. 46.


7. An IRA, including an IRA funded under a simplified employee pension, is not subject to spousal annuity rights at all. Treas. Reg. §1.401(a)-20, Q&A 3(d).

a. Simple retirement accounts, which became available January 1, 1997, should be subject to the same treatment as simplified employee pensions.

II. AVOIDING PENALTY TAXES

A. Premature Distributions.

1. A ten-percent additional income tax is imposed on premature distributions, which are distributions before the participant reaches age 59½ unless one of a number of exceptions applies. I.R.C. § 72(t).

2. The following exceptions apply:

a. A distribution made to a beneficiary or to the estate of a participant or account holder after the death of the participant or account holder. I.R.C. § 72(t)(2) (A)(ii).

b. A distribution because of the total disability of the participant or account holder. I.R.C. § 72(t)(2)(A)(iii).

c. A distribution that is not included in taxable income because it is rolled into a IRA or a qualified retirement plan. I.R.C. §§ 72(t)(1), 402(c)(1) and 408(d)(3).

d. A distribution to an alternate payee pursuant to a QDRO. I.R.C. § 72(t)(2)(C).
(1) This exception only applies to a participant in a qualified retirement plan.

e. A distribution to a participant in a qualified retirement plan (but not an account holder of an IRA) who separates from service after reaching age 55. I.R.C. § 72(t)(2)(A)(v).

f. The portion of a distribution that is not included in taxable income because it represents the basis of the participant or account holder in the plan benefit or IRA because of nondeductible contributions. I.R.C. § 72(t)(1).

g. Distributions during a year to a participant or account holder to the extent that the participant or account holder is entitled to a deduction for medical expenses paid during the year because medical expenses for the year are in excess of 7.5 percent of adjusted gross income, whether or not the participant or account holder actually itemizes his or her deductions. I.R.C. § 72(t)(2)(B).

h. Withdrawals used by the account holder to pay for medical insurance for the account holder and the account holder's spouse and dependents if the account holder has received unemployment compensation for 12 consecutive weeks under any federal or state unemployment compensation law. I.R.C. § 72(t)(2)(D).

(1) This exception only applies to IRA distributions.

i. Distributions from an IRA for qualified higher education expenses for the account holder, the account holder's spouse, or any child or grandchild of the account holder or the account holder's spouse. I.R.C. § 72(t)(2)(E).

(1) This exception only applies to IRA distributions.

j. A distribution that qualifies as a first-time homebuyer distribution, which must be used for the cost of acquiring, constructing or reconstructing (including usual or reasonable settlement, financing, or other closing costs) the principal residence of the account holder or his or her spouse, or the principal residence of a child, grandchild or ancestor of the account holder or the account holder's spouse. I.R.C. §§ 408A(d)(2)(A)(iv), (5), 72(t)(2)(F).

(1) This exception only applies to IRA distributions.
(2) The individual for whom the home is being acquired (and if married, such individual's spouse) must not have had an ownership interest in a principal residence during the two-year period ending on the date of acquisition.

(3) Individuals on extended active duty in the Armed Forces and individuals with homes in foreign countries may not qualify as a qualified first-time homebuyer if the period for tax-free rollover of gain on the sale of a prior residence has been suspended.

(4) The amount distributed must be used within 120 days of the distribution for the payment of eligible costs.

(5) If a distribution from an IRA is not used for the costs of acquiring, constructing or reconstructing a principal residence because of a delay or cancellation in the purchase or construction, and the distribution is rolled over to an IRA within 120 days of the distribution, it will not be subject to income tax nor to the rule limiting rollovers to one in a year.

(6) The total lifetime amount that can qualify as a first-time homebuyer distribution from all of an individual's IRAs is $10,000.

k. A distribution that is one of a series of substantially equal periodic payments made at least annually over the life of the participant or account holder or the joint lives of the participant or account holder and his or her designated beneficiary, or over a period certain equal to the life expectancy of the participant or account holder or the joint life expectancies of the participant or account holder and his or her designated beneficiary. I.R.C. § 72(t)(2)(A)(iv).

(1) This exception only applies to a participant in a qualified retirement plan if he or she has separated from service.

(2) The IRS has approved three methods of determining whether the substantially equal periodic payment requirement has been satisfied. Notice 89-25, 1981-1 C.B. 662, Q&A 12.

(a) The advisor may want to compare the annual payment under all three methods to determine the most suitable method for the account holder's needs.
See Toolson, Structuring Substantially Equal Payments to Avoid the Premature Withdrawal Penalty, 73 Journal of Taxation 276 (November, 1990), for a discussion of these methods.

(3) The beneficiary whose life is being used to determine the payout period must be the same person entitled to any benefits remaining at the death of the participant or account holder. I.R.C. § 72(t)(2)(A)(iv).

(4) Once the exception for substantially equal periodic payments applies, any modification of the series of payments for a reason other than the death or disability of the participant or account holder will require the participant or account holder to pay the penalty tax, plus interest on the penalty tax, that would have been imposed on the distributions had the exception not applied to any of the payments unless the modification occurs after the later of the end of the five-year period beginning with the date of the first payment or the date the participant or account holder reaches age 59½. I.R.C. § 72(t)(4)(A).

(a) For example, if the participant or account holder begins receiving substantially equal periodic payments under this exception when the participant or account holder is age 53, the participant or account holder may not modify the series of payments until reaching age 59½, which is more than five years after the payments commenced.

(b) On the other hand, if the participant or account holder begins receiving substantially equal periodic payments under this exception when he or she is age 58, the participant or account holder must wait until reaching age 63 to change the series of payments.

(c) In the latter case, only the payments made before the participant or account holder reached age 59½ are subject to the recapture of penalties and interest.

4. It may not always be possible to avoid the ten-percent additional income tax on premature distributions if the participant or account holder faces a financial hardship that cannot be satisfied from other sources, including borrowing from the plan, and none of the exceptions applies.

   a. Because, in most cases, the participant or account holder will be in a lower income tax bracket in the year in which he or she has a financial hardship, the ten-percent additional income tax plus the regular income tax paid on the distribution will not usually negate the prior benefit of tax deferrals on the contributions to the qualified retirement plan or IRA and the earnings accumulated in the plan or IRA.

B. Excess Retirement Distributions.

1. A 15-percent excise tax was imposed on distributions from qualified retirement plans and IRAs received during a calendar year in excess of the annual threshold amount, which was $160,000 for 1997. I.R.C. §§ 4980A(a) and (c)(1).

2. The Small Business Job Protection Act of 1996 (the 96 Act) suspended the 15 percent excise tax on excess retirement distributions (but not accumulations) for distributions received in 1997, 1998, and 1999. 96 Act § 1452(b), adding I.R.C. § 4980A(g).

3. TRA 1997 repealed the excise tax on excess retirement distributions received after 1996.

4. If an individual filed an income tax return paying the excise tax on an excess retirement distribution that could have been avoided by electing to accelerate the grandfathered amount, but the individual chose not to do so because at the time it was not advantageous, the individual may be able to file an amended return requesting a refund of the excise tax.

   a. Before the repeal, the election to accelerate the grandfathered amount was only advisable if the amount subject to the excise tax was substantial.

   b. Because the excise tax has been repealed, the grandfathered amount is no longer of any consequence.

   c. Note that Prop. Treas. Reg. § 54.4981A-1T, Q&A b-12(c), does not permit an election to accelerate to be made after the individual's death, except for the year of death or for a year in which a return has not been filed.
C. **Excess Retirement Accumulations.**

1. A counterpart to the excess retirement distribution tax was the excess retirement accumulation tax, which was a 15-percent excise tax imposed on an individual's excess retirement accumulation. I.R.C. § 4980A(d).

2. TRA 1997 repealed the excise tax on excess retirement accumulations for taxpayers dying after 1996.

3. A surviving spouse of a participant in a qualified retirement plan or IRA who died before 1997 with an excess retirement accumulation should elect to defer the excise tax if the election is available

   a. A surviving spouse qualifies to make the election to defer the payment of the excise tax if he or she is the beneficiary of at least 99 percent of the decedent's qualified retirement plan benefits and IRAs.

   b. If an estate tax return has already been filed and the election was not made but the surviving spouse was eligible to make the election, it may be possible to file an amended return and receive a refund.

   c. PLR 9437041 allowed an executor to file an amended return to make the election to defer the excise tax based on Treas. Reg. § 301.9100-1, but one of the requirements was that the grant of the extension to make the election did not jeopardize the government's interests.

      (1) It could be argued that, since the excise tax has been repealed, the government's interests would be jeopardized if the extension to make the election were granted, resulting in a refund of the tax with no future liability for the tax.

D. **Minimum Distribution Rules.**

1. A 50 percent excise tax is imposed on the amount of a minimum distribution that is not actually distributed. I.R.C. § 4974(a).

   a. This penalty tax must be avoided in all events.

   b. Some commentators had suggested that, when it has been determined that a traditional IRA to Roth IRA rollover is beneficial, skipping all or part of one year's minimum distribution may be advisable if it will reduce the individual's adjusted gross
income to a level that he or she will be eligible to make the rollover.

(1) However, under the final regulations the amount distributed from the traditional IRA will be treated as including that year's minimum distribution. Treas. Reg. § 1.408A-4, Q&A 6.

(2) Therefore, that amount will be treated as distributed and then contributed to the Roth IRA and will be included in the individual's AGI for purposes of determining eligibility to make a traditional IRA to Roth IRA rollover and may be an excess contribution, depending upon the account owner's AGI and other contributions to IRAs.

2. The minimum distribution rules provide that no later than the participant's RBD, the participant's plan benefits and IRA balances must be paid in a lump sum or must begin to be paid out in substantially equal periodic payments over:

a. The life of the participant;

b. The joint lives of the participant and a designated beneficiary;

c. A period not extending beyond the life expectancy of the participant; or

d. A period not extending beyond the joint and last survivor expectancy of the participant and a designated beneficiary.


3. The RBD for traditional IRA account holders and participants in a qualified retirement plan who own more than five percent of the sponsoring employer (i.e., a sole proprietor, or a partner, LLC member, or shareholder who owns more than five percent of the sponsoring employer) is April 1 following the calendar year in which the individual reaches age 70½.
4. The RBD for participants in qualified retirement plans who do not own more than five percent of the sponsoring employer is April 1 following the later of the calendar year in which the participant reaches age 70½ or the calendar year in which the participant retires.

a. This is a new definition of the RBD which was added by the Small Business Job Protection Act of 1996 (the 96 Act) that is effective for payments required to be made after 1996.

(1) Thus, an employee who reached age 70½ in 1996 but did not retire and who was not a more-than-five percent owner, was not required to take a distribution by April 1, 1997. 96 Act § 1404(a), amending I.R.C. § 401(a)(9)(c).

b. According to the House Ways and Means Committee Report (as contained on page 64 of the Joint Explanation of the Conferees), a qualified retirement plan may, but is not required to, permit a participant who is currently receiving distributions, but would not be required to under the new definition, to stop receiving distributions until required to under the new definition of the RBD.

(1) The Internal Revenue Service (IRS) has provided extensive guidance on what a plan may do to implement the new definition of RBD. See Notice 97-75, Notice 96-67, Announcement 97-24, Announcement 97-70, Treas. Reg. § 1.411(d)-4, Q&A 10, and Rev. Proc. 97-41.

c. The 96 Act amendment to the RBD definition does not affect IRA account holders or more-than-five-percent owners of plan sponsors whose RBD remains April 1 following the year in which they attain age 70½.

d. One problem with the new definition of required beginning date is the uncertainty over the meaning of the term "retires."

(1) Must a participant work full time or will merely working on a part-time basis allow the participant to defer the commencement of required minimum distributions after reaching age 70½?

(2) What if a participant had always been a part-time employee?

(3) In nonbinding discussions, IRS representatives have stated that more-than-five-percent owner and retirement status are
determined separately for each plan in which an individual participates. If so, it appears that:

(a) A participant will be required to take distributions from plans in which he or she participated that are sponsored by employers for whom the participant no longer works, even though the participant continues to work for another employer after reaching age 70½;

(b) A participant in a plan sponsored by an employer with respect to which the participant was a more-than-five-percent owner will be able to roll his or her accrued benefit (except to the extent the distribution is a required minimum distribution) into the plan of a new employer with respect to which the participant is not a more-than-five-percent owner and thereby defer the payment of the accrued benefit until he or she retires from the new employer.

5. If a participant dies before reaching his or her RBD, the minimum distribution rules require the deceased participant's plan benefits or IRAs to be distributed by December 31 of the fifth calendar year following the year in which the participant's death occurs, unless one of two exceptions applies. I.R.C. § 401(a)(9)(B)(ii); Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A C-2.

a. Under the first exception, which applies if the participant has a designated beneficiary other than his or her spouse, the payments may be paid over the life of the designated beneficiary or over a period certain not extending beyond the life expectancy of the designated beneficiary, provided that the payments to the designated beneficiary begin not later than December 31 of the calendar year after the calendar year in which the participant died. I.R.C. § 401(a)(9)(B)(iii); Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A C-3(a).

b. Under the second exception, which applies if the designated beneficiary is the spouse of the participant, the payments may be made over the life of the spouse or over a period not extending beyond the spouse's life expectancy, provided that the payments begin by the later of December 31 of the calendar year immediately following the calendar year in which the participant died or December 31 of the calendar year in which the participant died.

(1) However, this exception does not apply if the spouse is not the only beneficiary, unless each beneficiary is entitled to a separate share or account. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A C-3(a).

6. If the participant dies after his or her RBD but before the entire benefit has been distributed, the remaining portion of the benefit must be distributed at least as rapidly as under the method of distribution in effect at the date of the participant's death. I.R.C. § 401(a)(9)(B)(i).

7. Regardless of whether the participant dies before or after his or her RBD, if the spouse is the beneficiary of all or part of the participant's benefit or IRA, he or she may roll the benefit (or the part of which he or she is beneficiary) into his or her own IRA, or, in the case of an IRA, treat the decedent's IRA as his or her own IRA.

a. If the participant dies after his or her RBD, and the required minimum distribution has not been distributed to him or her before his or her death, the required minimum distribution would have to be paid to the surviving spouse before the end of the year.

b. If the surviving spouse has already reached his or her RBD, he or she must begin receiving required minimum distributions in the year following the year of the participant's death.

8. A designated beneficiary must be an individual. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A D-2A.

a. An individual beneficiary of a trust may be treated as a designated beneficiary if the trust meets certain requirements. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A D-5.

(1) See below for a discussion of these requirements.

b. If there are two or more beneficiaries, only the oldest beneficiary will be treated as a designated beneficiary unless each beneficiary is entitled to a separate share or account. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A E-5(a).

c. If there are two or more beneficiaries and one of the beneficiaries is not an individual, the participant will be treated as not having any designated beneficiary unless the beneficiaries are entitled to
separate shares or separate accounts. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A E-5(a).

(1) A separate account in an individual account is a portion of a participant's benefit determined by an acceptable separate accounting including allocating investment gains and losses, and contributions and forfeitures, on a pro rata basis in a reasonable and consistent manner between such portion and any other benefits. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A H-2A(a).

(2) A benefit in a defined benefit plan is separated into segregated shares if it consists of separate identifiable components that may be separately distributed. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A H-2A(b).

d. The life expectancy used in determining the required minimum distribution cannot be increased after the RBD by changing to a younger designated beneficiary, but is reduced by changing to an older designated beneficiary and is reduced to only the participant's life expectancy by changing to a beneficiary (such as a charity) that does not qualify to be a designated beneficiary. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A E-5(c).

e. Under the minimum distribution incidental death benefit rule, a nonspouse beneficiary will be treated as no more than ten years younger than the participant while the participant is alive. Prop. Treas. Reg. § 1.401(a)(9)-2, Q&A 4.

(1) However, once the participant dies, the beneficiary's actual life expectancy will be used (which will be the beneficiary's life expectancy in the year before the participant's RBD, reduced by one year for each year that has elapsed). Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A F-3A(b).

(2) While the participant is alive, the life expectancies of both the participant and the beneficiary will be recalculated for purposes of determining the appropriate period under the minimum distribution incidental death benefit rule, treating the beneficiary as no more than ten years younger than the participant.

(3) If the participant lives long enough, the normal method of determining the remaining payout period may produce a shorter period than the minimum distribution incidental
death benefit rule, in which case, the normal method will then be used.

9. The minimum distribution is determined annually by dividing the remaining life expectancy (or joint life expectancies if that is the form of payment selected) into the value of the participant's plan benefits and IRAs as of the valuation date (usually December 31) in the year preceding the year in which the distribution has to be made. Prop. Treas. Reg. § 1.401(a)(9)-1. Q&A F-1(a).

   a. Consequently, the longer the payout period the smaller the minimum distribution will be.

   b. Life expectancies, except when distributions are made as irrevocable annuities, are determined at the first to occur of the death of the participant or the year preceding the participant's RBD.

      (1) If the participant dies before his or her RBD, the designated beneficiary's life expectancy is determined in the year in which payments must commence. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A E-2(a).

         (a) If the designated beneficiary is not the surviving spouse, the life expectancy is determined in the year after the participant's death.

         (b) If the designated beneficiary is the surviving spouse and the spousal exception applies, his or her life expectancy is determined in the year in which the participant would have reached age 70½.

   c. If, however, the participant began receiving his or her benefits as an irrevocable annuity prior to his RBD, life expectancies will be determined as of the year the annuity begins. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A E-1(c).

10. In the case of the participant and the participant's spouse, life expectancies may be recalculated each year or not recalculated. I.R.C. § 401(a)(9)(D).

   a. Note that the life expectancy of an individual who survives one year is reduced by less than one year if recalculation is elected, since that individual will now be expected to live to an older age.

      (1) For example, because an individual age 70 has a life expectancy of 16 years, while an individual age 71 has a
life expectancy of 15.3 years, the life expectancy of an
individual who survives from age 70 to age 71 is only
reduced by seven-tenths of a year. Treas. Reg. § 1.72-9,
Table V.

b. By recalculating the life expectancy of an individual each year, the
individual will continue to have a life expectancy under the
mortality table contained in the Treasury Regulations until the
individual reaches age 115. Treas. Reg. § 1.72-9, Table V.

c. Under the default rule of the proposed regulations, the life
expectancies of the participant and the spouse will be recalculated
unless they elect not to recalculate, the plan or IRA provides that
life expectancies will not be recalculated in any event, or the plan
or IRA provides that life expectancies will not be recalculated
absent an election to recalculate. Treas. Reg. § 1.401(a)(9)-1,
Q&A E-7.

d. An election (or failure to elect), if permitted under the plan or IRA,
becomes irrevocable on the RBD. Treas. Reg. § 1.401(a)(9)-1,
Q&A E-7(c).

e. The life expectancy of a designated beneficiary, other than the
spouse, may not be recalculated. Prop. Treas. Reg. § 1.401(a)(9)-
1, Q&A E-8(b).

(1) Not recalculating may be an option for the participant and
the spouse beneficiary, as described above.

(2) With nonrecalculation, the original life expectancy, based
on the age of the beneficiary in the year following the death
of the participant or the year preceding the participant's
RBD, whichever occurs first, will be reduced by one each
year until it reaches zero. Prop. Treas. Reg. § 1.401(a)(9)-
1, Q&A E-8(c) Ex. 1.

(3) If a participant or beneficiary whose life expectancy was
not being recalculated dies before the expiration of his or
her original life expectancy, his or her remaining life
expectancy will continue to be used for determining the
minimum distribution to the individual entitled to the
remaining benefit. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A
E-8(c) Ex. 3.

f. Under the proposed regulations dealing with the minimum
distribution rules, if an individual's life expectancy is being
recalculated, the individual's life expectancy in the year following
the year in which he or she dies will be zero. Prop. Treas. Reg.
§ 1.401(a)(9)-1, Q&A E-8(a).

(1) Consequently, if the life expectancies of both the
participant and the participant's spouse are being
recalculated, the balance of any plan benefits and IRAs
must be distributed to the individual entitled to receive
them before December 31 of the year following the year in
which the survivor of the participant and the participant's
spouse dies.

(2) On the other hand, if the participant's life expectancy was
being recalculated but not the life expectancy of the spouse,
the payments could continue to be made over any
remaining life expectancy of the spouse regardless of how
soon the survivor of the participant and the spouse died.

