

# IRA'S AND RETIRING PLANS: DEFUSING THE TAX TIME BOMB

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I. INTRODUCTION .....	1
A. RECENT CHANGES IN THE LAW .....	1
1. Suspension of Excise Tax on Lifetime Distributions .....	1
2. Repeal of Five Year Averaging.....	1
3. Changes in the Required Distribution Date for Certain Employees.....	1
4. IRA Withdrawals for Medical Expenses.....	1
5. Death Benefit Repealed.....	1
6. Non-Working Spousal IRA.....	1
7. Accelerated Death Benefits .....	1
B. THE IRA DILEMMA .....	1
1. IRA's Have Been Too Successful.....	1
2. Adverse Income Tax Consequences .....	2
3. Adverse Estate Tax Consequences.....	2
II. PLANNING FOR THE OWNER'S DISTRIBUTION DURING LIFE .....	2
A. CASHING OUT BEFORE DEATH.....	2
B. CASHING OUT VS. DEFERRAL.....	3
1. In General, Deferral is Better.....	3
C. COMMUNITY PROPERTY AND CREDITOR PROTECTION ISSUES .....	3
1. IRA's are Subject to California's Community Property Rules.....	3
2. Qualified Plans Are Not Subject to California's Community Property Rules.....	3
3. Spousal Consent for Community Property Interests in IRAs. ....	3
4. Federal Beneficiary Designation Issues .....	4
5. Creditor Protection Issues .....	4
6. Conversion of Qualified Retirement Plan to an IRA.....	5
. MINIMUM DISTRIBUTION RULES.....	5
1. Congressional Determination — IRA's Must be Distributed .....	5

2. Calculating the Minimum Distribution .....	6
3. Tax Planning under the Minimum Distribution Rules .....	7
4. If the Owner Dies before the RBD .....	9
5. IF Owner Dies After the RBD.....	9
E. INCOME TAX AND ADDITIONAL “PENALTY” TAX CONSIDERATIONS.....	9
1. Income Tax Considerations .....	9
2. Additional Penalty Taxes .....	9
III. CHOOSING THE PROPER BENEFICIARY.....	10
A. SPOUSE .....	10
1. Advantages.....	10
2. Disadvantages .....	11
3. Inherited IRA’s and Spousal Designations .....	11
B. A TRUST .....	11
1. Use of a Trust .....	11
2. When the Estate is the Beneficiary of the IRA.....	15
3. Individuals.....	16
IV. ESTATE PLANNING ISSUES WITH IRA’S.....	16
A. FUNDING MARTIAL OR BY-PASS (CREDIT SHELTER) TRUST WITH AN IRA.....	16
1. The Pecuniary Gift Issue .....	16
2. Survivor’s Trust.....	16
3. Q-TIP Trust.....	17
4. Qualified Domestic Trust (“Q-DOT”) for Non-U.S. Citizen Spouses.....	17
5. The By-Pass Trust.....	17
6. Charities .....	18
7. Planning Considerations:.....	18
V. RECOMMENDED READING MATERIALS.....	19

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## I. INTRODUCTION

### A. Recent Changes in the Law

#### 1. SUSPENSION OF EXCISE TAX ON LIFETIME DISTRIBUTIONS

- a) The 15% excise tax on excess distributions under IRC Sec. 4980A has been waived for tax years 1997, 1998 and 1999. This applies only to lifetime distributions. The excise tax will apply to excess accumulations at death.

#### 2. REPEAL OF FIVE YEAR AVERAGING

- a) Commencing in the year 2000, five-year forward averaging will be repealed. IRC Sec. 402(d)

#### 3. CHANGES IN THE REQUIRED DISTRIBUTION DATE FOR CERTAIN EMPLOYEES

- a) For participants in qualified plans who own less than 5% of the company, the minimum distribution rules are delayed during the time the participant is still employed. IRC Sec. 401(a)(9)(C).

#### 4. IRA WITHDRAWALS FOR MEDICAL EXPENSES

- a) The 10% penalty for premature withdrawals from IRAs will not apply to medical expenses in excess of 7 ½ % of adjusted gross income. IRC Sec. 72(t)(3)(a) and (2)(D).