(a) For example, assume a participant age 70½ has a
spouse age 59. The participant elects to have the
benefits paid out over a period certain equal to the
joint and last survivor expectancy of the participant
and her spouse. She elects to have her life
expectancy recalculated each year, but not the life
expectancy of her spouse (which would be 25
years). The initial joint and last survivor
expectancy would be approximately 27 years.
Assume that the spouse dies after three years and
the participant dies two years later, or five years
after the payments commenced. The balance of the
participant's benefits and IRAs may be paid out
over the remaining 20 years of the original 25-year
life expectancy of the spouse to the alternate
beneficiary entitled to receive the plan benefits or
IRAs upon the death of the survivor.

Having the participant's life expectancy recalculated each year will
guarantee that distributions will continue as long as the participant
is alive.

(1) If the participant is in poor health, the participant's life
expectancy should not be recalculated.

(2) If the spouse's life expectancy was not being recalculated
and the spouse dies before the participant, the remaining
life expectancy of the spouse will continue to be used for determining the minimum distribution to the participant.

E. Naming a Trust as a Beneficiary.

1. In order for an individual who is the beneficiary of a trust to be treated as the participant's designated beneficiary, the trust must satisfy four requirements upon the later to occur of the date the trust is named as the designated beneficiary or the participant's RBD.

   a. The trust must be a valid trust or would be a valid trust under state law if it had a corpus.

   b. The beneficiaries of the trust entitled to the plan benefits or IRAs must be identifiable.

   c. The trust must be either irrevocable or, by its terms, will become irrevocable at the participant's death.

   d. Certain documentation requirements must be satisfied.

   Prop. Treas. Reg. § 1.401(a)(9)-1, Q&As D-5 and D-6.

2. As a practical matter, these requirements must be met at the first to occur:

   a. The participant's death; or

   b. The later of:

      (1) The participant's RBD; or

      (2) The date the trust is named as the participant's beneficiary.

3. The requirement that the beneficiaries entitled to the plan benefits or IRAs be identifiable is necessary because the age of the oldest beneficiary is required to calculate the minimum distribution.

   a. If there are any beneficiaries entitled to the plan benefits or IRAs which do not qualify to be designated beneficiaries for purposes of calculating minimum distributions, such as charities or creditors (e.g., funeral expenses), the participant may be treated as not having a designated beneficiary. PLR 9820021.

   b. Further, having a beneficiary of a QTIP trust who is older than the spouse, such as a parent of the participant, should be avoided.
4. New proposed regulations, which were issued on December 30, 1997, eliminated the requirement that the trust had to be irrevocable at the RBD, although the trust must become irrevocable at the participant's death.

   a. Although the technical language of the new proposed regulations seems to indicate that there must be language in the trust agreement that makes the trust irrevocable at the participant's death, this requirement should be satisfied if the trust becomes irrevocable at the participant's death under state law.

   b. A testamentary trust would not meet the technical requirements of the new proposed regulations, since at the RBD it would not be a valid trust under state law even if it had a corpus, which, of course, a testamentary trust would not have until some time after the participant's death.

      (1) However, an IRS official involved in drafting the regulations has indicated to the author that it was not intended to treat testamentary trusts differently than revocable trusts for purposes of this requirement.

5. Under the documentation requirements, the participant must furnish to the plan administrator at the RBD either the trust instrument or a list of beneficiaries, including contingent and remainder beneficiaries, and the conditions on their entitlement.

   a. In addition, the participant would have to certify that the list is complete and agree to furnish an updated list if the trust instrument is amended and a copy of the trust instrument if requested.

   b. No later than the end of the ninth month following the month in which the participant dies the trustee of the trust would have to furnish to the plan administrator either a copy of the trust instrument or a final list of the beneficiaries and agree to furnish a copy of the trust instrument if requested.

Prop. Treas. Reg. § 1.104(a)(9)-1, Q&A D-7.

6. The changes made by the new proposed regulations issued on December 30, 1997 affecting the irrevocability requirement and documentation requirement should allow individuals to use revocable and testamentary trusts as plan benefit or IRA beneficiaries without losing the benefit of a designated beneficiary to extend minimum distributions; however, clarification in the final regulations will be required concerning actual trust language concerning its irrevocability upon the grantor's death,
the status of testamentary trusts, and the effect on the beneficiary designation requirement of powers of appointment contained in the trust.

a. Although it is arguable that the existence of a power of appointment should not affect the ability of a trust to satisfy the four requirements, until clarification by the IRS, a power of appointment should be limited so that its exercise will only be effective after the death of the original designated beneficiary and all possible appointees are individuals, as opposed to entities, such as charitable organizations.

7. Also, the documentation requirements are over-broad, since in many cases there will be numerous contingent and remainder beneficiaries that will have to be listed, as well as a description of how they will become entitled to receive a benefit.

a. Only the name and age of the oldest beneficiary of each separate share of the trust that is a beneficiary of the trust with respect to the plan benefit is needed by the plan administrator to determine the required minimum distribution.

b. A plan administrator will not usually be qualified to interpret the terms of a trust agreement.

c. No documentation should be required to be provided to the financial institution sponsoring an IRA, since IRA sponsors are not responsible for determining required minimum distributions and the account holder may take the total of the required minimum distributions calculated separately for each of his or her IRAs from any one or more of his or her IRAs. See Notice 88-38, I.R.B. 1988-15.

III. DEFERRING OR REDUCING INCOME TAXES

A. General Considerations.

1. If a participant needs the money in the plan for current consumption, he or she should consider qualifying the distribution as a lump sum distribution so that he or she can take advantage of being taxed separately from his or her other income using five-year averaging if he or she has reached age 59{1/2}, and ten-year averaging and capital gain treatment if he or she reached age 50 before 1986. I.R.C. § 402(d).

a. Under five or ten-year averaging, a lump sum distribution will typically be taxed at a substantially lower rate than if included in the recipient's other income.
b. Averaging and capital gain treatment do not apply to distributions from an IRA. I.R.C. § 408(d)(1).

c. The 96 Act repeals five-year averaging for taxable years beginning after December 31, 1999, but retains the transition rule for ten-year averaging (but not five-year averaging) and capital gain treatment for participants who reached age 50 before 1986. 96 Act § 1401(a).

2. If the participant does not need the money in the qualified retirement plan or IRA for current consumption, he or she will usually find it to be advantageous to defer the receipt of plan benefits or IRAs until he or she is required to receive such benefits under the minimum distribution rules.

a. In many cases, a retiring participant may direct that his or her plan benefit be transferred directly to an IRA so that he or she may control the investment of the funds and, in many cases, have greater distribution flexibility.

(1) However, in some cases leaving the funds in the plan may achieve a higher rate of return and may insulate the funds from the participant's creditors.

(a) Funds held in an ERISA qualified plan are currently excludible from a participant's bankruptcy estate under Patterson v. Shumate, 112 SCt 2242 (1992).

(b) Funds in an IRA will only be excludible from the account holder's bankruptcy estate if the applicable federal or state exemption law shields IRAs from creditors.

(c) Under the federal exemption scheme, IRAs are exempt "to the extent reasonably necessary for the support of the debtor and any dependent of the debtor." In re Carmichael, 100 F.3d 375 (5th Cir. 1996).

b. Deferral has two benefits.

(1) The amount that would have been paid in tax on a current distribution will remain invested for the benefit of the participant; and
The earnings on the plan benefit or IRA (including the amount that would have been paid as income tax) will continue to accumulate income tax free.

c. Although deferral may cause some of the benefits to become subject to a higher income tax rate if rates are again increased by Congress or the state legislature, the tax-free accumulation will offset this cost after a period of years that will depend upon the rate of return on the investments and the participant's current and future marginal income tax brackets.

d. In order to achieve maximum deferral, the participant or account holder should wait to begin receiving distributions until he or she reaches the later of age 70½, or, in the case of a qualified retirement plan in which he or she is a not-more-than-five percent owner, retires.

(1) If the value of the participant's plan benefits and IRAs is substantial, the first year's distribution should be taken before the end of the year preceding his or her RBD.

(a) Although the law permits the participant to wait until April 1 of the following year to take the first distribution, if the participant waits until his or her RBD, he or she must receive another distribution before the end of same year to avoid the 50-percent excise tax.

(b) The receipt of two distributions in one year may push some of the participant's income into a higher tax bracket.

B. Selecting a Preferred Method of Payment.

1. If the participant is happily married and has sufficient nonretirement plan or IRA assets to fund a credit shelter trust (in 1999 $650,000 can be transferred by gift or at death free of federal transfer tax without using the marital deduction), it is frequently most advantageous for the participant to name his or her spouse as the primary beneficiary and elect to receive his or her plan benefits and IRAs over a period equal to the joint and last survivor expectancy of the participant and his or her spouse.

   a. Although naming someone other than the spouse may increase the initial period if the other designated beneficiary is younger than the spouse, it will also limit the options available if the participant dies before the spouse.
b. In addition, under the minimum distribution incidental death benefit rule, a designated beneficiary other than the participant's spouse will be treated as no more than ten years younger than the participant while the participant is alive for purposes of determining the amount that has to be paid each year to avoid the 50 percent excise tax. I.R.C. § 401(a)(9)(G); Prop. Treas. Reg. § 1.401(a)(9)-2.

c. In some cases, it may be advisable to name a child or grandchild as the designated beneficiary if the spouse has sufficient money of his or her own or is in bad health.

(1) This would ensure that at the death of the participant the benefit could be paid out over the longer life expectancy of the child or the grandchild.

(2) However, the benefit would not qualify for the marital deduction and to the extent that the value of the benefit or IRA exceeds the amount offset by the unified credit, estate tax would be payable on the benefit or IRA.

d. If the spouse is the designated beneficiary and, after minimum distributions have begun, the participant dies first, the spouse will have two options.

e. First, he or she can continue to receive the plan benefits over his or her remaining life expectancy.

(1) The participant's life expectancy will not be taken into account if it was being recalculated, but will be taken into account if it was not being recalculated.

f. The better choice, if permitted under the plan, would be to have the remaining balance, except for the minimum distribution for the year in which the participant died, transferred to an IRA established for the benefit of the spouse. I.R.C. § 402(c)(9).

(1) A direct rollover (a transfer directly to the IRA) will avoid the mandatory 20 percent withholding required with respect to an eligible rollover distribution from a qualified retirement plan (but not an IRA). I.R.C. § 3405.

(a) Note that after 1992, a distribution from a qualified retirement plan is an eligible rollover distribution unless the distribution is a required minimum distribution, a periodic payment (over ten years or
more) or a hardship distribution from a 401(k) plan. I.R.C. § 402(c)(4).

(2) If the spouse is the beneficiary of the decedent's IRA, the spouse may treat the IRA as his or her own IRA. I.R.C. § 408(d)(3); Prop. Treas. Reg. § 1.408-8, Q&A 4(b).

(3) A spouse who is named as the beneficiary who either treats the decedent's IRA as the spouse's or rolls the decedent's account or benefit into the spouse's IRA would then be permitted to have the IRA paid out over a period equal to the joint and last survivor expectancy of the spouse and a new designated beneficiary, such as a child or a grandchild, beginning at the spouse's RBD. I.R.C. §§ 408(a)(6) and 401(a)(9)(A).

(a) The spouse could elect to have his or her life expectancy recalculated so that the payments would continue to him or her no matter how long he or she lived. I.R.C. § 401(a)(9)(D).

(b) Regardless of the age of the new designated beneficiary, while the spouse is alive, the designated beneficiary would be treated as no more than ten years younger than the spouse under the minimum distribution incidental death benefit rule, unless the new designated beneficiary is a new spouse of the surviving spouse. I.R.C. § 401(a)(9)(G); Prop. Treas. Reg. § 1.401(a)(9)-2.

(c) Once the spouse dies, the balance in the IRA could be paid over the designated beneficiary's remaining life expectancy, regardless of whether the designated beneficiary survived the spouse. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A E-8(c) Ex. 2.

(d) For example, assume that at the time the participant died the spouse was age 72 and the spouse named a grandchild, age 26, as the designated beneficiary, and that the spouse dies five years after the participant died. As a 26-year old, the grandchild's life expectancy is 56 years. However, the grandchild would be treated as age 62 for purposes of determining the minimum distribution to the spouse in the first distribution year (resulting in a joint and last survivor expectancy of 24.4 years).
When the spouse dies five years later, however, the balance in the IRA can be paid out over the grandchild's unrecalculated remaining life expectancy, which would be 51 years, i.e., the grandchild's original 56-year life expectancy minus the five years that have elapsed since the payments commenced to the spouse.

g. If the spouse is older than the deceased participant, and the participant dies before his or her RBD, the spouse may wait until the deceased participant would have reached age 70½, and then have the deceased participant's plan benefit or IRA rolled over to his or her own IRA.

(1) This will allow the spouse to defer the commencement of the payment of the benefit for as long as possible under the minimum distribution rules.

(2) It will also allow the spouse to have a designated beneficiary both before and after payments are required to be made.

(a) If the spouse does not have the deceased participant's benefit rolled into his or her own IRA, he or she may name a designated beneficiary to receive benefits if the spouse dies before the participant would have reached age 70½, but the spouse may not have a designated beneficiary once payments must commence, and only the spouse's life expectancy will be used for determining the required minimum distribution.

(b) However, once the spouse has the deceased participant's benefits rolled into his or her own IRA, the spouse may name a designated beneficiary to receive any remaining benefits after his or her death, regardless of whether payments are required to be made to the spouse, and the designated beneficiary's life expectancy may then be used for purposes of determining the amount of the required minimum distribution to the spouse, subject to the minimum distribution incidental death benefit rule.

h. If the spouse is under age 59½, the spouse may want to wait until he or she reaches age 59½ to roll over the decedent's benefit or
IRA so that any withdrawals before age 59½ will not be subject to the ten percent premature withdrawal tax.

(1) However, a spouse may be unable to treat a deceased account holder's IRA as his or her own IRA or roll over an IRA of a deceased account holder after relying upon the exception to the ten percent penalty tax on early distributions for payments to a beneficiary of a deceased participant. PLRs 9608042 and 9418034.

(a) The IRS ruled that the surviving spouse made an irrevocable election not to treat the deceased participant's IRA as her own.

(2) These rulings could be read as only preventing the spouse from treating the IRA as his or her own and not as preventing a rollover to a new IRA.

(3) These rulings may not apply where the surviving spouse leaves the decedent's qualified retirement plan benefit in the plan until he or she reaches age 59½, and then has the balance of the plan benefit rolled or transferred into his or her own IRA.

(4) To avoid the problem altogether, the spouse could roll part of the IRA or plan benefit into his or her own IRA, keeping enough in the participant's plan or IRA to use if he or she needs it before he or she reaches age 59½.

IV. NAMING A QTIP TRUST AS BENEFICIARY

A. Reason for Naming a QTIP Trust.

1. Unless one of the transition rules applies because the participant terminated employment with the sponsoring employer before 1983, in the case of the unlimited exclusion, or before 1985, in the case of the $100,000 exclusion, plan benefits and IRAs will be subject to federal estate tax. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA 82) §§ 245(a) and (c); the Deficit Reduction Act of 1984 (DEFRA 84) § 525(a); the Tax Reform Act of 1986 (TRA 86) § 1852(e)(3).

a. If a participant separated from service before 1983 and has not changed his or her beneficiary designation or form of benefit with respect to the plan after 1982, the plan benefit will be excluded from his or her federal gross estate as long as five or ten-year
averaging is not elected and the plan benefit is not payable to the participant's estate.

b. If a participant separated from service after 1982 but before 1985, and has not changed his or her beneficiary designation or the form of benefit with respect to the plan after 1984, $100,000 of the participant's plan benefit will be excluded from his or her federal gross estate as long as five or ten-year averaging is not elected and the benefit is not payable to the participant's estate.

2. If a participant wants to qualify the plan benefits or IRAs for the marital deduction in order to defer the federal estate tax on plan benefits or IRAs until the death of his or her spouse, but does not want to give the spouse control over the plan benefits or IRAs, the participant may name a trust designed to qualify for the marital deduction as the designated beneficiary. I.R.C. §§ 2056(b)(5) or (7).

3. When a goal of the participant is to eliminate the spouse's control over the plan benefits and IRAs, a qualified terminable interest property (QTIP) trust will be the type of marital deduction trust used for this purpose.

   a. Only the QTIP trust assures the participant of ultimate control over the disposition of any remaining assets in the trust at the death of the spouse.

   b. An estate trust, which qualifies for the marital deduction, requires that any remaining assets in the trust be payable to the spouse's estate.

   c. A life income/general power of appointment trust requires that the surviving spouse have the right either to withdraw the assets from the trust during his or her lifetime or to designate where the assets in the trust will go at his or her death.

   d. A charitable remainder trust (CRT) in which the spouse is the only noncharitable beneficiary will qualify for both the charitable and marital deductions. However, at the death of the surviving spouse, the assets in the CRT will go to the charitable organization.

4. A participant's spouse will be required to consent to the designation of a trust as the primary beneficiary of either all of the participant's plan benefit or the portion of the plan benefit representing the spouse's annuity rights under REA. I.R.C. §§ 401(a)(11) and 417.

   a. In the case of an IRA, spousal consent is not required.
b. If the participant's benefits are in a plan not subject to the qualified joint and survivor annuity rules, such as a profit sharing plan, the participant may have the benefit transferred to an IRA to avoid obtaining the spouse's consent to naming the QTIP trust as the beneficiary.

5. In order to use the surviving spouse's life expectancy for purposes of determining the required minimum distribution once the participant reaches his or her RBD and to avoid the five-year distribution rule if the participant dies before his or her RBD, the spouse must be treated as the participant's designated beneficiary under the rules discussed above when a trust is named as the beneficiary. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A B-4.

B. Qualifying for the Marital Deduction.

1. A QTIP trust must distribute the income from the assets held in the trust to the surviving spouse at least annually. I.R.C. § 2056(b)(7)(B)(ii)(I).

a. The regulations interpreting this requirement in connection with a life income/general power of appointment trust require that either the assets in the trust be income producing or the surviving spouse have the right to demand that the trustee convert unproductive assets to productive assets or distribute other assets equal in value to the income that would have been produced by the unproductive assets if they were productive assets. Treas. Reg. § 20.2056(b)-5(t)(4) and (5).

(1) The requirement is also satisfied even if the income is retained in the trust as long as the spouse has a continuing and unrestricted right to demand the income be distributed to him or her at any time.

(2) The final QTIP regulations adopt these rules for purposes of determining whether the spouse is entitled to all the income. Treas. Reg. § 20.2056(b)-7(d)(2).

b. If the income generated by the decedent's plan benefits or IRAs is not currently distributed to the QTIP trust and then redistributed to the surviving spouse, the IRS could take the position that the income requirement has not been satisfied.

c. However, if the trustee of the QTIP trust has the right to withdraw the plan benefit or IRA at any time, as is the typical case, and the surviving spouse has the right to require the trustee to make unproductive assets productive, there should be no requirement
that any amount be paid out to the QTIP trust from the plan or IRA until required under the minimum distribution rules.

(1) Note that because the constructive receipt doctrine does not apply to qualified retirement plan benefits and IRAs, the trust will not be taxable on amounts subject to the trustee's right to withdraw that are not actually withdrawn.

2. The income generated by the plan benefit or IRA will exceed the amount required to be distributed to the QTIP trust under the minimum distribution rules in two situations.

a. If the participant dies before the participant reaches age 70½ and the surviving spouse is the designated beneficiary, payments do not have to commence to the surviving spouse until the participant would have reached age 70½. I.R.C. § 401(a)(9)(B)(iv).

(1) Some commentators have questioned whether the spouse can defer the payment of the benefit until the participant would have reached age 70½ if the benefit is payable to a trust.

b. Once the payments begin, the required distribution in the first few years may not equal the income generated by the plan benefit or IRA.

(1) For example, if the surviving spouse is age 59 when the participant would have reached age 70½, the spouse's life expectancy will be 25 years.

(2) Consequently, the first required minimum distribution will equal four percent of the value of the plan benefits and IRAs, which may be considerably below the income they generate during the year.

3. Unfortunately, the IRS in one published ruling and a number of private letter rulings has led commentators to conclude that the plan benefit or IRA itself must satisfy the requirements of a QTIP trust and the executor of the deceased participant's estate must make the QTIP election with respect to the plan benefit or IRA. Rev. Rul. 89-89, 1989-2 C.B. 231; PLRs 9416016, 9321059, 9245033, and 9220007.

a. In order for the plan benefit or IRA to satisfy the QTIP requirements, the form of payment of the plan benefit or IRA selected by the participant before his or her death must require that
an amount at least equal to the income generated by the plan benefit or IRA be payable to the QTIP trust.

b. Furthermore, under the terms of the QTIP trust, income distributions from the plan or IRA must be treated as income for trust accounting purposes so that it will be redistributed to the spouse.

c. Satisfying the IRS's position may require an earlier or larger distribution from the plan or IRA than would have been required under the minimum distribution rules, thereby accelerating the payment of income tax on the benefit or IRA.

4. The IRS's position that a QTIP election must be made to qualify a plan benefit or IRA for the marital deduction may arise out of a concern that the plan benefit or IRA remaining at the surviving spouse's death would not be includible in the surviving spouse's estate if the election were not made.

a. If a QTIP election is made with respect to the plan benefit or IRA, any remaining plan benefit or IRA at the spouse's death will be includible in the spouse's federal gross estate under I.R.C. § 2044.

b. However, the same result could be achieved by requiring that any remaining plan benefit or IRA continue to be paid to the trust created for the benefit of the spouse after he or she dies, so that the QTIP election made with respect to that trust will automatically cause the plan benefit or IRA to be includible in the surviving spouse's gross estate under I.R.C. § 2044.

5. As a result of the IRS's position, the conservative approach when it is desirable to name a QTIP trust as the beneficiary of a qualified retirement plan benefit or IRA, is as follows:

a. The payment and beneficiary designation form for the qualified retirement plan benefit or IRA should provide that the QTIP trust be paid each year beginning with the year following the year in which the participant dies the greater of (x) the income generated by the assets representing the accrued benefit in the qualified retirement plan or the assets in the IRA or (y) the required minimum distribution determined under I.R.C. § 401(a)(9).

b. The trustee of the QTIP trust should have the right under both the payment and beneficiary designation form and the QTIP trust agreement to require the plan trustee or IRA sponsor to convert
nonincome-producing or low income-producing assets into assets producing adequate income.

(1) In the case of a defined benefit plan, which does not provide for a specific account that represents the deceased participant's accrued benefit, the trustee of the QTIP trust should have the right to treat a certain amount of the value of the accrued benefit as income each year, perhaps based on the state's income and principal act.

(2) The trustee should also be given the right under both the payment and beneficiary designation form and the QTIP trust agreement to withdraw the accrued benefit or IRA balance at any time so that the trustee could withdraw an amount equal to the income that would have been produced if the assets were producing adequate income.

c. The QTIP trust agreement should provide that the part of any distribution from a qualified retirement plan or IRA that represents income will be paid to the spouse in the same manner as any income generated by other assets held by the trust and no expenses that would be chargeable against principal will be charged against the income element of the distribution.

d. The spouse should have the right under the trust agreement to demand the trustee of the QTIP trust to make nonincome-producing assets income producing or to convert nonincome-producing assets into assets producing adequate income.

(1) The trustee of the QTIP trust should have the right under the trust agreement to distribute other assets of the trust to satisfy this demand.

e. A QTIP election should be made for both the trust and the qualified retirement plan benefit or IRA, by listing the plan benefit or IRA on Schedule M of Form 706.

6. This approach will defer the payment of principal from the qualified retirement plan or IRA as long as permitted under the faster of the minimum distribution rules and the QTIP income requirement, thereby deferring payment of tax on the principal and retaining the principal in a tax-free vehicle.

a. This approach will also ensure that the principal when paid to the trust is not paid out to the spouse unless required under an
ascertainable standard (or some other standard) contained in the trust agreement permitting principal distributions.

b. However, from an income tax standpoint, it may be preferable to distribute the principal to the spouse, who is likely to be in a lower income tax bracket than the trust, which reaches the 39.6 percent bracket when it has $8,450 of taxable income in 1999, while the spouse does not reach the 39.6 percent bracket until he or she has $283,150 of taxable income in 1999 (or $141,575 for a married individual filing a separate return).

V. OTHER ESTATE TAX CONSIDERATIONS

A. Naming the Credit Shelter Trust as Beneficiary.

1. If the participant does not have sufficient assets outside of qualified retirement plan benefits and IRAs to take advantage of his or her applicable exclusion amount ($650,000 for 1999), he or she may consider one of two ways of using the plan benefits or IRAs for this purpose.

2. First, the participant could specifically designate a credit shelter trust as the beneficiary of a portion of the participant's plan benefits or IRAs.

a. If the spouse were the named income beneficiary of the credit shelter trust, the life expectancy of the spouse could still be used to determine the required distributions to the participant during his or her lifetime, assuming that the remainder beneficiaries are all individuals who are younger than the spouse, such as the couple's children or grandchildren. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&As D-5 and E-5(a).

b. Once the participant died, the payments would continue to the credit shelter trust over the remaining life expectancy of the participant's spouse (assuming that the participant's life expectancy was being recalculated and the spouse's was not).

c. The spouse would not have the option of rolling the remaining plan benefits or IRAs that were payable to the credit shelter trust into his or her own IRA.

d. If other beneficiaries of the trust could receive distributions attributable to the plan benefit or IRA before the spouse's death, the payment of the benefit or IRA would have to begin by the end of the year following the year in which the participant died rather than by the end of the year in which the participant would have reached age 70½. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A C-3(a).
3. A second option would be to designate the spouse as the primary beneficiary and the credit shelter trust as the secondary beneficiary.

   a. If the participant dies before the spouse, the spouse may disclaim the amount of plan benefits and IRAs necessary to use the participant's unused applicable exclusion amount.

      (1) GCM 39858 sanctioned the use of a qualified disclaimer with respect to qualified retirement plan benefits.

   b. In order to satisfy the qualified disclaimer rules under the I.R.C., the designation of the spouse should remain revocable while the participant is alive.

      (1) If the participant irrevocably names the spouse as the beneficiary of his or her plan benefits and IRAs, the nine-month period within which a qualified disclaimer must be made will commence upon the date that the irrevocable beneficiary designation is made rather than at the death of the participant.

   I.R.C. § 2518(b).

4. Note that it may be better for the participant to use assets (including Roth IRAs) other than plan benefits or IRAs to fund the credit shelter trust, since the plan benefits and IRAs will be subject to income tax when received by the trust, thereby reducing the amount passing estate tax free to the participant's children or other beneficiaries when the spouse dies.

   a. Had the plan benefits and IRAs been paid to the spouse or a trust designed to qualify for the marital deduction, the income tax paid on the benefits would have reduced the amount that will be subject to estate tax when the spouse dies.

   b. However, if there are no other assets available to fund a credit shelter trust, a credit shelter reduced by income taxes when the plan or IRA is distributed may be better than no credit shelter at all.

      (1) Nonetheless, depending upon the circumstances, the benefit of tax-free income may offset the benefit of the estate tax savings.

      (2) However, if the oldest beneficiary of the trust is a child or grandchild and not the spouse, similar income tax benefits
may be achieved by naming the credit shelter trust as beneficiary.

B. Payment of Estate Taxes.

1. The advisor should be certain that the client has considered the source of payment of federal and state estate and death taxes attributable to plan benefits and IRAs.

2. If the residuary beneficiaries of the client's estate are also the beneficiaries of the plan benefits and IRAs, a clause in the client's will requiring the estate to pay all such taxes will accomplish the client's objectives.

   a. In effect, each of the residuary beneficiaries will pay a pro rata portion of these taxes.

3. On the other hand, if the plan benefits and IRAs are being paid to beneficiaries who are not also residuary beneficiaries under the client's will or trust, in most cases the client's objectives will be accomplished by having the beneficiaries entitled to the plan benefits or IRAs responsible for paying the taxes on the benefits or IRAs.

4. Because the beneficiary will be subject to income tax on any amounts withdrawn to pay the estate tax, the amount withdrawn will have to be grossed up if the beneficiary wants to use the plan benefits or IRAs to satisfy all his or her tax liabilities arising from being named the beneficiary.

   a. Life insurance on the participant's life could provide the cash to pay the death taxes.

5. Although the plan benefit may not be currently payable under the terms of the plan, the beneficiary entitled to the plan benefit may still be legally responsible to pay the estate tax.

   a. In such event, the beneficiary would have to use other resources to pay the tax.

   b. If there were no other resources and there were no other assets in the estate, it is unclear how the tax would be currently paid.

   c. Under I.R.C. § 6324(a)(2), the federal government cannot place a tax lien on a benefit held in a trust that meets the requirements of I.R.C. § 401(a) (dealing with qualified retirement plans).
d. Perhaps an extension to pay the tax could be granted for reasonable cause under I.R.C. § 6161.

VI. USING AN IRA FOR CHARITABLE GIVING

A. Introduction.

1. Many individuals have accumulated large balances in qualified retirement plans and traditional IRAs.
   a. These amounts will be subject to income tax when distributed.
   b. In addition, they will be includible in the participant's federal gross estate when he or she dies.

2. While the discussion will deal primarily with IRAs, the same rules and consequences generally apply to using qualified retirement plan benefits for charitable giving.
   a. Certain rules pertaining only to qualified retirement plans, and not to IRAs, will be noted below.
   b. Since qualified distributions from Roth IRAs are not subject to income tax, there is no special benefit in using Roth IRAs for charitable bequests.

(1) Therefore, when this section speaks about IRAs, it is referring to traditional IRAs and not Roth IRAs.

3. Using a qualified retirement plan benefit or an IRA to fund a charitable bequest has significant tax benefits.

B. Tax Consequences.

1. As with any charitable bequest, the IRA will be deductible for federal (and usually state) estate tax purposes if a charity is named as the beneficiary.

2. Because a charitable organization generally is exempt from federal (and usually state) income taxation, except for its receipt of unrelated business income, the distribution of the IRA to the charitable organization will escape federal and state income taxation.
   a. A nonexempt beneficiary would pay tax on the IRA when received.
b. See Hoyt. Transfers From Retirement Plans to Charities and Charitable Remainder Trusts: Laws, Issues and Opportunities, 13 Va. Tax Law Rev. 641 (Spring, 1994), in which the author discusses the possibility that the noncharitable beneficiary of a CRT may recognize taxable income when retirement plan benefits or IRAs are paid to the trust, based on the economic benefit doctrine.

(1) However, the IRS has ruled that a distribution of a qualified retirement plan benefit to a CRT was includible in the gross income of the CRT and would not be taxable unless the CRT had unrelated business taxable income for that year. See, PLR 199901023.

(a) In addition, the beneficiary would not be taxable as a result of the distribution to the CRT, but only when he or she received the unitrust payments from the CRT.

(2) Note that private letter rulings are directed only to the taxpayers who requested them and may not be used or cited as precedent.

c. A private letter ruling issued in 1996 held that a private foundation was subject to the two percent excise tax on investment income under I.R.C. § 4940 when it received a distribution from a qualified retirement plan (actually it was a Keogh plan for self-employed individuals).

(1) The CPA who requested the ruling subsequently wrote an article taking issue with the holding. See Mulcahy, Is a Bequest of a Retirement Account to a Private Foundation Subject to Excise Tax, 85 Journal of Taxation, 108 (August 1996).

(2) Fortunately the Service later ruled that a foundation that was the beneficiary of an IRA and a qualified retirement plan benefit was not subject to excise tax on investment income under I.R.C. § 4940.

(a) The ruling was based on the fact that retirement accounts are deferred compensation income and therefore are not included in the definition of gross investment income of a foundation. PLR 9838028, issued June 21, 1998.
3. Because an IRA is income in respect of a decedent, a noncharitable beneficiary of a deceased account holder must treat the receipt of the IRA in the same manner as the account holder would have, i.e., as ordinary income.

   a. Income in respect of a decedent, generally speaking, is cash or other consideration received by a beneficiary of a decedent that would have been includible in the decedent's gross income for federal income tax purposes had he or she survived to receive the income.

      (1) In contrast, other assets held by the decedent at death receive a new basis (stepped up in the case of appreciated property) equal to the fair market value as reported for estate tax purposes.

      (2) In addition to benefits from qualified retirement plans and IRAs, other examples of income in respect of a decedent are nonqualified deferred compensation, vacation pay, and installment payments on a note received pursuant to an installment sale. See I.R.C. § 691(a).

   b. A taxpayer who receives income in respect of a decedent subject to income tax is entitled to an income tax deduction (IRD deduction) equal to the federal (but not state) estate tax attributable to the income.

      (1) The amount of the IRD deduction is determined by subtracting from the federal estate tax actually due the federal estate tax that would have been payable if all income in respect of a decedent, including IRAs, had not been included in the federal gross estate.

         (a) The difference is then allocated proportionately to each item of income in respect of a decedent included in the decedent's federal gross estate. See I.R.C. § 691(c).

         (b) In the case of a CRT, the Service has ruled that the federal estate tax that would have been paid is determined without the charitable deduction for the remainder interest. PLR 199901023.

      (2) The deduction is not subject to the two-percent floor on miscellaneous itemized deductions but is included in the itemized deductions that are reduced by three percent of the
taxpayer's adjusted gross income in excess of certain dollar
amounts.

(3) The Service has ruled that a CRT that includes a plan
benefit in the gross income is entitled to reduce its ordinary
income (first tier income under the four-tier system) by the
IRD deduction; the deduction does not pass through to the
noncharitable beneficiary. PLR 199901023.

(a) Consequently, the noncharitable beneficiary may
never realize the benefit of the deduction unless the
CRT distributes all of its first tier income.

4. Example of Tax Savings.

a. Because federal taxes will reduce the amount received by a
noncharitable beneficiary, the cost of making a charitable bequest
is significantly less than the face amount of the bequest.

b. A beneficiary of a $1,000,000 IRA subject to the maximum federal
estate and income tax rates would receive $271,800 after the
payment of federal estate and income tax, not taking into account
state and local taxes.

(1) The federal estate tax is $550,000 ($1,000,000 x 55
percent), leaving $450,000 ($1,000,000 - $550,000) passing
to the beneficiary before income taxes.

(2) A generation-skipping tax could also apply if the
beneficiary is two or more generations below the account
holder and the $1,000,000 exemption has been used for
other transfers. Here we assume that this tax will not be
incurred.

(3) The $450,000 would be subject to a 39.6 percent maximum
federal income tax rate, resulting in a federal income tax of
$178,200.

(4) The beneficiary would receive $271,800 ($450,000
-$178,200).

(5) If the account holder had named a charitable organization
as the beneficiary of the $1,000,000 IRA, the net cost to the
family of their foregone legacy would only be $271,800.
(a) That is the amount the family would have received net of federal estate and income taxes if family members had been designated as beneficiaries.

c. The actual cost to the family of the charitable bequest of the IRA is further reduced if there is a state estate or death tax, even if the state estate tax is only a "pick-up" tax equal to the exact amount that the estate receives as a credit for federal estate tax purposes.

(1) Although with a pick-up tax the total of federal and state estate taxes remains the same, the deduction for federal income tax purposes is limited to the federal estate tax.

(2) For example, if the credit is ten percent of the federal estate tax (a hypothetical figure), the deduction in the preceding example would be limited to $495,000 ($550,000 - $55,000 (ten percent of $550,000)), resulting in an income tax of $199,980 ($1,000,000 - $495,000 = $505,000; $505,000 x 39.6 percent = $199,980), and a balance to the family of $250,020 ($450,000 - $199,980).

5. Funding a Pecuniary Bequest.

a. A qualified retirement plan benefit or IRA should not be used to satisfy a pecuniary bequest to a charity.

(1) If the IRA is used to satisfy such a bequest, the estate will recognize current income equal to the amount of the IRA paid to the charity to satisfy the bequest because the estate is treated, for income tax purposes, as receiving a distribution from the IRA and using it to satisfy its obligation to pay the pecuniary bequest.

(2) The estate would be entitled to a charitable income tax deduction if the will required the use of the IRA to satisfy the bequest.

(3) The same result would apply in the case of any other income in respect of a decedent used to satisfy a pecuniary bequest.

I.R.C. §§ 642(c)(1) and 691(a)(2).
b. The estate's recognition of income can be avoided by naming the charity as the beneficiary of all or part of an IRA. I.R.C. § 691(a)(2).

(1) If the entire balance of an IRA is not going to be paid to the charity, the account holder should name the charity as a beneficiary of a specific fraction or percentage of the IRA.

(a) Designating the charity as the beneficiary of a fraction or percentage of an IRA should prevent the acceleration of the payment of the balance of the other portions of the IRA to noncharitable beneficiaries.

(b) Because the beneficiary of each specified fractional share of the IRA will be treated as a "designated beneficiary" of that fraction under the minimum distribution rules, the payment of each beneficiary's share can be spread over that beneficiary's life expectancy.

C. Naming a Charity as a Beneficiary Under the Minimum Distribution Rules.

1. Under the minimum distribution rules, a designated beneficiary must be an individual, including an individual who is a beneficiary of a trust that meets certain requirements. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A D-2A.

a. Because a charitable organization is not an individual, it does not qualify as a designated beneficiary.

2. If a charitable organization is one of a number of beneficiaries of the account holder's IRA, the account holder will be treated as not having designated a beneficiary unless the charitable organization is entitled to a separate account of the IRA or defined contribution qualified retirement plan, or a segregated share of a defined benefit qualified retirement plan. Prop. Treas. Reg. §§ 1.401(a)(9)-1, Q&As E-5(a)(2) and H-2.

a. A fraction or percentage of the account holder's IRA will likely be treated as a separate account if the financial institution sponsoring the IRA separates the IRA into separate accounts as of the date of death.

b. A dollar amount would not satisfy the separate account requirement that it share in the investment gains and losses, since it would remain constant.
3. If the account holder wants the charitable organization to receive only a specific dollar amount, the planning to avoid the acceleration of the payments to the noncharitable beneficiaries becomes more complicated.

a. In this case, the account holder could designate the charitable organization as a beneficiary of a specific amount from a separate IRA, with a current value approximately equal to the amount the account holder desires to leave to the charity.

b. Before the account holder reaches his or her RBD, the account holder can keep the IRA designated to go to the charity close to a desired dollar amount by having the trustee or custodian of the IRA make a direct transfer of any excess amount to his or her other IRAs at the end of each year.

   (1) If the account holder dies before his or her RBD, the charitable organization will receive the balance in the separate IRA or, if less, the specific dollar amount.

   (2) Any remaining balance in the IRA not payable to the charity would have to be paid to the noncharitable beneficiary or beneficiaries by the end of the fifth year after the year in which the account holder died.

c. Because the separate IRA naming the charity as the beneficiary would qualify as a separate account, the other IRAs of the decedent could be paid to the noncharitable beneficiaries over their life expectancies.

4. It could be argued that specifying a dollar amount of an IRA also should constitute a separate account if the participant dies before his or her RBD, since the specific dollar amount would constitute a fraction of the IRA at that point and would then be distributed outright to the charity, leaving the balance to be paid out over the designated beneficiary's life expectancy or, if the spouse is the beneficiary, to be rolled into a spousal IRA.

a. However, a specific dollar amount payable to the charity may not satisfy the separate account requirement for the period between the participant's death and the date of payment to the charity if it will not be allocated a share of investment earnings during this period under the terms of the beneficiary designation or under state law. See Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A H-2A(a).
5. Once the account holder reaches his or her RBD, he or she will be required to begin withdrawing required minimum distributions from his or her IRAs.

   a. The account holder could withdraw a sufficient amount from the IRA benefitting the charity or transfer any excess to another IRA if necessary to reduce the value of the IRA benefitting the charity to the desired amount.

   (1) However, the amount transferred will be separately accounted for under the transferee IRA and required minimum distributions will be calculated as if the charity remains the beneficiary, i.e., only the life expectancy of the account holder may be considered. Prop. Treas. Reg. §§ 1.401(a)(9)-1, Q&A G-4(b) and 1.408-8, Q&A A-7.

   b. Because the required minimum distribution generally may be withdrawn from any of the taxpayer's IRAs, rather than from each IRA, the account holder could keep the IRA intended to pass to the charity at the desired level by withdrawing or not withdrawing the required minimum distribution from it or from one or more of his or her other IRAs each year. Notice 88-38, I.R.B. 1988-15.

   (1) In the example in Notice 88-38, I.R.B. 1988-15, the account holder was allowed to withdraw the required minimum distribution, which was computed on the total of the account balances in three separate IRAs, each with a different designated beneficiary, from the two IRAs with the oldest designated beneficiaries.

D. Naming the Spouse as Primary Beneficiary, with Charity as Successor.

1. In some instances, the account holder may wish to provide income to his or her spouse during the spouse's lifetime if the spouse survives the account holder, followed by the payment of any remaining balance in the IRA to a charitable organization at the death of the spouse.