#### 5. DEATH BENEFIT REPEALED

- a) The \$5,000 death benefit exclusion under IRC Sec. 101(b) has been repealed, effective for taxpayers who have died after August 20, 1996.

#### 6. NON-WORKING SPOUSAL IRA

- a) A non-working spouse may contribute \$2,000 to an IRA, effective January 1, 1997, provided a joint return is filed. The deduction is phased out if the working spouse's income exceeds \$50,000. IRC Sec. 219(c).

#### 7. ACCELERATED DEATH BENEFITS

- a) Amounts received after December 31, 1996 as qualified accelerated death benefits will be tax-free under IRC Sec. 101(g) and 818(g).

### B. The IRA Dilemma

#### 1. IRA'S HAVE BEEN TOO SUCCESSFUL

- a) IRA's have become a significant vehicle for wealth generation over the past 10 years, mainly because of the "miracle of compounding" principal. Often the IRA can be the most valuable asset in a taxpayer's estate.

## 2. ADVERSE INCOME TAX CONSEQUENCES

- a) Distributions from IRA's are taxed at ordinary income tax rates. Also, under IRC Sec. 4980A, there is an excise tax of 15% on distributions in excess of \$155,000.
- b) Upon death, the IRA distributions are subject to the "income with respect to a decedent" rules under IRC Sec. 691 ("IRD") and are taxed as ordinary income.
  - (1) Note: While estate taxes paid are generally deductible for income tax purposes when a beneficiary receives IRA distributions under the IRD rules, California does not allow an income tax deduction for estate taxes paid to the federal government. R&T Code Sec. 17024.5 (b)(14). The result can be a large income tax paid to California.
  - (2) Also, there is no federal income tax deduction for the state death tax credit amount paid to California, so the IRD deduction is further diminished.

## 3. ADVERSE ESTATE TAX CONSEQUENCES

- a) Under IRC Sec. 4890(d), there is a 15% excise tax levied against excess retirement accumulations. Excess retirement accumulations is the excess of the present value of a single life annuity with annual payments of \$155,000, based on an individual's life expectancy, as if the taxpayer were still alive.
  - (1) The excess under IRC Sec. 4890(d) is subject to both estate and generation-skipping taxes ("GST").

## II. PLANNING FOR THE OWNER'S DISTRIBUTION DURING LIFE

### A. Cashing Out Before Death

- a) Cashing out before death simplifies the estate tax consequences since the IRA distribution, while subject to income tax, will be removed from part of the estate. Distributions should be tailored to comply with the excess distribution rules of IRC Sec. 4980A.
  - (1) Because of the IRA's deferral aspects, a cash-out should occur shortly before death.
  - (2) Cashing out might be appropriate if the participant wanted to utilize the unified estate and gift tax credit in connection with a long-term trust for the beneficiaries. The cost, however, is the loss of the IRA deferral potential.
  - (3) An owner may withdraw distributions from an IRA prior to attaining age 59 ½ without paying the Ten Percent (10%) premature distribution penalty, provided there are substantially equal annual periodic payments. IRC Sec. 72 (t). Notice 89-25 discusses how to calculate the payments.
    - (a) This exception is also available to a surviving spouse who is under age 59 ½ and who wants current IRA distributions. The

surviving spouse rolls over the deceased spouse's IRA into a new IRA and elects early payment.

## **B. Cashing Out vs. Deferral**

1. IN GENERAL, DEFERRAL IS BETTER.
  - a) In most cases, the tax planner's strategy will be to maximize the deferral by stretching out the payment period and minimizing the payments per year.
  - b) If deferral is not available or will be minimal because of certain irrevocable elections made with respect to the IRA, then cashing out could be an option, especially in those situations where the unified credit is needed for a long-term trust.