2. If the account holder is confident that the spouse will name the charitable organization as the beneficiary of the balance of the IRA remaining at the spouse's death, the spouse could be named the beneficiary to receive the IRA if the account holder dies before the spouse.
3. The surviving spouse could then treat the IRA as his or her own IRA, and under the minimum distribution rules, the spouse could wait until he or she reaches age 70½ before he or she would have to begin receiving distributions from the IRA.

   a. The spouse could name the charitable organization as his or her beneficiary.

   b. Because the charitable organization would not qualify as a designated beneficiary for purposes of the minimum distribution rules, the required minimum distribution to the spouse would be determined using only his or her life expectancy.

   c. When the surviving spouse dies, the balance in the IRA would be paid to the charitable organization.

   d. Although the IRA would be includible in the surviving spouse's gross estate for federal estate tax purposes, it would qualify for the estate tax charitable deduction.

   e. In addition, the charity, as a tax-exempt organization, would not pay any income tax on the receipt of the balance of the IRA remaining at the surviving spouse's death.

E. Naming a QTIP Trust as a Beneficiary.

1. If the account holder is concerned that the spouse may have a change of heart and name someone other than the charity as the beneficiary of the IRA, the account holder may ensure that the balance in the IRA at the death of the surviving spouse will pass to the charitable organization through the use of either a qualified terminable interest property (QTIP) trust or a charitable remainder trust (CRT).

2. A QTIP trust, which qualifies for the marital deduction for federal estate tax purposes, requires that all the income be paid to the surviving spouse at least annually and that no one other than the spouse receive anything from the trust while the spouse is alive. I.R.C. § 2056(b)(7).

3. Because the assets remaining in the trust at the surviving spouse's death may be paid to a beneficiary designated by the first spouse to die, the first spouse can retain ultimate control of the disposition of the remaining assets, including the principal portion of the distribution from the IRA that is not distributed to the spouse.

   a. However, it is likely that any principal retained in the trust will be taxed at a higher rate than if distributed to the spouse.
b. For a trust, taxable income in excess of $8,450 (for 1999) is taxed at the 39.6 percent maximum federal income tax rate, while the spouse will not reach the 39.6 percent rate until his or her taxable income exceeds $283,150 (for 1999).

4. Although the assets remaining in the trust are includible in the surviving spouse's gross estate for federal estate tax purposes, the value of any assets passing to a charitable organization would be deductible.

F. **Naming a Charitable Remainder Trust as Beneficiary.**

1. In a CRT, one or more noncharitable beneficiaries are entitled to receive, at least annually, either a fixed dollar amount or a fixed percentage of the current value of the assets in the trust. See, generally, I.R.C. § 664.

   a. No additional amounts may be paid from the trust until it terminates.

   b. Upon the death of the noncharitable beneficiary or the survivor of the noncharitable beneficiaries, the trust terminates, and the assets remaining in the trust are paid to one or more charitable organizations.

2. If the surviving spouse is the only noncharitable beneficiary, the entire value of the IRA passing to the CRT would be deductible from the federal gross estate when the account holder dies.

   a. The surviving spouse's interest would qualify for the marital deduction and the charitable remainder interest would qualify for the charitable deduction. I.R.C. § 2056(b)(8).

   b. None of the balance of the IRA remaining at the death of the surviving spouse would be includible in his or her federal gross estate.

3. There are at least two drawbacks to naming a CRT as the beneficiary of an IRA.

   a. When the account holder reaches his or her RBD, the account holder can only use his or her own life expectancy for determining the amount of the required minimum distribution each year, since the charitable organization does not qualify as a designated beneficiary.

   b. Because no distributions other than the fixed dollar amount or fixed percentage is permitted to the surviving spouse from the
CRT, using a CRT instead of a QTIP trust eliminates the ability of the trustee to make additional distributions to the surviving spouse for his or her support, health or other needs, as well as to enable the surviving spouse to make gifts to other beneficiaries.

G. Choosing the Appropriate Trust.

1. The decision as to which form of trust to use depends upon a number of factors.

2. With the QTIP trust, the surviving spouse could be given the power to withdraw the principal for his or her needs or to make gifts to other beneficiaries of the account holder, if this were desired.

3. A possible disadvantage of using a QTIP trust to accomplish the objectives of the account holder is the loss of the ability to defer the payment of the IRA to the trust over the surviving spouse's life expectancy.

   a. Under one interpretation of the minimum distribution rules contained in the proposed regulations, the account holder would not be treated as having a designated beneficiary. See, e.g., Shumaker and Riley, Strategies for Transferring Retirement Plan Death Benefits to Charity, 19 ACTEC Notes 162 (Winter, 1993).

      (1) As a result, if the account holder were to die before his or her RBD, the entire IRA would have to be paid to the QTIP trust by the end of the fifth year following the year of the account holder's death.

      (2) In addition, once the account holder reached his or her RBD, only his or her life expectancy could be used for purposes of determining the required distribution each year, rather than the joint and last survivor expectancy of the account holder and his or her spouse, which could have been used if the account holder had named the spouse as the designated beneficiary rather than the QTIP trust with the charitable organization as the remainder beneficiary.

   b. This interpretation of the proposed regulations is based on the multiple beneficiary rule that applies if the account holder has named more than one beneficiary and one of the beneficiaries does not qualify as a designated beneficiary. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A E-5(a).
(1) In such a case, the account holder is treated as not having a designated beneficiary.

(2) Since a charitable organization cannot be a designated beneficiary according to the proposed regulations, an account holder will not have a designated beneficiary if he or she has multiple beneficiaries and one of them is a charitable organization.

(3) A charitable organization that is named as the remainder beneficiary of a QTIP trust may be treated as a beneficiary under the multiple beneficiary rule if it has a right to any benefits distributed during the spouse's lifetime, rather than just a contingent right to the IRA following the spouse's death. Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A E-5(e)(1).

(a) Because the charitable organization presumably will be in existence at the surviving spouse's death, regardless of how long the spouse lives, and will be entitled to whatever IRA balance is remaining at the death of the surviving spouse, as well as any distributions treated as principal remaining in the QTIP trust, the charitable organization could be viewed as having a vested right to a portion of the IRA.

(4) However, if the surviving spouse's life expectancy is not being recalculated, there would be no remaining balance in the IRA if the surviving spouse outlives his or her life expectancy and if the trustee of the QTIP trust has paid out all of the distributions from the IRA to the surviving spouse, including the principal portion of the distributions, none of the IRA would pass to the charitable organization at the spouse's death.

(a) Viewed in this way, the charity's interest could be treated as contingent on the surviving spouse not outliving his or her life expectancy.

(b) This view is supported by a PLR addressing a QTIP trust beneficiary of an IRA, where upon the death of the IRA owner, the surviving spouse was treated "as the sole primary beneficiary" for minimum distribution purposes, and the children who became beneficiaries upon the spouse's death were disregarded. PLR 9704029.
(c) But see PLR 9820021, which held that because a charitable organization was the remainder beneficiary of a QTIP trust named as the participant's beneficiary, which could retain amounts that had been distributed to it from the plan, the participant did not have a designated beneficiary.

i) The IRS reasoned that persons other than the spouse, i.e., the charities, were entitled to benefits distributed from the plan during the spouse's lifetime, although they would not actually receive any of the benefit until after the spouse died.

(d) It is arguable that if the trust agreement requires the entire required minimum distribution to be distributed to the beneficiaries of a trust (in the case of a trust intended to qualify for the marital deduction, the only beneficiary would be the surviving spouse), then there would be no amounts that were distributed to the trust during the lifetime of the designated beneficiary that would ultimately pass to the charitable remainder beneficiary.

4. If there is concern that the charity's right will be vested, the acceleration of income can be avoided by naming a charitable remainder annuity trust or unitrust as the beneficiary rather than a QTIP trust.

a. Because the CRT is tax exempt, there should be no income tax when the IRA is paid to the trust upon the account holder's death.

(1) The surviving spouse will generally pay income tax on the amount he or she receives from the CRT each year.

b. The flexibility to make distributions in excess of the fixed dollar or percentage amounts to the surviving spouse that would have been available if a QTIP trust were named as the beneficiary may not be important if the spouse has other funds available for his or her support, health or other needs.

c. Although distributions of additional amounts cannot be made to the spouse for making annual exclusion gifts, which could have been permitted from the QTIP trust, estate taxes would be saved if the surviving spouse used funds that would otherwise be included
in his or her federal taxable estate to make such gifts rather than assets that would eventually pass to a charitable organization.

H. Providing for a Child.

1. If the account holder is not married or has otherwise provided for his or her surviving spouse, but wishes to provide income for a child, naming a CRT as beneficiary of his or her IRA may provide more income to the child during his or her lifetime than would an outright bequest of the IRA to the child.

   a. Because the bequest to a CRT will result in a charitable deduction of the actuarial value of the charity's remainder interest for estate tax purposes, less federal estate tax will be payable upon the death of the account holder.

   b. In addition, the payment of the IRA to the CRT will not cause immediate income taxation.

   c. Both the income tax and the estate tax that would otherwise have been paid on the IRA will be available to be invested to provide income during the life of the child, and if desired by the account holder, the lifetime of the child's surviving spouse.

   d. Some of the additional income could be used to purchase life insurance on the life of the child or the joint lives of the child and his or her spouse to replace the balance of the IRA that passes to the charitable organization when the child or the survivor of the child and his or her spouse dies.

      (1) The proceeds would be payable to the child's descendants or other intended beneficiaries.

2. The amount paid from the CRT to the child and spouse during their lifetimes will be taxable income in most cases.

3. Because TRA 97 requires that the minimum value of the charity's remainder interest be at least ten percent of the initial net fair market value of the assets transferred to the trust, a young age of the child or of the child and the child's spouse (resulting in a long life expectancy and a low remainder value) may preclude the use of a CRT. TRA 97 § 1089, amending I.R.C. § 664(d).

4. Instead of using a CRT, the IRA could be paid out over the child's life expectancy if the child is the designated beneficiary or a trust for the
benefit of the child is the beneficiary and the child is treated as the
designated beneficiary.

I. Spousal Rights.

1. ERISA and the I.R.C. may require a married participant who intends to
name a charitable organization, including a CRT or a QTIP trust, as the
beneficiary of qualified retirement plan benefits to obtain the consent of
the spouse. I.R.C. §§ 401(a)(11) and 417, ERISA § 205.

2. Under ERISA and the I.R.C. requirements, if the participant dies before
the participant begins receiving benefits under the plan, the participant's
spouse has the right to receive a portion of the participant's benefit in the
form of a qualified preretirement survivor annuity, which provides for
annual or more frequent payments for his or her lifetime.

3. In addition, once the participant begins receiving benefits under the plan,
the benefits must be paid to the participant in the form of a qualified joint
and survivor annuity.

   a. Under a qualified joint and survivor annuity, annual or more
      frequent payments are made to the participant during his or her
      lifetime, and if the spouse survives, annual or more frequent
      payments would continue to the spouse for his or her lifetime.

4. Certain profit sharing plans, stock bonus plans and ESOPs are not required
to provide the survivor annuity forms of payment if they provide that all of
a participant's vested account balance must be paid to the participant's
surviving spouse if the participant dies before withdrawing the account
balance.

5. The survivor annuity rules do not apply at all to IRAs.

6. A surviving spouse may consent to a waiver of his or her right to the
qualified preretirement survivor annuity or vested accrued benefit in a
profit sharing plan, stock bonus plan or ESOP if the participant dies before
the participant begins receiving benefits, and to the right to have the
participant's benefit paid in the form of a qualified joint and survivor
annuity once the participant begins receiving benefits.

   a. The consent must be witnessed by a notary public or plan
      representative. See, generally, I.R.C. §§ 401(a)(11) and 417, and
      ERISA § 205 and the regulations thereunder.
J. **Withdrawals to Make Charitable Contributions.**

1. An individual who has a considerable amount of wealth accumulated in IRAs or qualified retirement plan benefits, but does not have other liquid assets, may consider withdrawing amounts from the IRAs or qualified retirement plans to fund a CRT during his or her lifetime.

2. The charitable deduction would reduce the current income tax on the amount withdrawn, and the account holder or participant would be entitled to receive payments from the CRT during his or her lifetime.

3. The participant's surviving spouse could also be entitled to payments from the trust during his or her lifetime.

4. The account holder would receive a charitable deduction for income tax purposes equal to the actuarial value of the charity's interest.

5. In addition, the actuarial value of the charity's interest would be deductible for gift tax purposes, thereby reducing the transfer tax base of the account holder or participant.

6. H.R. 1311, which was introduced in the House of Representatives on March 25, 1999, would allow a tax-free transfer from an IRA to a charitable organization, or to a CRT or pooled income fund or to a charitable organization to purchase a charitable gift annuity, but only after the account holder has attained age 59\(\frac{1}{2}\).

   a. Only the account holder and his or her spouse could have any interest in the CRT, pooled income fund, or charitable gift annuity.

   b. The bill would allow an individual to transfer his or her IRA to a charity without including the amount in adjusted gross income.

   c. Although under current law the individual would be entitled to a charitable deduction as a result of the transfer, the deduction would be limited to 50 percent of the individual's adjusted gross income, which would include the taxable part of the IRA that was transferred.

   d. A similar bill was introduced in 1997, but was never acted on.

K. **Conclusion.**

1. As can be seen, creative uses of charitable giving techniques can both reduce the federal and state income and transfer tax cost of receiving
qualified retirement plan benefits and IRAs and provide more income to the participant's or account holder's beneficiaries.

2. However, a number of technical rules must be considered when planning for distributions from qualified retirement plans and IRAs to avoid the payment of penalty taxes and unnecessary income and transfer taxes.

VII. IRAS: IN GENERAL

A. Contribution Limitations.

1. An individual may contribute the lesser of $2,000 or the individual's compensation for the year to a traditional IRA or a Roth IRA (or it can be allocated between the two). I.R.C. §§ 219(b)(1), 408(o)(2), and 408A(c)(2).

   a. For married couples filing jointly, this dollar limit is increased to $4,000 and the combined compensation of the spouses is considered.

   b. However, no more than $2,000 may be contributed to the IRAs of either spouse. I.R.C. § 219(c).

2. No contributions may be made to a traditional IRA in the year in which the individual attains age 70½ or any later year. I.R.C. § 219(d)(1).

3. Once amounts have been contributed to an IRA, the investment return is not currently subject to income tax.

B. Deductibility of Contributions.

1. The contributions made to a traditional IRA may be deductible for income tax purposes.

2. If either the participant or the participant's spouse is an active participant in a qualified retirement plan, then the amount deductible is reduced or eliminated once the participant's or couple's adjusted gross income exceeds a certain amount. I.R.C. § 219(g)(1).

   a. In 1999, in the case of a single individual who was an active participant in a qualified retirement plan, the deductible amount of the individual's IRA contribution is reduced pro rata as the individual's adjusted gross income, determined before the IRA deduction, increases from $31,000 to $41,000. I.R.C. §§ 219(g)(2)(A), (3)(B)(ii).
(1) For example, if a single individual who is an active participant in a qualified retirement plan has adjusted gross income of $36,000 (before taking into account any deduction for a contribution to an IRA), his or her deduction for an IRA contribution for 1999 is limited to $1,000, or 50 percent of the $2,000 limit on IRA contributions for an individual. The 50 percent reduction is determined by taking the excess of the individual's adjusted gross income over $31,000, which is $5,000, and dividing it by $10,000, the excess of $41,000 over $31,000.

b. In the case of a couple filing a joint return, the reduction of the deductible amount begins at $51,000 of adjusted gross income, and the couple may no longer deduct contributions to a traditional IRA once their adjusted gross income exceeds $61,000. I.R.C. §§ 219(g)(2)(A), (3)(B)(i).

c. The phase-out range for a married person filing separately is from $0 to $10,000.

d. A special rule allows a married person who is separated from his or her spouse for the entire year and who files a separate return to be treated as a single person for purposes of determining the amount of deductible contributions he or she may make to a traditional IRA. I.R.C. § 219(g)(4).

3. There is a $200 de minimis deduction available to an individual whose adjusted gross income is between $40,000 and $41,000 or a couple whose adjusted gross income is between $60,000 and $61,000 in 1999. I.R.C. § 219(g)(2)(B).

a. For example, if a couple's adjusted gross income is $60,500, they each may deduct $200 of their IRA contributions, even though the deduction without regard to this de minimis rule would have been limited to $100 ($9,500/$10,000 = 95 percent, 95 percent times $2,000 equals a reduction of $1,900, leaving a deductible amount of $100 absent the de minimis rule).
4. The phase-out amounts are increased in years after 1999 as follows:

a. Single Taxpayers.

<table>
<thead>
<tr>
<th>Tax Years Beginning In</th>
<th>Single Taxpayers</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>$32,000-$42,000</td>
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<tr>
<td>2003</td>
<td>$40,000-$50,000</td>
</tr>
<tr>
<td>2004</td>
<td>$45,000-$55,000</td>
</tr>
<tr>
<td>2005 and thereafter</td>
<td>$50,000-$60,000</td>
</tr>
</tbody>
</table>

b. Married Taxpayers Filing Jointly.

<table>
<thead>
<tr>
<th>Tax Years Beginning In</th>
<th>Married Taxpayers Filing Jointly</th>
</tr>
</thead>
<tbody>
<tr>
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<td>$52,000-$62,000</td>
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<tr>
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<tr>
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<tr>
<td>2006</td>
<td>$75,000-$85,000</td>
</tr>
<tr>
<td>2007 and thereafter</td>
<td>$80,000-$100,000</td>
</tr>
</tbody>
</table>


5. A spouse of an active participant who is not an active participant in a qualified retirement plan may make deductible contributions to a traditional IRA, unless the adjusted gross income of the couple exceeds $160,000.

a. The amount the spouse may deduct is reduced proportionately after the adjusted gross income of the couple reaches $150,000, until it reaches $160,000. TRA 97 § 301(b), amending I.R.C. § 219(g), adding new paragraph (7).
C. Premature Withdrawals.

1. An additional ten-percent income tax is imposed on the taxable portion of a distribution from an IRA before the account holder reaches age 59½, unless an exception applies. I.R.C. § 72(t).

2. See Section II.A.2. for a discussion of the exceptions to the additional ten-percent income tax on premature distributions.

VIII. ROTH IRAS

A. Introduction.

1. TRA 97 added a new type of IRA, known as a Roth IRA. I.R.C. § 408A, added by TRA 97 § 302(a).

2. A Roth IRA is an individual retirement account described in I.R.C. § 408(a) and, except as otherwise specified, is treated the same as other IRAs. I.R.C. §§ 408A(a) and (b) and 7701(a)(37).

   a. A Roth IRA must be clearly designated as such in the IRA document. Treas. Reg. § 1.408A-2, Q&A2.

   b. A SEP or a SIMPLE may not be designated as a Roth IRA. I.R.C. § 408A(f)(1).

      (1) This means that SEP and SIMPLE contributions may not be made to a Roth and vice-versa.

      (2) However a SEP or SIMPLE IRA may be converted to a Roth IRA under certain conditions described below.

3. Contributions to the Roth IRA, which can be made only for tax years beginning after December 31, 1997, are not deductible. I.R.C. § 408A(c)(1).

4. The annual amount that can be contributed is the same as for a traditional IRA, i.e., $2,000 in the case of an individual, or $4,000 in the case of a married couple filing jointly, provided that the contribution to either spouse's IRA does not exceed $2,000 and that the contribution does not exceed the compensation income of the account holder or the account holder and his or her spouse, as applicable. I.R.C. § 408A(c)(2).
5. In addition, the amount that can be contributed is reduced by any amounts contributed to a traditional IRA.

   a. Contributions are first applied to a traditional IRA, then to a Roth IRA. Treas. Reg. § 1.408A-3, Q&A 3(d), example 2.

6. Contributions to a Roth IRA are permitted after age 70½. I.R.C. § 408A(c)(4).

7. SEP and SIMPLE contributions do not reduce Roth IRA contributions. I.R.C. § 408(f)(2).

8. Contributions for a year (plus earnings) may be directly transferred (recharacterized) from a traditional IRA to a Roth IRA or vice versa at any time before the tax return due date (including extensions) for that year, as discussed below.

B. Limitation on Contributions to Roth IRAs.

1. Annual contributions to a Roth IRA are subject to a phase-out similar to the contribution deduction phase-out for a traditional IRA, although it is not dependent on participation in a qualified retirement plan. I.R.C. § 408A(c)(3)(A).

   a. For a single taxpayer or head of household, the phase-out begins at $95,000 of modified adjusted gross income (MAGI), and no contribution is permitted once adjusted gross income reaches $110,000.

   b. For a married couple filing a joint return and certain qualifying widowers, the phase-out begins at $150,000 of MAGI, and no contribution is permitted once adjusted gross income reaches $160,000.

   c. For a married individual filing a separate return, the phase-out begins at $0 of MAGI, and no contribution is permitted once adjusted gross income reaches $10,000.