## **C. Community Property and Creditor Protection Issues**

1. IRA'S ARE SUBJECT TO CALIFORNIA'S COMMUNITY PROPERTY RULES
  - a) Estate of MacDonald, 51 C. 3<sup>rd</sup> 262, 272 Cal. Rptr. 153 (1990) was a transmutation case in which the court discussed the right of a non-participant spouse of an IRA to dispose of her community property interest in the IRA.
2. QUALIFIED PLANS ARE NOT SUBJECT TO CALIFORNIA'S COMMUNITY PROPERTY RULES
  - a) Ablamis v Roper, 937 F 2d 1450 (9<sup>th</sup> Cir, 1991) held that federal law pre-empted state law and the community property rights under state law with respect to qualified federal retirement plans. Therefore, none of the participant's retirement plan was part of the non-participant spouse's estate for estate tax purposes and, consequently, her unified estate and gift tax credit could not be applied to the plan.
    - (1) Note: If the participant rolled-over the plan to an IRA, then California's community property laws would then apply under the MacDonald Case.
3. SPOUSAL CONSENT FOR COMMUNITY PROPERTY INTERESTS IN IRAS.
  - a) California Probate Code Sec. 100 provides that upon death of a married person, the community property is split between the decedent and the surviving spouse. Prob. Code Sec. 5000 permits written documents signed by spouses to control the non-probate transfer of property on death.
  - b) Prob. C. Sec. 5010-5032 cover spousal consents involving non-probate transfers of community property. These provisions will apply to beneficiary designations for IRAs involving trusts or individuals other than a spouse.
    - (1) A written document containing the consent of the spouse regarding transfers of community property is required. The property which is subject to the agreement should be clearly specified.

(2) Consent can be modified (Prob C. Sec. 5023) or revoked (Prob C. Sec. 5031). Under Prob. C. Sec. 5030(c), a spousal consent becomes irrevocable upon the death of either spouse.

(a) However, there is a specific exception under Prob. C. Sec. 5023(b)(3) which permits a surviving spouse to make modifications after the death of the consenting spouse. This exception will permit the surviving spouse to change beneficiaries of an IRA, if necessary, after the death of the consenting spouse.

c) Note: Usually, an IRA beneficiary designation form will not specify that California law is controlling; therefore, a document containing the requisite consents, along with an express provision that California law will be controlling, should be attached to the form.

#### 4. FEDERAL BENEFICIARY DESIGNATION ISSUES

a) ERISA plans, in general, require that retirement benefits must take the form of a survivor annuity. Usually this is in the form of a joint and survivor annuity - a single annuity paid over the life of the participant (and possibly over the life of the surviving spouse).

b) If the participant dies before the starting date, the surviving spouse is entitled to an annuity called a qualified pre-retirement survivor annuity.

c) Under IRC Sec. 401(a)(11)(B)(iii)(I), the participant can waive these annuities with the consent of the non-participating spouse.

(1) There are strict and detailed requirements for waiving these requirements. IRC Sec. 417(a)(2)(A). The designated beneficiary may be an individual, class of beneficiaries or a trust. Reg. 1.401(a)-20, Q&A-31.

(a) Once a designation has been made, it cannot be changed by the participant unless the non-participating spouse permitted a change in the initial consent.

(b) The consent must acknowledge the effect of the waiver and must be signed before a notary or the plan representative. These conditions must be met once the couple is married.

(c) Waivers contained in a prenuptial agreement or consents made before marriage are ineffective. IRC Reg. 1.401(a)-20, Q&A-28.

#### 5. CREDITOR PROTECTION ISSUES

a) ERISA qualified plans are exempt from creditors. Patterson v. Shumate, 112 S Ct. 2242 (1992). The IRS, however, may be able to attach vested pension benefits under certain circumstances.

b) IRA's are not protected by federal law. Under California law, IRA's receive some creditor protection: they are exempt from creditor attachment to the extent necessary to provide for retirement support,

including the support of a spouse and dependents, after taking into account all other sources of support. CCP Sec. 704.115(e).

(1) Query: Would an attachment by a creditor trigger both income tax and possibly a 10% early withdrawal penalty? If so, who pays — the participant or the attaching creditor? Note: An IRS levy is considered an early distribution that is subject to this penalty.

(2) Would an attachment of a portion of the IRA be treated as an “assignment of income” and therefore trigger an immediate tax on the entire IRA?

#### 6. CONVERSION OF QUALIFIED RETIREMENT PLAN TO AN IRA

a) While there could be community property advantages with respect to the conversion of a qualified retirement plan to an IRA, keep in mind that the absolute creditor protection afforded under federal law is eroded under California law.

(1) If the participant in a qualified plan has creditors or is involved in litigation, a rollover to an IRA should be avoided.