   (1) However, such an individual who has lived apart from his or her spouse for the entire year is treated as being a single taxpayer for this purpose.

2. MAGI has the same meaning as it does for purposes of contribution deductions for a traditional IRA by active plan participants, except that any amount included in gross income because of a rollover from a
traditional IRA to a Roth IRA is not taken into account. I.R.C. § 408A(c)(3)(C)(i).

a. Effective in 2005, required minimum distributions under I.R.C. § 401(a)(9) from traditional IRAs and qualified retirement plans are excluded for purposes of the $100,000 MAGI limitation for conversions.

3. Excess contributions to a Roth IRA are subject to the six percent excess contribution excise tax under I.R.C. § 4973(f).

4. The regulations coordinate the Roth IRA phase out and the combined Roth/traditional IRA $2,000 per year contribution limit; i.e., the $2,000 combined limit continues to apply even though a reduced amount is allowable as a contribution to the Roth IRA.

a. For example, if an individual, with compensation exceeding $2,000, is, based on his or her MAGI, subject to a phased out Roth IRA contribution limit of $1,340, that individual may make total IRA contributions of $2,000, of which up to $1,340 may be made to his or her Roth IRA and $660, plus the excess of $1,340 over his or her Roth IRA contributions, to his or her traditional IRA as a nondeductible contribution. Treas. Reg. § 1.408A-3, Q&A 3(d), example 4.

C. Conversions From Traditional IRAs.

1. A traditional IRA can be converted or rolled into a Roth IRA as long as the taxpayer is either a single filer or a married person filing jointly whose MAGI does not exceed $100,000. I.R.C. §§ 408A(c)(3)(B) and (d)(3).

a. The regulations call such a rollover a "conversion." Treas. Reg. § 1.408A-8(b)(2).

b. However, as noted above, Roth IRAs must be established under documents that clearly designate the account as a Roth IRA.

c. The $100,000 MAGI limit for traditional IRA to Roth IRA rollovers is determined in the year that the amount is distributed from the traditional IRA.
2. Some commentators have stated that the $100,000 amount should apply to each spouse, based on the technical language of the statute, which refers to "the taxpayer's adjusted gross income." I.R.C. § 408A(c)(3)(C).


(1) This position receives some support from the estimated tax and tax refund statute and regulations that provide that a prior year joint tax liability is divided among a couple, now filing separately or due separate refunds, based on their separate incomes.

b. The regulations and the Blue Book take the position that the $100,000 amount applies to the combined MAGI of both spouses. Treas. Reg. § 1.408A-4, Q&A 2(b).

(1) This position is in accord with the joint return regulations which provide that when a joint return is filed there are "two taxpayers," but "only one taxable income" and that MAGI is computed on an aggregate basis. Treas. Reg. § 1.6013-4(b).


a. A married person filing separately, who has lived apart from his or her spouse for the entire year is treated as single for this purpose.

4. A simplified employee pension (SEP) or a simple retirement account (SIMPLE) may be converted to a Roth IRA.

a. However, a SIMPLE rollover must await the expiration of the two year period after which the individual first participated in any SIMPLE maintained by the employer.

Treas. Reg. § 1.408A-4, Q&A 4.

5. The regulations specify three methods by which such a conversion can occur:

a. A distribution from a traditional IRA that is rolled over to a Roth IRA within 60 days;
b. A trustee to trustee transfer from a traditional IRA to a Roth IRA maintained by a different trustee: or

c. A transfer from a traditional IRA to a Roth IRA maintained by the same trustee.

Treas. Reg. § 1.408A-4, Q&A 1(b).

6. The taxable portion of the IRA will be subject to income tax, but not to the ten percent additional income tax for premature withdrawals or the six percent excess contribution excise tax. I.R.C. § 408A(d)(3)(A)(i), (ii); Treas. Reg. § 1.408A-4, Q&A 7.

a. If the rollover was made in 1998, the amount that would have been included in gross income is included in gross income ratably over a four tax-year period beginning in 1998. I.R.C. § 408A(d)(3)(A)(iii).


(1) The election is irrevocable after the due date (including extensions) for the 1998 federal income tax return. I.R.C. § 408A(d)(3)(A), flush language; Treas. Reg. § 1.408A-4, Q&A 10.

(2) The election to include the full taxable conversion amount in income in 1998, rather than taking the normal four-year spread, is made on Form 8606 that is filed with the individual's 1998 federal income tax return. I.R.C. § 408A(d)(3)(A), flush language; Treas. Reg. § 1.408A-4, Q&A 10.

c. The inclusion of income from a 1998 rollover is accelerated if a distribution is taken during 1998-2000.

(1) The amount included is equal to the lesser of:

(a) The amount included under the four-year spread plus the amount distributed; or

(b) The rollover amount not previously included in income.
There is a complete acceleration of the remaining unrecognized income in year of the account holder's death, unless the account holder's spouse is the beneficiary of 100 percent of all the decedent's Roth IRAs and the spouse makes an irrevocable election to continue the spread by the due date (including extensions) of the spouse's return for year of the account holder's death.

(1) The surviving spouse may make the election to continue the four-year spread on either Form 8606 or Form 1040 in accordance with the instructions on the Forms.

A traditional IRA distribution in 1997 may not be contributed to a Roth IRA in 1998, even if the general rollover requirements are fulfilled, e.g. it was deposited within 60 days of the date of distribution.

a. Such a transaction is a "failed conversion" that may be recharacterized (discussed below) or be treated as a Roth IRA excess contribution subject to a six percent penalty.

The ten percent early withdrawal penalty tax applies to a traditional IRA rollover conversion that is distributed to the account holder within the five-taxable-year period beginning in the year in which it was made as if that amount is included in gross income, unless an exception applies.

The recharacterization rules (discussed below) may be used to correct a failed conversion, such as one attempted by an individual whose MAGI exceeds the limitations.

a. A failed conversion, if not recharacterized, is treated as a regular annual Roth IRA contribution.

(1) To the extent that the individual's annual Roth contribution exceeds his or her allowable annual contribution, it will be an "excess contribution."

b. Unless the excess contribution is withdrawn, with applicable investment earnings, by the date for filing the individual's income tax return for the year, it will be subject to a six percent per year excise tax, until corrected.
10. For an individual who has attained age 70½ by the end of a calendar year, a conversion during that year may not include that year's required minimum distribution from the traditional IRA. Treas. Reg. § 1.408A-4, Q&A 6.

11. A conversion made by any of the three methods is a distribution subject to the IRA withholding rules.
   a. Withholding is generally required on distributions from IRAs, unless the distributee makes a written election not to have withholding apply.
   b. Most individuals making a conversion will probably make a no withholding election, to facilitate such an individual's conversion of the entire value of his or her traditional IRA.

   (1) In that case, the converter will need another source of cash for paying his or her income taxes and may find it necessary to make estimated tax deposits to avoid penalties.
   c. A trustee to trustee conversion in 1998 is not subject to withholding.

   Treas. Reg. § 1.408A-6, Q&A 13.

12. If an individual has been receiving substantially equal periodic payments from a traditional IRA, for the purpose of coming within that exception to the premature distribution penalty tax, the individual may, if he or she or is otherwise eligible, convert the traditional IRA to a Roth IRA.
   a. In such case, the substantially equal periodic payments must continue from the Roth IRA, or prior distributions from the traditional IRA will be subject to recapture of the penalty tax.
   b. If the four-year spread applies, the distribution will cause acceleration of income recognition.

   Treas. Reg. § 1.408A-4, Q&A 12.

D. **Distributions.**

1. Distributions from a Roth IRA are not subject to the minimum distribution rules during the account holder's lifetime. I.R.C. § 408A(c)(5).
   a. After the account holder's death, a Roth IRA must be paid out either entirely by the end of the year which contains the fifth
anniversary of the account holder's death, or over the lifetime or life expectancy of the designated beneficiary, commencing by the end of the year following the account holder's death, except in the case of a spouse, where the payments do not have to begin until the year in which the account holder would have reached age 70½.

b. If the account holder's beneficiary is his or her spouse, the surviving spouse may roll the Roth IRA into his or her own Roth IRA or treat the deceased account holder's Roth IRA as his or her own Roth IRA.

Treas. Reg. § 1.408A-6, Q&A 14.

2. An individual beneficiary required to receive minimum distributions from a traditional IRA or SIMPLE IRA may not choose to take such minimum distributions from Roth IRA, nor may Roth IRA minimum distributions be taken from a traditional IRA or SIMPLE IRA. Treas. Reg. § 1.408A-6, Q&A 15.

a. There is an obvious tax policy reason for this position, as the different types of IRAs have substantially different tax treatments, upon distribution, as well as differing minimum distribution requirements.

b. Further a beneficiary may elect to satisfy the minimum distribution requirements for a Roth IRA from another Roth IRA only if both Roth IRAs were inherited from the same decedent.

3. Distributions from a Roth IRA are not included in gross income for federal income tax purposes if they are qualified distributions. I.R.C. § 408A(d)(1).

4. A qualified distribution is a distribution from a Roth IRA after five taxable years and the distribution is:

a. Made after the individual reaches 59½;

b. Made after the individual's death;

c. Made on account of the individual's total and permanent disability; or

d. A qualified first-time homebuyer distribution as defined for purposes of the exception to the premature withdrawal penalty.

5. The five-taxable-year period begins with the first taxable year for which the individual made a contribution to a Roth IRA (or the individual's spouse made a contribution to a Roth IRA) established for the individual. Treas. Reg. § 1.408A-6, Q&A 2 and 3.

6. A corrective distribution of an excess contribution plus earnings is never a qualified distribution; i.e., the earnings are always taxable. I.R.C. § 408A(d)(2)(C).

7. If a distribution is made before the end of the five-taxable-year period, but would have otherwise been a qualified distribution, it will not be subject to the ten percent premature withdrawal tax. Treas. Reg. § 1.408A-6, Q&A 5(a).
   a. Each of the "purposes" for a qualified distribution is an exception to the ten percent penalty tax.
   b. Of course, there are other possible exceptions to the ten percent tax.

8. The following ordering rules apply for determining what comprises a distribution:
   a. Roth IRAs are considered separately from traditional IRAs
   b. All of an individual's Roth IRAs and all distributions from that individual's Roth IRAs during a taxable year are aggregated, i.e., the individual is treated as having a single Roth IRA from which a single distribution occurred. Treas. Reg. § 1.408A-6, Q&A 9(a).
   c. In determining the character of the amounts distributed, the aggregated distributions from the aggregated Roth IRAs are first attributed to:
      (1) Regular contributions,
      (2) Conversions of traditional IRAs,
         (a) On a first-in, first-out basis; and
         (b) Within each conversion, considering taxable amounts (amounts included in income as a result of the conversion) before basis amounts (amounts
excluded from income when the conversion was made); then

(3) Earnings.

Treas. Reg. § 1.408A-6, Q&A 8(a).

d. The various amounts comprising a Roth IRA are calculated as of the end of the distribution year.

9. If a Roth IRA owner dies prior to the end of the five taxable year period for determining whether distributions are qualified distributions, and the individual has multiple beneficiaries, the various categories of contributions and earnings that comprise his or her Roth IRA are allocated pro-rata among the multiple beneficiaries based on the amount of their respective entitlements.

a. Therefore, if one of the beneficiaries should receive a distribution soon after the account owner's death, while benefits of the other individuals remain in the Roth IRA, the beneficiary receiving a distribution will be treated as receiving a pro-rata portion of the regular contributions, each conversion contribution previously included in income, each conversion contribution previously not included in income (i.e., the nondeductible contributions) and investment earnings, with the total amount of each category determined as of the end of the distribution year.

b. The amount of all of the components that are deemed distributed will equal the amount of cash or fair market value of assets distributed.


10. A distributee's basis in property distributed from a Roth IRA is its fair market value as of the date of distribution, whether or not the distribution was a qualified distribution. Treas. Reg. § 1.408A-6, Q&A 16.
E. **Recharacterized Contributions**

1. Trustee-to-trustee transfers between different types of IRAs (Roth or traditional) by the return due date (including extensions) for a year, of IRA contributions made during a year plus earnings, will be treated as having been made to the transferee IRA. (Act § 6005(b)(6), adding I.R.C. § 408A(d)(6)).

   a. To make such a transfer from a traditional IRA to a Roth IRA, no deduction may be taken for the original contribution to the traditional IRA. I.R.C. § 408A(d)(6)(B)(ii).

2. This provision may be used to undo a traditional to Roth conversion and then a new traditional to Roth conversion may then be made.

   a. Under interim rules for 1998 and 1999, effective 11/1/98, only one reconversion to a Roth IRA may be made. Treas. Reg. § 1.408A-5, Q&A 9(b).

   b. After 1999, a recharacterized traditional IRA may not be reconverted to a Roth IRA until the later of (1) the taxable year after the year the original conversion occurred or (2) the end of the 30-day period beginning on the date of the recharacterization. Treas. Reg. § 1.408A-5, Q&A 9(a)(1).

3. Employer contributions to a SIMPLE or a SEP may not be recharacterized as contributions to another type of IRA. Treas. Reg. § 1.408A-5, Q&A 5.

4. The recharacterization provision appears useful for cleansing a conduit IRA, where a current contribution or rollover has been made to an existing IRA that consisted of only a distribution from a qualified retirement plan, to preserve the ability to rollover the conduit IRA to another qualified retirement plan.

5. If a distribution from a traditional IRA occurs in one tax year, then is contributed to a Roth IRA in the following tax year, but within the 60-day rollover time limit, the contribution is treated as having occurred in the tax year of the distribution for recharacterization purposes. Treas. Reg. § 1.408A-5, Q&A 1(b).

   a. For example, a traditional IRA distribution on December 15, 1998, that is contributed to a Roth IRA on January 15, 1999 (as a conversion), by a calendar year taxpayer who does not extend the time for filing his income tax returns, may be transferred to a traditional IRA and recharacterized no later than April 15, 1999.
b. Under the final regulations the time period for transfer and recharacterization is based on the taxable year "for which" the contribution was made. whereas, the statute bases the recharacterization period on the contributions made "during such taxable year."

(1) Like the rollovers discussed above, this provision will, in certain cases, eliminate a full year from the recharacterization period that might otherwise be available.

(2) For example, an annual Roth IRA contribution for the 1998 tax year that is deposited on April 13, 1999, by an individual who extends his 1998 federal income tax return filing date until August 15, 1999, may be recharacterized as a traditional IRA contribution no later than August 15, 1999.

(3) A broader reading of the statutory language would allow the recharacterization to be made by the due date, including extensions, for the 1999 federal income tax return.

6. A “tax-free” transfer that was made during the year are not “contributions” that can be recharacterized. Treas. Reg. § 1.408A-5, Q&A 4.

a. However, for purposes of determining whether an amount was contributed to an IRA for a taxable year, any subsequent tax-free transfers of that amount are disregarded; i.e., if a contribution was eligible for recharacterization, it may still be recharacterized, even though it was transferred in the interim to a different IRA of the same type. Treas. Reg. § 1.408A-5, Q&A 7.

7. Recharacterizing transfers are not treated as rollovers for purposes of the one rollover per year limitation. Treas. Reg. § 1.408A-5, Q&A 8.

8. To make a recharacterization, the individual electing to make the recharacterization is required to notify the trustee/custodian of both the transferor IRA and the transferee IRA of:

   a. The type and amount of contribution to be recharacterized;

   b. The amount of the net income allocable to the contribution that is to be transferred;

   c. The date on which the contribution was originally made;

   d. The year for which it was made; and
e. Provide a direction to the trustee/custodian of the first IRA to transfer the contribution and net income from first trustee/custodian to the second (which may be the same financial institution).

Treas. Reg. § 1.408A-5, Q&A 6(a).

9. If the contribution to be recharacterized is the only amount that was contributed to the transferor IRA, the entire balance must be transferred. Treas. Reg. § 1.408A-5, Q&A 2(b).

10. A recharacterization must be reported on the individual's federal income tax return for the year for which the recharacterization is effective and is irrevocable following the date for filing the tax return (including extensions) for that year. Treas. Reg. § 1.408A-5, Q&A 6(b).

F. Planning for Roth IRAs.

1. Whether to convert traditional IRAs (or to roll over qualified retirement plans into traditional IRAs followed by a conversion to a Roth IRA) will be an important financial decision for individuals who currently have traditional IRAs (or qualified plan benefits, eligible to be rolled into traditional IRAs) who meet the filing status and adjusted gross income limitations.

2. The following variables will be important in making the decision:

a. The individual's tax rate at time of the conversion (higher rates favor not converting).

b. The individual's tax rate at time of expected distributions (higher rates favor converting).

c. The length of time until the expected distributions (a longer time favors converting).

d. Whether distributions will be needed before death ("not needed" favors converting).

e. The expected investment earning rate (higher rates favor converting).

f. The political risk that a future Congress might change the unusually favorable tax treatment of Roth IRAs.
3. An individual who made a valid conversion and then experienced a decline in the market value of his or her IRA assets will save substantial tax liability by recharacterizing the conversion as a traditional IRA contribution and then reconverting the IRA to a Roth IRA with a lower market value (and a lower income tax liability).

   a. However, for calendar years after 1999, the final regulations permit a reconversion only after the end of the year in which the recharacterization occurs or, if later, the end of the 30-day period beginning on the date of the recharacterization.

   Treas. Reg. § 1.408A-5, Q&A 9(a)(1).

4. An owner of a closely-held business who can control his or her income may be able to reduce his or her MAGI for one year to below $100,000, allowing him or her to make a Roth IRA conversion.

   a. Switching assets that produce taxable income into assets that produce tax-exempt income or deferred income (including unrealized appreciation) may help the taxpayer qualify for a Roth IRA rollover.

5. Rollovers of a qualified retirement plan benefit to either a traditional IRA or a Roth IRA may not be favorable for individuals facing possible tort or contract liabilities because of the loss of the greater protection from creditors afforded to benefits held in an ERISA qualified pension plan under Patterson v. Shumate, 112 S. Ct. 2242 (1992).

   a. A state's exemption law applicable to traditional IRAs may protect a Roth IRA from creditors, depending upon its wording.

   b. For example, Virginia's statute, by its terms, will apply to Roth IRAs and provides an exemption amount based on the account holder's age, e.g. $89,512.50 at age 60.

6. It has been suggested that individuals may achieve a significant transfer tax savings by making both an irrevocable beneficiary designation and an irrevocable renunciation of any right to any distribution from his or her Roth IRA. See Wilf, The Roth IRA: A New Estate Planning Opportunity, Pension & Benefits Weekly, October 27, 1997.

   a. Presumably, this would be a completed gift to the irrevocably designated beneficiary.

   (1) Also presumably, distributions from the Roth IRA would not have to begin until the owner's death, at which time the
Roth IRA balance can be distributed over the life expectancy of the designated beneficiary.

(2) The distributions from the Roth IRA to the beneficiary would not be subject to income tax if they meet the five tax-year holding period requirement to be a qualified distribution.

b. The regulations discourage the irrevocable renunciation and designation strategy by stating that a gift of a Roth IRA constitutes an "assignment" and that, at the time of the gift, the assets of the Roth IRA are deemed to be distributed to the owner. Treas. Reg. § 1.408A-6, Q&A 19.

(1) Therefore, such assets are no longer held in a Roth IRA.

(2) If the deemed distribution occurs prior to the account owner being eligible to receive a qualified distribution, he or she will include some or all of amount in his or her gross income.

(3) Thereafter, of course, such assets would not have the benefit of the tax-free internal build-up that is a primary benefit of having an IRA.

c. While the public policy basis of the regulation's discouragement of the renunciation strategy is clear, i.e., the benefits of the technique in certain cases seems to be too good to be true, the Treasury's legal reasoning does seem to be rather strained.

(1) There is no specific statutory prohibition on an assignment of an IRA.

(2) The prohibitions on pledging an IRA as security for a loan or on borrowing from an IRA and the requirement that an IRA be a trust established for the exclusive benefit of an individual or his beneficiaries do not seem to clearly support the IRA's conclusion.

(3) One line of reasoning supporting the Treasury's conclusion may be that no one can be a beneficiary of an individual's Roth IRA (or any IRA) before the death of the individual; i.e., a living individual does not have a "beneficiary" for whom an IRA may be maintained.
(a) That position seems to be alluded to in long-standing traditional IRA regulations that should also apply to Roth IRAs.

d. A special correction rule was provided, whereby, if a gift of a Roth IRA was made prior to October 1, 1998, but was reconveyed to the Roth IRA owner prior to the end of 1998, the transaction would have been treated as never having occurred for federal income, estate and gift tax purposes.

(1) An individual in need of making such a correction would have wanted to determine whether and how a reconveyance could be accomplished under the applicable state property law.

(2) Impediments to making the correction could have existed if the beneficiaries failed to consent to the reconveyance or if they lacked the legal capacity to do so, e.g., if they were minors.

7. A Roth IRA rollover may be a means to correct an inadvertent failure to elect out of recalculation or to name a designated beneficiary at the individual's RBD, because the individual's RBD would be changed to the individual's date of death.

8. It may be helpful to contrast a traditional IRA to Roth IRA rollover to other transactions that have similar tax consequences; i.e. taxable distributions from traditional IRAs that are then invested in other vehicles that have tax-free investment returns.

a. Life insurance. Probably substantially higher fees and expenses. Mortality protection.

b. Municipal bonds. Expected lower returns.

c. Only with a Roth IRA rollover is there an exemption from the 10% penalty tax for someone under age 59 ½.

d. Non-IRA assets may clearly be part of an intervivos gift program.

9. It is probably wise for anyone who will ever have annual or conversion contributions to a Roth IRA to make a contribution for his or her earliest eligible tax year.

a. That will start the five-year non-exclusion period running.
IX. COMMUNITY PROPERTY LAW CONSIDERATIONS

A. Introduction.

1. In a community property state, a participant's spouse is generally deemed under state law to own a share of the participant's interest in a qualified retirement plan or IRA.


   b. There is also significant authority that IRAs are subject to community property laws. See, for example, In Re Estate of MacDonald, 794 P.2d 911 (Cal. 1990); but compare Stewart v. Estate of Stewart, No. 352-680, 1st J.D.C. Caddo Parish, La. (decided February 24, 1988) (no community property ownership of IRA) with Succession of Egan, 543 So.2d 940 (La. Ct. App. 5th Cir. 1989) (community property principles do apply to IRAs), and with Succession of McVay, 476 So.2d 1070 (La. Ct. App. 3d Cir. 1985) (the IRA was separate but an accounting was due for the community investment).

   (1) Although § 408(g) indicates that the requirements for IRAs are applied without regard to any community property laws, it is unlikely that Congress intended to modify community property rights in IRAs.

   (2) The reference to community property was probably intended to allow a participant in a community property state to use 100 percent of his or her earnings for purposes of determining the amount that can be contributed to an IRA and to prevent a nonworking spouse from making IRA contributions based on the earnings of the working spouse, which are now permitted.
2. The statutory and case law of the community property states is not well developed or uniform concerning the rights of either a participant's spouse upon divorce or the distributees or beneficiaries of a participant's spouse who dies before the benefit has been distributed from the plan.

B. The Spouse's Community Property Interest in Qualified Retirement Plans.


2. REA amended the I.R.C. and ERISA to grant a participant's spouse certain rights in qualified retirement plans.

3. The REA amendments also allow a participant's spouse to enforce his or her community property rights through a QDRO. See § 414(p).

4. Even in a harmonious marital situation, a QDRO can provide tax and estate planning benefits, provided that a QDRO can be used in this situation.

   a. Payments pursuant to a QDRO are not subject to the ten-percent additional income tax on premature distributions. § 72(t)(2)(C).

   b. Distributions to a spouse or former spouse who is an alternate payee under a QDRO can be rolled into the alternate payee's IRA. § 402(e)(1)(B).

   c. A spouse or former spouse who is an alternate payee under a QDRO may also elect special averaging. § 402(d)(4)(J).

   d. A division of a participant's qualified retirement plan benefits pursuant to a QDRO can provide flexibility in the allocation of the benefits between a marital trust and a credit shelter trust, especially when the spouse dies first.

5. QDROs are most often used in the case of marital dissolutions.
6. A QDRO may require that the spouse receive his or her interest before the participant has separated from service, as long as the participant has reached his or her earliest retirement age. § 414(p)(4).

a. As mentioned above, the spouse can roll the distribution into an IRA.

b. By taking an immediate distribution from the participant's plan, the spouse is able to retain rights in the benefits even if the spouse dies before the participant dies or begins receiving benefits.

7. The heirs or beneficiaries of the spouse may have difficulty in enforcing any interest given to them under the will of the spouse or inherited from the spouse.

a. A QDRO probably cannot be used for purposes of enforcing these rights.

(1) The fact that § 402(e)(1)(A) taxes the participant on any distributions made pursuant to a QDRO other than to a spouse or former spouse indicates that the only other intended recipients would be dependents of the participant.

(a) It would be a strange result if the participant had to pay income taxes on distributions made to children of a deceased spouse's previous marriage.

(2) The Labor Department issued two ERISA opinion letters on December 4, 1990, 90-46A and 90-47A (CCH Pension Reporter ¶ 23,816Z), stating that a state's probate court order dividing and segregating a portion of the pension benefit of a participant for the estate of the deceased spouse did not qualify as a QDRO.

(a) The opinions are based on a finding that the intent of Congress in developing the QDRO procedure was to assure greater opportunity for women (whether employees or homemakers) to receive private pension income.

(b) The legislative history, according to the Labor Department, indicated that, in enacting these provisions, Congress focused on the division of pension benefits in a marital dissolution or dependent support situation.
(3) Under REA, a QDRO can be obtained only by a spouse or former spouse, not by his or her successors at death.

(4) In Ablamis v. Roper, 937 F.2d 1450 (9th Cir. 1991), the court held that ERISA's anti-alienation provisions preempted California's community property law except to the extent a participant's spouse could enforce his or her rights pursuant to a QDRO. The court then held that a QDRO only applied to domestic relations cases and not to probate proceedings. There was a strong dissent.

(5) The Supreme Court, in Boggs v. Boggs, 118 S. Ct. 9 (U.S. 1997), held that ERISA preempts the state law community property rights of the nonparticipant spouse in benefits that had been in a qualified retirement plan at the date of his or her death that were not perfected through a QDRO, including his or her right to transfer those rights in his or her will.

8. Consequently, a spouse should consider exchanging his or her interest in the participant's qualified retirement plan benefits and IRAs for other property or perfecting those rights with a QDRO.

9. If the participant dies first, the current spouse will be entitled to receive either a survivor annuity or the entire accrued benefit of the deceased participant under REA.

   a. This right is not dependent upon community property laws, but upon the express provisions of REA.

   b. The rights of a former spouse under a QDRO protecting his or her community property interest is superior to the right of the participant's surviving spouse under REA to a survivor annuity or the participant's accrued benefit. § 414(p)(5).

10. It may be possible for the heirs or legatees of a deceased spouse to make a claim against property outside the plan.

   a. However, in Boggs v. Boggs, the Supreme Court held that ERISA preemption extends to assets that were in a qualified pension plan at the deceased spouse's date of death, even if subsequently distributed.
C. The Spouse's Community Property Interest in IRAs.

1. Although the I.R.C. does not prohibit paying amounts to third parties from an IRA, the participant will be subject to immediate income taxation and possibly the ten-percent additional income tax on premature distributions.

   a. The IRA cannot be put into the spouse's name during the participant's lifetime.

   b. Since a QDRO does not apply to an IRA, it cannot be used to divide the IRA in a tax-free division.

2. The spouse's share of the participant's IRA can be transferred tax-free to his or her own IRA pursuant to a decree of divorce or separate maintenance. § 408(d)(6).

3. There is no federal law that prevents the heirs or legatees of a participant's spouse from claiming their share from the participant's IRA, and such a claim has been upheld by the California Supreme Court in In Re Estate of MacDonald, 794 P.2d 911 (Cal. 1990).

   a. Such a payment may cause immediate taxation to the participant and, if the participant is under age 59 1/2, a ten-percent additional income tax.

   b. In PLR 8040101, the IRS ruled that the legatees of the nonparticipant spouse were taxed on payments from the participant's IRA.

   c. However, if the IRA is composed of a rollover of an amount that was in a qualified retirement plan on the date of death of the participant's spouse, the state community property claim of the spouse's heir or legatee is preempted by ERISA. Boggs v. Boggs.

4. A participant can designate anyone as the beneficiary of his or her own IRA without the spouse's consent, since IRAs are not subject to the I.R.C. or ERISA spousal rights provisions added by REA.

   a. The participant's spouse may be entitled to claim his or her community property interest after the death of the participant if he or she is not named the beneficiary of at least that amount.
D. **Gift and Estate Taxes.**

1. If the participant dies first, only half of the value of qualified retirement plans and IRAs that is community property is includible in his or her estate.

   a. The spouse is entitled to the other half of the qualified retirement plan benefits and IRAs, but if they pass to someone other than the surviving spouse, he or she may be deemed to have made a gift.

   b. If the spouse is the sole beneficiary, there will be no estate tax due either on the participant's share, because of the marital deduction, or on the spouse's share, because he or she has not lost any ownership rights.

   c. Although § 2503(f) exempts from the gift tax the waiver by the spouse of the right to benefits granted under the I.R.C. and ERISA, it does not apply to the spouse's community property interest in the benefit.

      (1) Because in most (if not all) cases, the value of the spouse's rights under the I.R.C. and ERISA will exceed the value of his or her community property interest in the benefits, there should be no taxable gift if the spouse waives his or her community property interest, assuming that both the right under the I.R.C. and ERISA and the community property interest are coterminous and not cumulative, in which case the spouse's I.R.C. and ERISA rights would apply to the participant's community property interest, leaving him or her the right to his or her community property interest plus his or her I.R.C. and ERISA rights to the participant's community property interest.

   d. A former spouse with a community property interest in a qualified retirement plan who fails to obtain a QDRO before either the participant's death or his or her own death may be deemed to have made a taxable gift of his or her community property interest in the plan.

      (1) Adequate consideration paid to the spouse will avoid this result.
2. If the spouse dies first, his or her community property interest in qualified retirement plans and IRAs will be included in his or her gross estate.
   
a. It is arguable that after the Supreme Court's decision in Boggs v. Boggs, 118 S. Ct. 9 (U.S. 1997), because the spouse's community property interest in the participant's qualified plan benefit is preempted by federal law, none of the plan benefit should be included in the spouse's gross estate.
   
b. If the participant succeeds to the spouse's community property interest either under the spouse's will or automatically based on the theory that the state laws of inheritance are completely preempted by ERISA, it will qualify for the marital deduction. I.R.C. § 2056(b)(7), as amended by TRA 97 § 1311.
   
c. If the spouse does not transfer his or her interest in the participant's IRAs to the participant, it will not qualify for the marital deduction and will be subject to estate tax.

3. If the spouse dies first and the participant is not the beneficiary of the spouse's community property interest in the participant's IRA, the marital deduction will not be available and the participant's interest in the IRA will be clouded by the claims of the spouse's estate.

4. In most cases the participant's spouse should leave his or her interests in qualified retirement plans and IRAs outright to the participant.
   
a. If this disposition will overfund the marital deduction, an alternative beneficiary should be named, such as a credit shelter trust, so that the participant could disclaim some or all of the benefit.

5. In most cases the participant should name the spouse as the beneficiary of qualified retirement plan benefits and IRAs.

6. The designation should include a contingent disposition that would apply if the spouse dies first or disclaims the outright designation.
   
   (1) The contingent disposition might provide that the spouse's interest would pass outright to him or her, and the participant's interest would pass to a credit shelter trust in which the surviving spouse could receive an income interest.
(2) This designation takes advantage of the participant's unified credit without causing the spouse to make a gift as to his or her half.
Mrs. Smith, a widow, has accumulated $2 million in a pension plan. She dies in 1998 at age 65, survived by all her children and a grandchild. She was a resident of a state that only has a pick-up type estate tax (that is, the estate tax is equal to the federal estate tax credit for estate and inheritance taxes paid to the state). She has designated a trust that is held exclusively for the benefit of her grandchild whose parents are both alive as the recipient of the plan benefit, which is to be paid in a lump sum. The grandchild's interest in the trust is vested and will be included in the grandchild's federal gross estate.

Mrs. Smith's federal gross estate is $6 million, and therefore the marginal federal estate tax rate is 55 percent. The generation-skipping transfer (GST) tax rate is also 55 percent. The trust's marginal combined federal and state income tax rate is 43 percent (for federal income tax purposes, taxable income of a trust in excess of $8,450 is taxed at 39.6% in 1999). Mrs. Smith had used her GST exemption before her death. Assume that Mrs. Smith's will contains a tax apportionment clause that reduces a bequest by any estate and GST taxes attributable to the bequest.

**Calculation of Applicable Taxes**

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of benefit passing to Grandchild’s Trust before any taxes</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Estate tax rate</td>
<td>55%</td>
</tr>
<tr>
<td>Combined Federal and State Estate tax</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Amount passing to Grandchild’s Trust after estate and excise taxes</td>
<td>$900,000</td>
</tr>
</tbody>
</table>

Because the GST Tax in the case of a direct skip is tax exclusive (i.e., it is determined by applying the 55% GST Tax Rate to the amount passing after the GST Tax), the GST Tax can be determined by applying the following formula:

\[
\text{Amount passing to the recipient before the GST tax} - \frac{\text{Amount passing to the recipient before the GST tax}}{1+\text{GST tax rate}} = \text{GST tax}
\]
\[ \frac{900,000 \text{ divided by } 1.55 \times (1 + \text{GST tax rate})}{580,645.16} = 900,000 - 580,645.16 = \$319,354.84 \]

Amount subject to income tax

\[ \$803,845.16 \]

$2,000,000 less the IRD deduction of $1,196,154.84, which is the sum of the GST tax ($319,354.84) and the federal estate tax ($876,800). Note that the IRD deduction is limited to the federal estate tax; consequently, the total federal and state estate tax of $1,100,000 attributable to the $2,000,000 of IRD must be reduced by the state death tax credit attributable to the same amount, which is $223,200.

Combined Federal and State income tax rate

43%

Combined Federal and State income tax

345,653.41

Amount Left

$234,991.75

Summary of Taxes

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original Amount</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Combined Federal and State Estate Tax</td>
<td>($1,100,000)</td>
</tr>
<tr>
<td>GST Tax</td>
<td>($319,354.84)</td>
</tr>
<tr>
<td>Combined Federal and State Income Tax</td>
<td>($345,653.41)</td>
</tr>
<tr>
<td>Total Taxes</td>
<td>($1,765,008.25)</td>
</tr>
<tr>
<td>Amount Left</td>
<td>$234,991.75</td>
</tr>
</tbody>
</table>

(About 12 percent of the total)

(Note that this is 3 percent more than the amount determined before the Taxpayer Relief Act repeal of the 15 percent excise tax on excess retirement accumulations.)
EXHIBIT B

EXAMPLE OF DEFERRAL

Example of the results achievable through deferral. Mary's accrued benefit on December 31, 1996 was $1,500,000. When she reaches age 70½ in 2001 (her date of birth was May 29, 1931), she elects to receive her first required distribution on December 31, 2001 and to have her plan benefit paid over the joint and last survivor expectancy of her and John, with her life expectancy being recalculated each year but not John's. John's date of birth was January 15, 1934. The value of her accrued benefit on December 31, 2000, assuming no additional contributions on her behalf and an eight percent growth factor, is $2,040,733. The amount of the required distribution that Mary receives on December 31, 2001 is $92,761 ($2,040,733 ÷ 22.0, because their joint and survivor expectancy is 22.0 years based on their attained ages, 70 and 67, in 2001). Mary dies on June 15, 2005, after receiving four required distributions, for a total of $422,780. Assume that under the proposed regulations the required distribution Mary would have been required to take in 2005, $130,156, must be paid to John before the end of 2005. He has the balance, $2,357,897, transferred to his own individual retirement account and names their daughter, Anne, who is age 44 in 2006, as his designated beneficiary. John elects to have his life expectancy recalculated, and, of course, cannot elect to have Anne's recalculated, even if this were desirable. The first required distribution to John, which he receives on December 31, 2006, is $96,635 ($2,357,897 ÷ 24.4). This is based on John's age of 72 and on treating Anne as age 62, because Anne is treated as ten years younger than John under the minimum distribution incidental death benefit rule. Assume John dies on September 15, 2011, after receiving five required distributions, for a total of $563,912. He did not receive the 2011 required distribution before he died. The account balance as of December 31, 2010 was $2,810,408. Assume the required distribution John would have been required to take in 2011, $139,821, must be paid to Anne before the end of 2011. This leaves a balance on December 31, 2011 of $2,895,419. The required distribution that must be paid to Anne before the end of 2012 is $88,545, based on Anne's remaining life expectancy of 32.7, determined by subtracting six from her life expectancy of 38.7 in 2006, when distributions began over the joint lives of John (recalculated) and Anne. The aggregate amount of the remaining payments over the period of Anne's life expectancy is $14,267,746, again assuming an eight percent growth rate. If Anne dies before the end of the period, whether before or after John dies, these payments will continue to Anne's beneficiary for the balance of the period, since her life expectancy is not being recalculated (and in fact cannot be recalculated). The aggregate amount of all payments before income taxes to Mary, John and Anne over the 44-year period (2001 through 2044) is $15,612,960. This assumes that any estate taxes are paid from other sources.
The following sample beneficiary designation forms and trust language forms are merely suggestions and should not be used unless the drafter fully understands the rules applicable to distributions from qualified retirement plans and IRAs. State law must be considered for IRAs, since state law may affect the interpretation of the IRA beneficiary designation forms and may give a surviving spouse or other individual certain rights with respect to a participant's benefit in an IRA. The I.R.C. and ERISA provisions granting to a surviving spouse rights in the participant's qualified retirement plan benefits must also be considered. In the case of a qualified retirement plan benefit, because the spouse is not the beneficiary and the form of payment is not a qualified preretirement survivor annuity, beneficiary designation Forms II, III, IV and V must have the consent of the participant's spouse, in writing, which must be either notarized or witnessed by a plan representative. The participant's spouse must also consent to Form I in the case of a qualified retirement plan benefit other than a defined contribution plan that is exempt from the qualified preretirement survivor annuity requirements, since the payment will be made in a lump sum rather than in the form of a survivor annuity. Finally, the plan itself must be reviewed carefully to be sure that the desired beneficiary designation is permitted under the plan.

Form I, which provides for an outright distribution of the plan benefit or IRA to the surviving spouse, will be used most often, particularly when there is a stable marriage and the participant has sufficient assets to fund a credit shelter trust. Form II will be used where the participant wishes to provide for the surviving spouse during his or her lifetime and qualify the benefit or IRA for the marital deduction, but wants to retain as much of the benefit as possible to pass to the participant's children by a prior marriage or other beneficiaries. Form II, which requires the greater of the required minimum distribution or the income generated by the plan benefit or IRA be paid each year, should satisfy the IRS's ruling position concerning qualifying plan benefits and IRAs payable to a QTIP trust for the marital deduction. Form III will be used in the same situations as Form II, but it does not comply with the current apparent ruling position of the IRS with respect to qualifying plan benefits and IRAs payable to a QTIP trust for the marital deduction because it only requires that the required minimum distribution be paid each year.

Form IV will be used when the plan benefit is the asset that will fund the credit shelter trust. Note that this form can be combined with the other forms when only a portion of the plan benefit or IRA is required to fund the credit shelter trust. The beneficiary designation may be made to a trust before it is divided into two trusts, one designed to qualify for the marital deduction and one designed to be a credit shelter trust. In such a case, the trust will usually have a formula to determine the percentage of the trust assets to be allocated to each trust. However, if the plan benefit or IRA is paid to a trust before its division, the trust may not be treated as satisfying the current requirement under the proposed regulations that the beneficiaries of the trust entitled to the plan benefit or IRA be identifiable. Consequently, if the plan benefit or IRA is paid directly to the trust before it is divided, the entire benefit may be required to be paid to the trust by the end of the fifth year after the year in which the participant dies, if the participant dies before the participant's required beginning date. The five-year rule may not apply if the spouse is the sole income
beneficiary of both trusts while he or she is alive because he or she will be the oldest beneficiary and there are no beneficiaries who are not individuals. However, if other beneficiaries may receive distributions from the plan or IRA under the terms of the trust agreement during the spouse's lifetime from the nonmarital deduction trust, payments of the plan benefit or IRA may have to commence to the trust beginning with the year after the participant's death, rather than when the participant would have reached age 70½. See Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A C-3(a). In addition, it could be argued that other beneficiaries will become identifiable once the trustee has allocated the assets, including the plan benefit or IRA, and the allocation should relate back to the participant's death. If some of the plan benefit or IRA is allocated by the spouse as the executor or trustee, or under a power given to him or her by the participant, to a marital trust that gives the spouse a power to withdraw all of the principal, the surviving spouse may be able to withdraw the benefit or IRA and roll it into his or her own IRA.* The final beneficiary form deals with a bequest to a charitable organization. The two sample trust language forms are designed to qualify the plan benefit or IRA for the marital deduction.