### D. Minimum Distribution Rules

#### 1. CONGRESSIONAL DETERMINATION — IRA’S MUST BE DISTRIBUTED

a) When Congress determined that IRA owners should receive distributions from their IRA’s during life, it was confronted with two policy issues:

(1) Choosing a **date** when withdrawals would occur — called the “required beginning date” (“RBD”); and

(2) Limiting the **time** over which the withdrawals would be made — called the “applicable life expectancy.” Congress chose a joint life expectancy of the owner and the beneficiary as the length of time for withdrawals.

(3) Therefore the consideration of an IRA beneficiary includes two factors: Who will receive the money and the length of that person’s life expectancy.

b) The minimum distribution rules play a critical role in the taxation of IRA’s, since certain irrevocable choices must be made on or before the RBD. The RBD is the last date the IRA is permitted to:

(1) Have a designated beneficiary; and

(2) Opt out of the annual recalculation rules pertaining to the owner’s life expectancy.

c) RBD sets the maximum applicable life expectancy which is used in the calculation of the minimum distribution (discussed below).

d) The RBD is April 1<sup>st</sup> of the calendar year after the beneficiary hits age 70 ½.

- (1) An individual attains age 70 ½ six months (not 180 days) after his 70<sup>th</sup> birthday. An owner born on or after July 1<sup>st</sup> will cause a delay in the RBD of one year.
  - (2) Example: An IRA owner born on April 10, 1926 attains age 70 ½ on October 10, 1996. The RBD would be April 1, 1997.
- e) Distributions in following years must be paid by December 31 of that calendar year.
  - f) The minimum distribution is a fraction, the numerator of which is the balance of plan on December 31 of prior year and the denominator of which is the applicable life expectancy (usually a joint life expectancy determined by tables).
    - (1) Example: If there is \$500,000 in the IRA at the end of 1996 and the life expectancy is 10 years, then the minimum distribution is \$50,000.  
 $\$500,000/10 = \$50,000$ 
      - (a) If in the previous example the life expectancy is 20 years, then the minimum distribution is \$25,000.  $\$500,000/20 = \$25,000$ .
      - (b) Therefore, the longer the life expectancy denominator, the smaller the minimum distribution and the greater potential for accumulating wealth within the IRA.
    - (2) When determining the applicable life expectancy, the beneficiary (other than a spouse) is treated as being no more than 10 years younger than the owner, regardless of that beneficiary's actual age. This is called the minimum distribution incidental benefit rule.
    - (3) Note: Once the owner dies, this 10-year rule no longer applies and the beneficiary's actual age is used.

## 2. CALCULATING THE MINIMUM DISTRIBUTION

- a) The minimum distribution is generally the value of the IRA at the end of the prior calendar year, divided by the applicable life expectancy. The applicable life expectancy changes each year.
  - (1) Without a designated beneficiary, the applicable life expectancy is the owner's life expectancy. See IRS Publication 590 (Individual Retirement Arrangements) and Reg. 20.2031-7(e) for the computations involving life expectancies and the valuation tables.
  - (2) If there is a designated beneficiary, then the life expectancy is the joint lives of the owner and beneficiary.
    - (a) As stated above, if the beneficiary is someone other than the owner's spouse, then the beneficiary's age is considered no more than 10 years younger than the owner.
- b) The recalculation method is used, unless the owner has affirmatively opted out of this method. Under the recalculation method, for each year an owner lives, his life expectancy decreases by less than one year.

- (1) Example: If an owner is 70 years old, his life expectancy is 16.0 years. Under the recalculation method, his life expectancy at age 71 will be 15.3 years. In contrast, under the term certain method (described below) his life expectancy at age 71 would be 15 years.
  - (2) Unfortunately, under the recalculation method, the life expectancy drops to zero the year after the owner's death. Conversely, the longer the owner lives, the distributions from the IRA will be smaller since the denominator of the fraction will be larger than under the term certain method.
- c) If the recalculation method is not used, then for each year the owner lives, the applicable life expectancy decreases by one year. This is called the "term certain method" and is the most conservative approach to calculating life expectancies.
- (1) After the owner's death, the applicable life expectancy continues to decrease by one year.
  - (2) Note: Many IRA custodial forms presume recalculation. Also, often the participant is never advised by the custodian about this critical choice.
- d) Once an election regarding the calculation method for life expectancy is made on or after the RBD, the election is irrevocable. Prop. Reg. 1.401(a)(9) -1 Q&A E-7.

### 3. TAX PLANNING UNDER THE MINIMUM DISTRIBUTION RULES

- a) Advantages under the recalculation method.
- (1) The recalculation method provides for a lower annual minimum withdrawal, compared to the term certain method, since the applicable life expectancy denominator of the equation remains higher. This is a distinct advantage since it allows a greater portion of the IRA principal to continue to grow tax-free.
    - (i) Under the law, recalculation is presumed, but under the boiler-plate language of the IRA custodian agreement, the term certain method may not be allowed.
    - (ii) It is possible to recalculate using the participant, but not the spouse; recalculation for both the owner and spouse is also permitted.
    - (iii) If one recalculates using the owner and the spouse and the spouse predeceases the owner after the RBD, then full distribution of the IRA will occur in the year after the participant's death.
- b) Disadvantages under the recalculation method.
- (1) The disadvantage occurs when no beneficiary is named, or the beneficiary predeceases the owner. In that case, the IRA is distributed in the calendar year following the owner's death.

(2) Also, if the owner has health problems and a shorter than actual life expectancy is predicted, the recalculation method should not be used.

- c) Advantage of the term certain method.
  - (1) To use the term certain method, the IRA agreement needs an express provision permitting this election and the election must be made prior to the RBD.
  - (2) The advantage of using a term certain is that the IRA will pay out over that term, whether or not the participant or the designated beneficiary die prior to the full distribution.
    - (a) The trade-off is the certainty of deferral under the term certain method against the potentially smaller minimum distribution when the recalculation method is used.

#### 4. IF THE OWNER DIES BEFORE THE RBD

- a) When the owner dies before the RBD, the life expectancy of the beneficiary is used and the IRA is distributed over this period, whether or not the beneficiary subsequently dies during the distribution.
- b) If there is no beneficiary designation, then the IRA is distributed within 5 years. The rule does not mandate equal annual payments, therefore, as long as the entire distribution is made within 5 years, there will be no penalty. IRC Sec. 401(a)(9).

#### 5. IF OWNER DIES AFTER THE RBD

- a) Usually, nothing occurs when an owner dies after the RBD, since the minimum distributions have commenced and the applicable life expectancy denominator is in place.
  - (1) If the designated beneficiary is more than 10 years younger than the owner, then the actual life expectancy will be used.
  - (2) A spousal roll-over is also available.

### **E. Income Tax and Additional “Penalty” Tax Considerations**

#### 1. INCOME TAX CONSIDERATIONS

- a) Income distributed from an IRA is taxed at ordinary income tax rates. An IRA which is part of the owner’s estate is an ordinary income asset and the distributions are taxed as IRD.

#### 2. ADDITIONAL PENALTY TAXES

- a) Under IRC Sec. 72(t), there is a Ten Percent (10%) tax on distributions made to persons under age 59 ½. This is considered an early withdrawal. California imposes a Two and one-half Percent (2 ½ %) tax penalty tax as well.
  - (1) Both presidential candidates have proposals to expand the withdrawal provisions for IRA’s without additional penalties.
- b) The failure to make a minimum distribution is penalized by a Fifty Percent (50%) tax under IRC Sec. 4974. This excise tax may be waived by the

IRS if the mistaken distribution was made due to a reasonable error and reasonable steps are being taken to fix the problem.

- c) There is an excess distributions tax and an excess accumulations tax of Fifteen Percent (15%) under IRC Sec. 4980A on the amount in excess of the permitted amounts.
  - (1) However, if the excise tax is paid on death, no additional excise tax will be paid; therefore, if the excise tax is small, consider paying it at the first death.
    - (a) Payment of the tax will allow the surviving spouse to withdraw the IRA during her life without regard to the annual distribution excise tax.
    - (b) Life insurance could be used to pay for this excise tax on the first death.
  - (2) Remember, the excise tax is deductible against estate taxes so the actual amount might be between 7% - 9% depending on the marginal tax rate of the estate.
  - (3) The unified credit cannot reduce the excess accumulations tax which is payable at the time the normal estate tax is due. The marital deduction and charitable deduction likewise cannot reduce this tax. Sec. 4980A (d) (2).