The forms are not meant to exhaust all the possible beneficiary designations a participant may wish to consider. Note these forms may not be appropriate once the participant has reached his or her required beginning date. At that point the participant will be required to name a designated beneficiary for purposes of determining the payout period and to elect not to have either his or her life expectancy or his or her spouse's life expectancy recalculated. If the participant dies after the RBD, the payments to the designated beneficiary after the participant's death must continue at least as rapidly as under the method in effect before the participant's death. However, if the surviving spouse is the beneficiary, he or she may roll the plan benefit or IRA into his or her own IRA or treat a decedent's IRA as his or her own IRA.

As with any sample forms, there is no guarantee that these forms are appropriate in any particular case or that they satisfy applicable federal or state law.

FORM I: BENEFICIARY DESIGNATION FOR QUALIFIED RETIREMENT PLAN BENEFIT OR INDIVIDUAL RETIREMENT ACCOUNT NAMING SURVIVING SPOUSE AS PRIMARY BENEFICIARY AND TRUST AS SECONDARY BENEFICIARY

My [benefit or IRA] shall be distributed in a lump sum to my [husband or wife] if my [husband or wife] survives me and does not disclaim [his or her] right to receive the [benefit or IRA]. If my [husband or wife] does not survive me, or if my [husband or wife] survives me but disclaims [his or her] right to receive such [benefit or IRA] pursuant to a qualified disclaimer as defined in I.R.C. § 2518(b) or (c)(3), my [benefit or IRA] shall be distributed to the trustee of the family trust created under the trust created by me as of ________________ in installments, payable at least annually, equal to the amount required to be distributed under the minimum distribution rules under I.R.C. § 401(a)(9) and the regulations thereunder, or any subsequent statute requiring minimum distributions from such [plans or IRAs]. If the [benefit or IRA] is payable to a trust, my trustee shall have the right at any time to withdraw all or any part of the remaining [benefit or IRA] or to designate a beneficiary of the trust to receive any remaining payments directly and to have the right to withdraw at any time all or any part of the remaining [benefit or IRA].

NOTE: If a trustee is also a beneficiary, the participant may want to restrict the right of the trustee to designate a beneficiary of the trust to have the right to withdraw the remaining benefits to avoid inclusion of the benefit or IRA in the beneficiary's federal gross estate because he or she has a general power of appointment over the benefit or IRA. This same comment applies to Forms II-IV and VII.
If my [husband or wife] survives me, my [benefit or IRA] shall be distributed to the QTIP trust created under the trust created by me as of , in installments, payable at least annually, equal to the greater of (x) the income generated or deemed to be generated by the [benefit retained in the plan or IRA] or (y) the amount required to be distributed under the minimum distribution rules under I.R.C. § 401(a)(9) and the regulations thereunder, or any subsequent statute requiring minimum distributions from such [plans or IRAs]. If my [husband or wife] does not survive me, my [benefit or IRA] shall be distributed to the trustee of the family trust created under the trust created by me as of , in installments, payable at least annually, equal to the amount required to be distributed under the minimum distribution rules under I.R.C. § 401(a)(9) and the regulations thereunder, or any subsequent statute requiring minimum distributions from such [plans or IRAs]. The trustee of whichever trust becomes entitled to distributions shall have the right at any time to withdraw all or any part of the remaining [benefit or IRA] or to designate a beneficiary of such trust to receive any remaining payments directly and to have the right to withdraw at any time all or any part of the remaining [benefit or IRA].

NOTE: This designation should satisfy the current ruling position of the IRS with regard to qualifying a plan benefit or IRA payable to a QTIP trust for the marital deduction. The executor may be required to elect QTIP treatment for the plan benefit or IRA in order to qualify the benefit or IRA for the marital deduction. See comment to Form I concerning the trustee's right to designate a beneficiary to have the right to withdraw the remaining benefit or IRA.
FORM III: BENEFICIARY DESIGNATION FOR
QUALIFIED RETIREMENT PLAN BENEFIT OR INDIVIDUAL
RETIREMENT ACCOUNT NAMING QTIP TRUST AS PRIMARY BENEFICIARY
AND FAMILY TRUST AS SECONDARY BENEFICIARY

If my [husband or wife] survives me, my [benefit or IRA] shall be distributed to the QTIP trust created under the _________ trust created by me as of ____________, in installments, payable at least annually, equal to the amount required to be distributed under the minimum distribution rules under I.R.C. § 401(a)(9) and the regulations thereunder, or any subsequent statute requiring minimum distributions from such [plans or IRAs]. If my [husband or wife] does not survive me, my [benefit or IRA] shall be distributed to the trustee of the family trust created under the trust created by me as of ______________, in installments, payable at least annually, equal to the amount required to be distributed under the minimum distribution rules under I.R.C. § 401(a)(9) and the regulations thereunder, or any subsequent statute requiring minimum distributions from such [plans or IRAs]. My trustee shall have the right at any time to withdraw any part or all of the remaining [benefit or IRA] or to designate a beneficiary of the trust to receive any remaining payments directly or to have the right to withdraw at any time all or part of the remaining [benefit or IRA].

NOTE: The current ruling position of the IRS is that the form of payment itself must qualify for the marital deduction. However, the plan benefit or IRA should qualify for the marital deduction as long as the spouse has the right to require any unproductive property be converted into productive property and the trustee has the right to accelerate payments from the plan or IRA. See Treas. Treas. Reg. § 20.2056(b)-5(f)(4). See comment to Form I concerning the trustee's right to designate a beneficiary to have the right to withdraw the remaining benefit or IRA.
FORM IV: BENEFICIARY DESIGNATION FOR QUALIFIED RETIREMENT PLAN BENEFIT OR INDIVIDUAL RETIREMENT ACCOUNT
NAMING CREDIT SHELTER TRUST AS PRIMARY BENEFICIARY

My [benefit or IRA] shall be distributed to the __________ trust created by me as of __________, in installments equal to the amount required to be distributed under the minimum distribution rules under I.R.C. § 401(a)(9) and the regulations thereunder, or any subsequent statute requiring minimum distributions from such [plans or IRAs]. My trustee shall have the right at any time to withdraw all or any part of the remaining [benefit or IRA] or to designate a beneficiary of the trust to receive any remaining payments directly and to have the right to withdraw at any time all or any part of the remaining [benefit or IRA].

NOTE: See comment to Form I concerning the trustee’s right to designate a beneficiary to have the right to withdraw the remaining benefit or IRA.
FORM V: DESIGNATION OF A CHARITABLE BENEFICIARY
TO RECEIVE BENEFITS UNDER A QUALIFIED RETIREMENT PLAN OR IRA

I direct that [all or _____ percent] of my [benefit or IRA] be distributed in a lump sum to the XYZ charitable organization.

NOTE: In order to qualify the charity's interest as a separate account of a defined contribution plan or IRA or a separate share of a defined benefit plan under the minimum distribution rules, the charity's portion should be designated as a fraction or percentage rather than a specific dollar amount once the participant has reached his or her RBD. Otherwise, only the participant's life expectancy can be used in determining the required minimum distribution once the participant reaches the RBD. [See Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A D-5.] Specifying a dollar amount should constitute a separate share if the participant dies before his or her RBD, since the specific dollar amount would constitute a fraction of the IRA at that point and would then be distributed outright to the charity, leaving the balance to be paid out over the designated beneficiary's life expectancy or, if the spouse is the beneficiary, to be rolled into a spousal IRA. However, there is an argument that failure to allocate investment earnings to the separate shares during the period from the participant's death until the actual payment is made or to set the amount aside in a separate account will cause the amount not to be a separate share. In addition, the qualified retirement plan benefits or IRAs should not be used to satisfy a pecuniary charitable bequest under the participant's will to avoid recognition of income by the estate.
FORM VI: PROVISION IN TRUST AGREEMENT WHEN TRUSTEE OF A TRUST IS GIVEN THE RIGHT UNDER A QUALIFIED RETIREMENT PLAN OR IRA BENEFICIARY DESIGNATION TO ACCELERATE WITHDRAWALS TO QUALIFY FOR THE MARITAL DEDUCTION

My [husband or wife] shall have the right to direct my trustee of the marital trust to make any unproductive property productive or to convert any unproductive property into income-producing property within a reasonable time. In lieu of making the property productive or converting the unproductive property, my trustee may distribute quarterly to my [husband or wife] other assets from the marital trust the value of which is equal to the income that would have been produced during the calendar quarter if the property had been made productive or converted into income-producing property. Unproductive property shall include any benefit held in a qualified retirement plan as defined in I.R.C. § 401(a), any qualified retirement annuity as defined in I.R.C. § 403(a) or 403(b), and any individual retirement account as defined in I.R.C. § 408(a), but only if and to the extent that income generated or deemed to be generated by the plan benefit, annuity, or account is not distributed to the trust at least annually or the assets in the separate account or share representing the plan benefit, annuity, or account are not producing adequate income.
FORM VII: PROVISION IN TRUST AGREEMENT
TO BE INCLUDED IN DIRECTIONS TO TRUSTEE
TO QUALIFY FOR THE MARITAL DEDUCTION

I direct my trustee to treat distributions from any qualified retirement plan as defined in I.R.C. § 401(a), any qualified retirement annuity as defined in I.R.C. § 403(a) or 403(b), or any individual retirement account as defined in I.R.C. § 408(a) as income of the trust to the extent that the distribution represents income generated or deemed to be generated by such plan, annuity, or individual retirement account, notwithstanding the treatment of such portion of the distribution under any law concerning the determination of income and principal for trust accounting purposes and my trustee shall not charge to such income any expense properly chargeable to the nonincome portion of the distribution. In addition, my trustee shall have the right in his or her or its sole discretion to withdraw any part or all of the remaining qualified plan benefit, annuity, or individual retirement account or to direct that the plan benefit, annuity, or individual retirement account be paid directly to the beneficiary of the trust who is entitled to the income of the trust and to give such beneficiary the right to withdraw at any time all or any part of the benefit, annuity, or individual retirement account.

NOTE: If the beneficiary is also the trustee, the trustee should not be given the right to give the beneficiary the right to withdraw, since such a right would be treated as a general power of appointment for transfer tax purposes.
Mary Smith is a participant in a money purchase pension plan sponsored by the Good Products Company, where she has been an employee for more than 40 years. She is currently a corporate officer and owns more than five percent of the stock of Good Products Company. She has no intention of retiring as long as her health, which is currently excellent, permits her to work. She has participated in the Good Products Company Money Purchase Pension Plan for 25 years. Her 66th birthday was May 29, 1998. She has come to you on December 15, 1998 for advice on naming a beneficiary to receive benefits if she dies before her required beginning date (April 1, 2003). Fifty percent of the value of her benefit is currently payable to John in the form of a qualified preretirement survivor annuity, as required under the I.R.C. and ERISA as amended by the Retirement Equity Act of 1984, and the balance is payable to her estate under the plan’s default rule. The value of her accrued benefit as of December 31, 1997 was $1,500,000.

Mary has been happily married to John for 40 years. They do not contemplate that their relationship will ever change. John is a retired sales representative, who was a participant in a defined benefit plan sponsored by the personal service corporation he owned. He received his benefit under the plan in the form of a lump sum distribution at age 60, when he liquidated the corporation. He elected to roll the entire distribution into an individual retirement account. The balance in his IRA is currently $800,000. John, who is about three years younger than Mary, reached age 63 on January 15, 1998. Mary and John have one child, Anne, who reached age 35 in 1998. Both Mary and John are United States citizens.

QUESTION I-1.

If Mary has other assets to fund a credit shelter trust, who should be the beneficiary of her plan benefit? [See Section III.B.3. of the outline and Form I.]

ANSWER:

Mary should name John as her beneficiary. This will be the most appropriate choice in situations where the client is happily married and has sufficient assets other than qualified retirement plan benefits and IRAs to fund a credit shelter trust. Naming the spouse as the beneficiary gives the surviving spouse a number of options and defers the payment of estate tax until the death of the surviving spouse. The following are considerations when naming John as a beneficiary of a lump sum payment or giving him the right to withdraw all of the plan benefit at any time.

1. The payment of the plan benefit in a lump sum to John (since he is a citizen of the United States) will qualify the benefit for the marital deduction for estate tax purposes.
a. The same result will be achieved if John leaves the benefit in the plan, but he has the right to withdraw the entire benefit at any time.

2. If the plan permits a lump sum distribution, John may roll the plan benefit into his own IRA, thereby deferring payment of income tax on the plan benefit.

a. He can wait until April 1 of the calendar year following the calendar year in which he reaches age 70½ to begin receiving distributions from his IRA.

b. If John were younger, any withdrawals from the IRA before he reached age 59½ would be subject to the ten-percent additional income tax unless an exception applied.

(1) If he had not rolled the plan benefit into his own IRA, and instead had taken withdrawals from the plan, the ten-percent additional income tax would not apply to withdrawals before he reached age 59½.

c. John may also name a beneficiary, such as his daughter Anne, to receive the balance in the IRA remaining at his death, and have the IRA paid over their joint and last survivor expectancy subject to the minimum distribution incidental death benefit rule.

d. If John meets eligibility requirements, i.e., the $100,000 AGI limit, he will have the option to roll the benefit from his traditional IRA into a Roth IRA.

(1) That action would cause the benefit to be currently taxed, but could shelter all future earnings and avoid minimum distributions while John is living.

3. Because Mary reached age 50 before 1986, John may also elect five-year averaging, ten-year averaging, and capital gain treatment for a distribution qualifying as a lump sum distribution. Five-year averaging will not be available after 1999.

4. Because the benefit is in a money purchase pension plan, John's consent under REA will be required to elect out of the qualified preretirement survivor annuity if the benefit is to be paid in a lump sum after Mary's death.

5. Designating John as the sole beneficiary may result in overfunding the marital deduction if the plan benefit is a substantial part of Mary's estate, in which case John may disclaim the receipt of some or all of the benefit if appropriate.
6. Under the minimum distribution rules, if Mary dies before her RBD, the payments do not have to commence until she would have reached age \(70\frac{1}{2}\) if the benefit is left in the plan.

   a. John may also name a new beneficiary and if he dies before payments must commence, the payments may be made over the beneficiary's life or life expectancy.

   b. John will still be able to roll any remaining benefits in excess of the required minimum distribution into his own IRA, even after payments must commence.

7. Designating John as the beneficiary of a lump sum distribution will not provide for professional management of the funds unless he engages advisors or transfers the funds to a trust with someone else as trustee.

8. Designating John as the sole beneficiary might not be appropriate if Mary had children by prior marriages.

QUESTION 1-2.

If Mary does not have any other assets to fund a credit shelter trust, who should be the beneficiary? [See Section V.A. of the outline and Form IV.]

ANSWER:

In this situation, Mary could name a trust designed to be excluded from John's gross estate as the beneficiary of her benefit to the extent necessary to take full advantage of the applicable exclusion amount ($650,000 in 1999). Although it is not entirely clear from the proposed regulations dealing with the minimum distribution rules, it should be possible for Mary to name a trust as the beneficiary of her plan benefit that, upon her death, will be divided into two shares. One share, which would equal the excess of any plan benefit not required to take advantage of the applicable exclusion amount, would be paid either outright to John or to a trust designed to qualify for the marital deduction. The other share would be paid to a trust that would be a typical credit shelter trust. Because John would be the income/current distribution beneficiary of both the marital deduction trust and the credit shelter trust and all remainder beneficiaries will be individuals younger than John, it should be possible to have the plan benefit payable to the trusts over his life expectancy. If John is not the only beneficiary entitled to receive distributions from the credit shelter trust under the terms of the trust agreement, distributions may have to commence beginning in the year after Mary's death, rather than when Mary would have reached age \(70\frac{1}{2}\). See Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A C-3(a). John may roll any of the plan benefit going to him outright into his own IRA. In addition, he may roll the portion of the plan benefit payable to the marital deduction trust into his own IRA if he has the discretion as executor or trustee to allocate the plan benefit to the marital deduction trust and he has the right to withdraw the balance payable to the marital deduction trust. John could then wait until his required beginning date before beginning
to receive the plan benefit. In most cases, naming John as the primary beneficiary, with a credit shelter trust as the alternate beneficiary, will give John the opportunity to decide at Mary's death whether the transfer tax benefit of a credit shelter trust outweighs the income tax benefit of a rollover of the entire benefit to John's own IRA.

In order to have a beneficiary of a trust treated as a designated beneficiary for purposes of the minimum distribution rules, the proposed regulations require the trust to satisfy the following four requirements at the later of the date the trust is named as a beneficiary or the RBD.

1. The trust must be a valid trust or would be a valid trust under state law if it had a corpus.

1. The beneficiaries of the trust entitled to the plan benefits or IRAs must be identifiable.

3. The trust must be either irrevocable or, by its terms, will become irrevocable at the participant's death.

4. The documentation requirements must be satisfied.

It is hoped that the final regulations will eliminate all these requirements and simply require the plan administrator be informed of the name or names and age or ages of the beneficiaries of the trust who are being treated as designated beneficiaries. The plan administrator should not be required to determine whether a trust is valid under state law, but should be able to assume that a trust is valid unless he or she has reason to believe otherwise. A testamentary trust will not be a valid trust at the participant's RBD. The IRS has informally indicated that it did not intend to preclude the use of a testamentary trust as a beneficiary of a plan benefit or IRA when it issued new proposed regulations on December 29, 1997. Also, in many cases the terms of a trust agreement will not provide that it will become irrevocable at the death of the creator of the trust, because the trust would become irrevocable under state law without any specific language in the agreement. Again, it is likely that the IRS did not intend to require specific language in the trust agreement, as long as the trust becomes irrevocable at the participant's death.

Under the documentation requirements, the participant must furnish to the plan administrator at the RBD either the trust instrument or a list of beneficiaries, including contingent and remainder beneficiaries, and the conditions on their entitlement. In addition, the participant must certify that the list is complete and agree to furnish an updated list if the trust instrument is amended and a copy of the trust agreement upon demand. No later than the end of the ninth month following the month in which the participant dies the trustee of the trust would have to furnish the plan administrator either a copy of the trust instrument or a final list of the beneficiaries and agree to furnish a copy of the trust instrument if requested. These requirements are over-broad, since only the name and age of the oldest beneficiary of each separate share of the trust who is a beneficiary of the trust with respect to the plan benefit is needed by the plan administrator to determine the required minimum distribution. Furthermore, no documentation should be required to be provided to the financial institution sponsoring an IRA, since IRA sponsors generally disclaim responsibility for determining required minimum distributions and the account holder may take the total of the
required minimum distributions calculated separately for each of his or her IRAs from any one or more of his or her IRAs.

If the trust fails to satisfy these requirements or if any of the identified beneficiaries of the trust may not be designated beneficiaries, the participant will be treated as having no designated beneficiary. In such a case, the entire benefit or IRA would have to be paid out by the end of the year containing the fifth anniversary of the participant's death if the participant died before his or her RBD and once the participant reaches the RBD, payments must be made only over his or her life expectancy. Consequently, the safe approach until the IRS issues more guidance would be to have the participant name a living revocable trust as his or her beneficiary that contains specific language that the trust will become irrevocable at the participant's death and that has only the spouse and individuals younger than the spouse as beneficiaries. In addition, the participant should decide whether to furnish the plan administrator a copy of the trust agreement or the list of beneficiaries discussed earlier. Certain plan administrators require the trust document.

The following additional considerations must be kept in mind if the credit shelter trust is named as the beneficiary.

1. The marital deduction will not be available.
2. Rollover treatment will not be available.
3. Because Mary reached age 50 before 1986, five-year averaging, ten-year averaging, and capital gain treatment will be available if the distribution qualifies as a lump sum distribution. Five-year averaging will not be available after 1999.
4. John's consent to waive his rights under REA will be required.
5. The trustee may be authorized to disclaim the right to the benefits, in which case the benefits may then be paid to a marital deduction trust or directly to John, depending upon the beneficiary designation form.
6. Designating the credit shelter trust as beneficiary is appropriate if Mary has no other assets to fund the credit shelter trust.
7. If there are other assets that will not be treated as income in respect of a decedent (IRD) that can be allocated to the credit shelter trust or directly to children or other beneficiaries, generally more wealth will escape estate taxation in John's estate if the plan benefit is allocated to him or a trust qualifying for the marital deduction since John or the trust will be paying the income tax on the distributions rather than the credit shelter trust or the children.
QUESTION 1-3.