### **III. CHOOSING THE PROPER BENEFICIARY**

#### **A. Spouse**

##### 1. ADVANTAGES

- a) Choosing the spouse as the designated beneficiary, provided the spouse survives the owner, usually permits the longest deferral.
  - (1) Example: Husband names wife as beneficiary and husband dies. Wife sets up a new IRA and names a child. This will produce the maximum deferral benefits.
- b) The transfer to a spouse will qualify for the marital deduction; therefore, no estate tax will be imposed on the decedent's estate.
- c) The spouse has the right to roll-over the IRA to a new IRA in which the spouse is treated as the owner. A spouse may treat the participant's IRA as his or her own IRA without the necessity of forming a new IRA. Prop Reg. Sec. 1.408-8, Q&A A-4.
  - (1) The spouse will receive a new life expectancy and may name a new beneficiary.
  - (2) The minimum distribution rules will be based on the life expectancy of the spouse and beneficiary.
  - (3) If the spouse is under age 70 ½ the required distribution rules are suspended until that age.

(4) Partial IRA rollovers are permitted under IRC Sec. 408(d)(3)(D).

d) A spouse may elect to defer the excess accumulation tax. This is done through an election under Sec. 4980A (d) (5) to treat prior owner-spouse's IRA accumulations as part of a new IRA.

(1) By making this election, the excise tax for excess accumulations under IRC Sec. 4980A (d) (5) is postponed.

e) **Potential Trap:** If the election under IRC Sec. 4980A (d) (5) is not made, the surviving spouse must rollover the IRA into a "clean" IRA; if the spouse places these proceeds into an IRA commingled with her own funds, the entire amount will be tainted under IRC Sec. 4980A (d). Temp. Reg. Sec. 54, 4981A-1T Q&A d-10.

(a) The entire amount will be subject to the excess accumulations tax, even if the tax was paid on the decedent owner's share.

## 2. DISADVANTAGES

a) Naming the spouse as the beneficiary will place the entire IRA in the spouse's estate for estate tax purposes.

b) Use of the decedent's unified estate and gift tax credit will not apply.

c) In some situations, the decedent spouse may want the IRA to go to children or other beneficiaries.

## 3. INHERITED IRA'S AND SPOUSAL DESIGNATIONS

a) The spousal rollover provisions apply to an IRA in which the spouse is named as the beneficiary.

b) An inherited IRA is an IRA that is maintained for the benefit of an individual who is not a spouse. Inherited IRA's cannot be rolled-over to a new IRA. IRC Sec. 408(d)(3)(C).

c) If one spouse inherits an IRA, the roll-over provisions will not apply even if the other spouse is named as beneficiary.

(1) Example: Father names his married daughter the designated beneficiary of his IRA. Daughter receives the IRA and names her husband as the beneficiary. Husband will not be entitled to use the roll-over provisions to extend the life of the IRA.

## B. A Trust

### 1. USE OF A TRUST

a) A trust as a beneficiary of an IRA should be used whenever —

(1) There is a complicated distribution scheme that the IRA custodian will not want to undertake.

(2) A beneficiary is under age, has creditor problems or is a spendthrift.

- (3) The participant wants the beneficiary to clarify who gets the IRA when the beneficiary dies through a Power of Appointment.

## b) The Designated Beneficiary Trap

- (1) An IRA's deferral mechanism works best when there is a designated beneficiary; otherwise, the minimum distribution provisions will be calculated solely on the owner's life expectancy.
- (2) Unfortunately, trusts do not have life expectancies and cannot be used as designated beneficiaries. The same is true if an estate is named as the beneficiary, or the IRA is payable to an estate because the owner failed to designate a beneficiary.
- (3) Note: If a revocable trust is mistakenly named as the beneficiary and the IRA is making payments under the minimum distribution rules, the owner's life expectancy becomes the applicable life expectancy since the revocable trust has no life expectancy.
  - (a) Adverse tax consequences can arise if the owner mistakenly uses a joint life expectancy with his wife (the primary beneficiary of the revocable trust) since there is a 50% excise tax if the minimum distribution is not taken. Usually, this penalty provision can be waived by the IRS if such a mistake is made.
  - (b) There is a narrowly-drawn exception under the proposed regulations that could apply in this situation (discussed below).

## c) Use of a Revocable Trust and the Designated Beneficiary Problem

- (1) The designated beneficiary issue can be solved by using the trust's beneficiaries as designated beneficiaries.
  - (2) Prop. Reg. Sec. 1.401(a)(9)-1 Q&A D-5 states that the trust's beneficiaries can become the designated beneficiaries of an IRA if on the later of the RBD, or on the date the trust is named as the beneficiary of an IRA, and for all subsequent periods —
    - (a) The trust is valid under state law;
    - (b) The trust is irrevocable;
    - (c) The beneficiaries are identifiable by name or relationship; and
    - (d) A copy of the trust instrument is provided to the IRA plan provider.
- d) Under the proposed regulations, a revocable trust existing on the RBD will fail to qualify as a designated beneficiary since it is not irrevocable.
- (1) Therefore, if a revocable trust is used, the trust should state that at the time of the RBD, the trust will become irrevocable with respect to the beneficiary designations for the IRA.
  - (2) Note: The IRA owner may still replace the designated beneficiary with another designated beneficiary (either a person or another irrevocable trust) so the owner retains flexibility regarding the designation of a beneficiary.

- (a) In summary: Revocable trusts cannot be designated beneficiaries. The solution: Convert the portion of the revocable trust dealing with the IRA to an irrevocable trust and give a copy to the plan provider.

e) When a Spouse is the Beneficiary of a Revocable Trust

- (1) When a spouse is the designated beneficiary under a revocable trust that fails to comply with the requirements of Prop. Reg. 1.401(a)(9)-1 Q&A D-5 (quoted above), the IRS will consider the spouse as the beneficiary for minimum distribution purposes, provided —

- (a) The spouse may withdraw the IRA benefits from the trust as a beneficiary, or as the trustee of the trust; and
- (b) The withdrawals must actually be made.
- (c) Note: The withdrawals cannot be made by a trustee other than the spouse. Also, a trust that gives income for life to a spouse could fail this test if the minimum distribution exceeds the income distribution, unless the spouse is the trustee and has the right to receive a full withdrawal.

f) Naming a Revocable Trust as the Contingent Beneficiary

- (1) Often a spouse will be named as the primary beneficiary and a revocable trust will be named as the contingent beneficiary.

- (a) This situation will become a problem if the spouse dies before the owner and the owner fails to choose a primary beneficiary before the RBD.
- (b) A problem could also arise if the spouse uses a disclaimer and the revocable trust becomes the beneficiary.

- (2) Whenever a trust is named as a beneficiary of an IRA, the requirements of Prop. Reg. 1.401(a)(9)-1 Q&A D-5 must be met.

g) Income Tax Issues When Using a Trust

- (1) IRA distributions to a trust consist of principal and income, both of which are taxable.

- (2) Trusts receive deductions for distributable net income (“DNI”) which does not include the entire amount received from the IRA.

- (a) Given the compressed tax brackets for trusts, there could be substantial taxes paid, if the trust is taxable on the portion of the IRA distribution that is not considered DNI.

- (b) There are three potential solutions:

- (i) Treat all IRA distributions as income to the trust since the principal is IRD which is taxed as ordinary income, even though it is principal for accounting purposes. This might be accomplished through a modification of the trust’s

language regarding principal and income accounting procedures.

- (ii) Under Prop Reg. 401(a)(9) -D-5(b), the beneficiary is treated as receiving the distribution directly from the IRA. Although this conclusion was reached for minimum distribution provisions, it could be argued that it applies to the taxation as well.
  - (iii) Make the trust a grantor trust with respect to the beneficiary. You might want to use the administrative powers in IRC Sec. 675 to avoid the IRA becoming part of the beneficiary's estate for estate tax purposes.
- (c) IRC Section 675 treats the grantor as the owner of the trust if he or she has certain prohibited administrative powers exercisable primarily in the grantor's interest, rather than in the interests of the beneficiaries. The prohibitive powers include:
- (i) The power to deal with the trust property for less than adequate consideration.
  - (ii) The power to borrow without adequate interest or security.
  - (iii) Actual loans made to the grantor which have not been completely repaid before the beginning of the taxable year.
  - (iv) The power to reacquire trust property by substituting other property of equivalent value is also prohibited (a continuing option in the grantor over what property will belong in the trust).
- (d) In Private Letter Ruling 9037011, the service ruled that an irrevocable trust in which a third party had the power, exercised in a non-fiduciary capacity, at any time to acquire trust property by substituting property of equivalent value, would cause the grantor to become the owner of all of the trust under IRC Sec. 675(4)(C).
- (e) More importantly, the IRS ruled that the power to substitute property held by the third party would not cause the trust corpus to be includable in the grantor's estate for estate tax purposes.