Assume that, instead of being married for 40 years to John, Mary's first husband died when Mary was 55 and she married John when she was 60. Assume also that Anne is Mary's daughter by her prior marriage. How might these facts affect Mary's choice of a designated beneficiary, assuming that the plan benefit constitutes most of Mary's wealth? [See Section IV. of the outline, and Forms II, III, VI and VII.]

ANSWER:

Mary should consider naming a QTIP trust as the beneficiary of her plan benefit. If she wants to qualify the plan benefit for the marital deduction in order to defer the federal estate tax on the benefit as long as possible, but does not want to give John control over the plan benefit remaining at his death, she should name a trust designed to qualify for the marital deduction as the beneficiary. Because her goal is to reduce John's control over the plan benefit, the trust should be a qualified terminable interest property (QTIP) trust. Only a QTIP trust assures Mary of ultimate control over the disposition of any remaining assets in the trust at John's death, including any plan benefit that was treated as principal and retained in the trust and any balance remaining in the plan. An estate trust, which qualifies for the marital deduction, requires that any remaining assets in the trust be payable to John's estate. A life income/general power of appointment trust requires that John have the right either to withdraw the assets from the trust during his lifetime or to designate where the assets in the trust will go at his death.

Qualifying the plan benefit for the marital deduction when it is payable to a QTIP trust may require the benefit to be paid out faster than required under the minimum distribution rules. Under one published revenue ruling and a number of private letter rulings, the beneficiary designation form required the plan or IRA to distribute annually to the trust all income generated by the decedent's accrued benefit or IRA.

For example, in Revenue Ruling 89-89, the IRS held that the decedent's executor could elect to treat a decedent's IRA as QTIP property. In that ruling, the decedent elected an IRA distribution requiring the principal balance to be distributed in equal annual installments over the surviving spouse's life expectancy to a testamentary QTIP trust and the income earned on the undistributed balance of the IRA to be paid annually to the trust. The trust agreement required that both the income earned on the undistributed portion of the IRA that the trust received from the IRA and the income earned by the trust on the distributed portion of the IRA had to be paid currently to the decedent's spouse. Finally, the executor elected QTIP treatment for both the trust and the IRA.

Unfortunately, this revenue ruling may lead one to conclude that a QTIP election would need to be made for an IRA and that equal annual installments of principal would have to be made from the IRA to a trust that otherwise qualifies for the marital deduction to qualify the value of the IRA for QTIP treatment. It would be impossible to have equal annual installments of principal from an IRA that consists of investments that may either appreciate or depreciate in value. In addition, principal distributions should have no effect on qualifying an asset for the marital deduction. It should not be necessary to make a QTIP election with respect to an IRA payable to a QTIP trust,
which is an asset of the trust. One is not typically required to make a QTIP election with respect to property interests that are held by or payable to a QTIP trust.

On the other hand, the IRS may believe that a QTIP election with respect to an IRA or qualified retirement plan benefit is necessary to assure that any remaining balance in the IRA or plan benefit is included in the surviving spouse's estate under I.R.C. § 2044. However, the IRA balance or remaining plan benefit should be included in the surviving spouse's estate under I.R.C. § 2044 without a separate QTIP election, because it will be treated as an asset of the trust at the spouse's death.

If the spouse has a right to require the trustee to convert the assets of the QTIP trust to income-producing property or to distribute other trust assets equal to the income that would have been produced by the unproductive property, the value of an IRA or plan benefit payable to the trust should qualify for the marital deduction regardless of whether current income from the IRA or plan benefit is required to be paid to the trust. Normally the beneficiary of an IRA has the right to withdraw the entire account balance at any time and in many qualified retirement plans the beneficiary may have the same right.

In TAM 9220007 (January 30, 1992), the IRS held that the value of an IRA payable to a QTIP trust was not eligible for QTIP treatment because none of the authorized distribution options contained in the decedent's beneficiary designation form gave the surviving spouse a qualified income interest for life. The IRS held that the trustee's subsequent addition of an option that met the QTIP requirements did not qualify the IRA for QTIP treatment since the property must "pass" from the decedent for the benefit of the spouse in a form satisfying all the QTIP requirements as of the date of death and cannot be contingent upon actions taken after death. In Estate of Clayton v. Commissioner, the Fifth Circuit rejected the IRS's position that all the property available for the election had to qualify for QTIP treatment, regardless of whether the executor actually made the election. See also Estate of Robertson v. Commissioner, Estate of Spencer v. Commissioner, and Clack v. Commissioner. The IRS has now adopted the rulings in these cases in final regulations, i.e., the spouse's income interest in the trust may be contingent on the executor making a QTIP election. In TAM 9220007, the IRS also ruled that the IRA account could not be treated as an asset of the QTIP trust, but had to be treated as a trust itself and therefore had to satisfy all the requirements of a QTIP trust.

As a result of the IRS's position, the conservative approach when it is desirable to name a QTIP trust as the beneficiary of a qualified retirement plan benefit or IRA is as follows:

1. The payment and beneficiary designation form for the qualified retirement plan benefit or IRA should provide that the QTIP trust be paid each year the greater of (x) the income generated by the assets representing the accrued benefit in the qualified retirement plan or in the IRA or (y) the required minimum distribution determined under I.R.C. § 401(a)(9).

2. The trustee of the QTIP trust should have the right under both the payment and beneficiary designation form and the QTIP trust agreement to require the plan
trustee or IRA sponsor to convert nonincome-producing or low income-producing assets into income-producing assets or assets producing adequate income.

a. In the case of a defined benefit plan, which does not provide for a specific account that represents the deceased participant’s accrued benefit, the trustee of the QTIP trust should have the right to treat a certain amount of the value of the accrued benefit as income each year, perhaps based on the state’s income and principal act.

b. The trustee should also be given the right under both the payment and beneficiary designation form and the QTIP trust agreement to withdraw the accrued benefit or IRA balance at any time so that the trustee could withdraw an amount equal to the income that would have been produced if the assets were producing adequate income.

3. The QTIP trust agreement should provide that the part of any distribution from a qualified retirement plan or IRA that represents income will be paid to the spouse in the same manner as any income generated by other assets held by the trust and no expenses that would be chargeable against principal will be charged against the income portion of the distribution.

4. The spouse should have the right under the trust agreement to require the trustee of the QTIP trust to make nonincome-producing assets income producing or to convert nonincome-producing assets to income-producing assets.

a. The trustee of the QTIP trust should have the right under the trust agreement to distribute other assets of the trust to satisfy this demand.

5. A QTIP election should be made for both the trust and the qualified retirement plan benefit or IRA, by listing the plan benefit or IRA on Schedule M of Form 706.

This approach will defer the payment of principal from the qualified retirement plan or IRA as long as permitted under the minimum distribution rules, thereby deferring the payment of tax on the principal and retaining the principal in a tax-free vehicle. This approach will also ensure that the principal when paid to the trust is not paid out to the spouse unless required under an ascertainable standard (or some other standard) contained in the trust agreement. However, the payment of income must commence immediately after the participant’s death, even though under the minimum distribution rules the payments would not have to begin until the participant would have reached age 70½. In addition, depending upon the surviving spouse’s age and the earnings rate of the account, the required minimum distribution may be less than the income generated by the plan benefit or IRA.

There are additional considerations if the marital trust is the beneficiary.

1. Rollover treatment will be foreclosed unless John has the right to revoke the trust or a lifetime power to withdraw assets from the trust.
2. Because Mary reached age 50 before 1986, five-year averaging, ten-year averaging, and capital gain treatment will be available if the distribution qualifies as a lump sum distribution. Five-year averaging will not be available after 1999.

3. John's consent to waive his rights under REA will be required.

4. If John disclaims his interest in the trust, the benefit may then be paid to a credit shelter trust or directly to other beneficiaries, such as Anne.

5. The four requirements under the minimum distribution rules concerning trusts should be satisfied if the five-year distribution rule is to be avoided.

6. If any of the remainder beneficiaries is not an individual younger than John, minimum distributions may be accelerated.

**QUESTION 1-4.**

Will Mary have to obtain John's consent if she names someone other than John as the beneficiary of her plan benefit? [See Section I.D. of the outline.]

**ANSWER:**

Yes, John will have to consent to the payment of the benefit to someone other than him because of the Retirement Equity Act of 1984. The consent must designate a beneficiary and a form of benefit that may not be changed without John's consent, unless he signs a general consent. His consent must acknowledge the effect of the election and must be witnessed by a plan representative or a notary public.

John may sign a general consent, which expressly permits Mary to change the beneficiary designation or form of payment or both without again obtaining John's consent. A general consent is not permitted unless the plan specifically permits such a consent. The general consent would have to acknowledge that John had the right to limit his consent to a specific beneficiary and a specific optional form of benefit and that he had voluntarily elected to relinquish both of these rights (or, if applicable, either of these rights). If Mary, with John's consent, names a revocable trust as the beneficiary, she could later change the beneficiaries or other terms of the trust without his consent.

Mary's waiver of a qualified joint and survivor annuity or qualified preretirement survivor annuity and John's consent to the waiver will be valid only if made during specific election periods. The waiver of a qualified joint and survivor annuity may be made only during the 90-day period ending on the first day of the period for which the first payment is to be made to Mary (referred to as the annuity starting date), and only after Mary has received a notice explaining the qualified joint and survivor annuity. Unless Mary makes an irrevocable election, she may, with John's consent, change the form of benefit after the annuity starting date.
Under the I.R.C., a waiver of a qualified preretirement survivor annuity can be made only on or after the first day of the plan year in which the participant reaches age 35. The regulations permit a participant who has not reached age 35 to make a waiver, but the participant must execute a new waiver after reaching age 35. The age 35 provision does not apply to plans, such as certain profit sharing plans, that are not required to provide the qualified preretirement survivor annuity and qualified joint and survivor annuity. The spouse may consent to a waiver of his or her right to the death benefit, which is the participant's entire non-forfeitable accrued benefit in such a plan, at any time.

The participant must be permitted to revoke his or her election during the applicable election period, although the plan may require that the spouse's consent to a waiver of the qualified preretirement or joint and survivor annuity not be revocable.

A beneficiary designation executed before August 23, 1984, naming someone other than the spouse as the primary beneficiary, whether or not the spouse consented to the designation, is not valid to deprive the spouse of his or her REA rights. In addition, a consent to a waiver signed before a marriage (such as in a premarital agreement) is not a valid consent according to the regulations. Although one state court has held that a premarital agreement may serve as a valid waiver of the spouse's REA rights, Estate of Hopkins, a number of federal courts have upheld the position taken in the regulations.

In 1993, a New York court, in Kartiganer v. Bloom, held that a beneficiary designation signed by an unmarried participant was not nullified when the participant subsequently married, so that when the participant died the person named under the beneficiary designation rather than the spouse was entitled to the participant's death benefits. This case is obviously contrary to the regulations, which state that a deemed waiver by an unmarried participant is null and void if the participant subsequently marries. See also the Callahan case where the Sixth Circuit held that a spouse who signed a premarital agreement waiving her right to the participant's benefits may be required to give up her right pursuant to the contract. Also, the court stated that a premarital agreement may qualify as a valid waiver if it satisfied both the statutory requirements and any plan requirements.

In most of these situations, the problem would have been avoided if the plan document required that, in order to be entitled to the spousal death benefit mandated by the I.R.C. and ERISA, the spouse must be married to the participant throughout the one-year period ending on the date of the participant's death. Although such a requirement is permitted under the I.R.C. and ERISA, many plans do not contain such a requirement because of the difficulty in administering such a provision. The plan administrator would have to determine when a participant married his or her spouse before making any payments to the spouse after the participant's death.

If a participant who is about to marry is entering into a premarital agreement, the beneficiary designation form for the plan should be signed and notarized (or witnessed by a plan administrator) and attached to the premarital agreement, and the premarital agreement, along with the attachment, should be furnished to the plan administrator. Based on dicta in the Callahan case, this may be sufficient to render the premarital agreement an effective waiver of the future spouse's rights to the participant's plan benefits. It may also be possible to condition the receipt of other economic
benefits provided to the fiancée under the premarital agreement on the fiancée's cooperation in signing any required waivers after the marriage.

A defined contribution plan, other than a money purchase pension plan, is not required to provide the qualified survivor annuities to a participant's spouse if it meets the following requirements:

1. The plan provides that the participant's nonforfeitable accrued benefit (reduced by any security interest held by the plan by reason of a loan outstanding to the participant) is payable in full on the death of the participant to the participant's surviving spouse (or, if there is no surviving spouse or the surviving spouse consents as described above, to a designated beneficiary);

2. The participant does not elect to receive the benefits in the form of a life annuity; and

3. With respect to the participant, the plan is not a direct or indirect transferee of a transfer after December 31, 1984 from a plan that is required to provide the qualified joint and survivor annuity and qualified preretirement survivor annuity. When there has been such a transfer, if the transferee plan separately accounts for the transferred assets and income therefrom, the balance of the participant's account is not subject to the survivor annuity rules.

In addition, an Employee Stock Ownership Plan (ESOP) is not subject to the qualified survivor annuity rules to the extent a participant has a right to demand a distribution of employer securities. IRAs, Simplified Employee Pension Plans (SEPPs) and simple retirement accounts (SIMPLEs) are not subject to the spousal consent rules at all.

QUESTION 1-5.

Assume that Mary desires to leave $500,000 to the University of Richmond to establish a chair in estate planning and the only other asset in her own name is stock in IBM that has a basis of $100,000 and a current fair market value of $500,000. Could Mary's desire to make this bequest affect her decision concerning the choice of a designated beneficiary? [See Section VI. of the outline and Form V.]

ANSWER:

Mary should use part of the plan benefit to satisfy her desire to make a gift to the University.

1. When the participant desires to make a substantial gift to charity, using a qualified retirement plan benefit or IRA to satisfy that desire may be advisable since the charity will not be subject to income tax when the benefit or IRA is paid to the charity. Because the IBM stock will get a step-up in
basis while the plan benefit will not, if John receives the stock. he may immediately sell the stock without recognizing any taxable income, but would have taxable income to the extent of any plan benefit received in excess of any IRD deduction for estate tax attributable to the benefit.

2. To avoid recognition of the income by the estate, the benefits should not be used to fund a pecuniary charitable bequest, unless the will requires the use of the benefit to satisfy the bequest. I.R.C. § 642(c). For example, Mary's estate would recognize $500,000 of taxable income if her executor uses part of her plan benefit to satisfy a $500,000 cash bequest to the University contained in Mary's will.

3. The portion of plan benefit payable to the University will be deductible in determining Mary's federal taxable estate as a charitable deduction.

4. John's consent to waive his spousal rights under the I.R.C. and ERISA will be required.

5. If only part of her plan benefit is to be paid to the University, a separate account should be established no later than her RBD in order to use the life expectancies of other designated beneficiaries for purposes of determining the required minimum payment of Mary's remaining benefit.

PART II

Assume that four years have elapsed (it is now December 15, 2002), and Mary is now seeking your advice on how to receive her benefits, since she will be required to begin receiving her benefits on or before April 1, 2003 (her required beginning date). Mary wants to defer the receipt of any distributions from the plan for as long as possible, since her current compensation from Good Products allows her and John to live according to the standard which the two of them have enjoyed for a number of years.

QUESTION II-1.

In what form should Mary begin to receive her benefits? [See Section III.B. of the outline.]

ANSWER:

If Mary and John can afford to do without the cash in her plan, then withdrawal of the plan benefit should be deferred as long as possible under the minimum distribution rules. The amount that would have been paid in income tax on a current distribution will continue to be invested. The income tax on the earnings of the entire amount, including the amount that would have been paid as income tax on a current distribution, will be deferred until the distribution is actually made, causing the amount retained in the plan to increase more rapidly. Deferral may cause the future distributions
to be taxed at a higher tax rate if Congress again raises rates. However, the benefit of the tax-free accumulation of income should offset the effect of higher rates after a few years.

Once Mary has reached her required beginning date, she should elect to have the benefit paid over a period certain equal to the joint and last survivor expectancy of Mary and John. Mary should elect to have only her life expectancy recalculated each year for purposes of determining the required distribution. Under the proposed regulations dealing with the minimum distribution rules, if the payment of the participant's benefit is to be made over the life expectancy of the participant or the joint life expectancies of the participant and the participant's spouse, the life expectancies of both of them will be recalculated unless the participant elects not to have either or both life expectancies recalculated. If the life expectancy of either spouse is being recalculated, when that spouse dies, his or her life expectancy will be zero in the following year. Consequently, if the life expectancies of both spouses are being recalculated, at the death of the surviving spouse the entire remaining benefit would have to be distributed before December 31 of the year following the year in which the individual died.

By not electing to have the life expectancy of John recalculated, the minimum period over which the payments will be made will be John's life expectancy, even if Mary and John both die before the end of John's life expectancy. Note that John's life expectancy would be 18.4 years, the life expectancy of a person age 67 (John will be 67 in the year in which Mary reaches 70½). By electing to have the life expectancy of Mary recalculated each year, Mary can be assured that the payments will continue as long as she is alive, regardless of when John dies. If John dies first and his life expectancy was not being recalculated, his life expectancy will continue to be used for purposes of determining the required distribution to Mary.

If Mary dies first, then John may, if permitted under the plan, withdraw the balance of the benefit and roll it into his own IRA, allowing him to defer receipt of any additional payments until his required beginning date, which will be April 1, 2006, the year following the year in which he will reach age 70½. He may now elect to have his life expectancy recalculated to assure that payments will continue as long as he is alive. He may also name Anne as his designated beneficiary and have the payments made over their joint and last survivor expectancy. Even though the payout period during his life will be limited by the minimum distribution incidental death benefit rule, which in effect treats Anne as no more than ten years younger than John, once he dies the required distribution to Anne will be based on Anne's remaining life expectancy.

**QUESTION II-2.**

When should Mary begin receiving her benefits? (Should she wait until her required beginning date to receive the first payment?) [See Section III.A.2.d. of the outline.]

**ANSWER:**

Mary's required beginning date, as mentioned, is April 1, 2003. If she waits until 2003 to receive the first distribution, she will be required to receive two distributions in 2003, one on or before April 1, 2003, to satisfy the required distribution for the year in which she reached age 70½
(2002), and another distribution by December 31, 2003, to satisfy the required distribution for the year 2003. This may push Mary into a higher federal income tax bracket.

In Questions II-3 through II-6, assume that John makes a spousal rollover.

QUESTION II-3.

If Mary dies before John, what will be the effect of naming his daughter Anne, who is now age 40, as his designated beneficiary on the amount of the required payments to John once he reaches his RBD? [See Section III.B.1.b. of the outline.]

ANSWER:

As a result of the minimum distribution incidental death benefit rule, while John is alive, Anne will be treated as no more than ten years younger than John for purposes of determining the period over which the payments must be made. For example, in calculating the required distribution that must be paid to John for the year in which he reaches 70½, he will be treated as age 70 (his birthday is January 15) and Anne will be treated as age 60, resulting in a divisor of 26.2, which is the joint life and last survivor expectancy of a person 70 years old and a person 60 years old.

QUESTION II-4.

If Mary dies before John, and John dies in the year 2004 (before his RBD, which is April 1, 2006), and he has named Anne as his designated beneficiary, over what period must the remaining balance be paid to Anne? [See Section III.B.2. of the outline.]

ANSWER:

The payments may be made to Anne over her life expectancy if the payments commence by December 31, 2005 (the calendar year following John's death).

QUESTION II-5.

If Mary dies before John and John dies on June 1, 2006 (after his RBD), over what period must the remaining balance be paid to Anne? [See Section III.B.2. of the outline.]

ANSWER:

Although Anne will be treated as no more than ten years younger than John for purposes of determining the required distribution to John during his lifetime, once John dies, Anne's remaining life expectancy can be used. In this case, Anne would be 43, and her remaining life expectancy would be 39.6. Her life expectancy was 40.6 in the year in which John reached age 70½ (2005), when she was age 42. Because her life expectancy may not be recalculated, her life expectancy in 2006 would be 39.6 because one year has elapsed since John reached age 70½.
QUESTION II-6.

When must Anne begin receiving the payments after John dies? [See Section III.B.2. of the outline.]

ANSWER:

Regardless of whether John dies before or after his RBD, Anne must begin receiving payments before December 31 of the year following John's death. However, if John died after his RBD but before receiving his required distribution for the year in which he died, Anne would probably be required to receive the required distribution that would have been paid to John if he had not died.