## 2. WHEN THE ESTATE IS THE BENEFICIARY OF THE IRA

- a) If an owner's spouse is the sole executor and beneficiary of the estate, and if the IRA is left to the estate, the surviving spouse will be treated as receiving the IRA directly from the decedent and will be permitted to rollover the IRA. PLR 9450042.
- b) If the owner died after the RBD, then the estate will assume the remaining term of the IRA pay out and will receive the required minimum distributions over that time period, provided a term certain, rather than the recalculation method, was chosen by the owner.

- (1) Note: The estate does not have to remain open for the entire period. The estate may accelerate payments or assign future payments to the beneficiaries.

### 3. INDIVIDUALS

- a) When an individual other than a spouse is the designated beneficiary, the minimum distribution rules are calculated with respect to the owner's life expectancy and the age of the designated beneficiary (but no more than 10 years younger than the owner).

- (1) Once the owner dies, then the minimum distribution rules are redetermined based on the individual's life expectancy.

- (a) Where there are multiple beneficiaries, the oldest beneficiary's age as of the RBD is used.

- (b) An owner of several IRAs can designate separate beneficiaries for each or he can split an IRA into several ones and name separate beneficiaries for each, provided this occurs before the RBD.

- (i) In meeting the minimum distribution requirements, the owner of several IRA's has the right to choose the amounts withdrawn from each IRA.

- (2) When naming grandchildren or other "skip" persons for generation-skipping tax purposes as the designated beneficiary of an IRA, the GST exemption should be used.

- (3) Remember: Under California law, the spouse's community property interest going to a child could cause gift tax consequences and the IRD deduction does not apply for gift taxes.

## IV. ESTATE PLANNING ISSUES WITH IRA'S

### A. Funding Marital or By-Pass (Credit Shelter) Trust with an IRA

#### 1. THE PECUNIARY GIFT ISSUE

- a) If an IRA is used to satisfy a pecuniary gift to either a by-pass trust or a marital trust, under a pecuniary formula allocation method, there could be immediate recognition of income.

- (1) This issue can be avoided by designating a particular trust as the designated beneficiary of the IRA or including a specific provision stating that the pecuniary formula will be satisfied with assets other than the IRA.

#### 2. SURVIVOR'S TRUST

- a) Typically, allocating the IRA to a survivor's trust will produce no benefit since the surviving spouse will need to withdraw the IRA from the trust to take advantage of the spousal roll-over rules.

### 3. Q-TIP TRUST

- a) A Qualified Terminal Interest Property ("Q-TIP") Trust created under IRC Sec. 2056 (b) (7) has certain disadvantages over naming the spouse as the beneficiary.
  - (1) The spousal rollover provisions and the election to treat the excess accumulations as part of the spouse's new IRA do not apply. Therefore, the excess accumulations tax of 15% will be levied at the owner's death.
  - (2) An IRA can qualify for a Q-TIP election if there is express language in the IRA that the trustee has an absolute right to withdraw all the IRA income.
    - (a) Also, the Q-TIP trust document must give the spouse the right to compel the trustee to demand the income from the IRA's sponsor and compel the trustee to distribute the income to the spouse. Reg. 20.2056(b)-7.
    - (b) Revenue Ruling 89-89 suggests that an actual payment of IRA income must be paid to the spouse each year. This ruling is questionable since it appears to conflict with the statutory language of IRC Sec. 2056 (b) (7).

### 4. QUALIFIED DOMESTIC TRUST ("Q-DOT") FOR NON-U.S. CITIZEN SPOUSES.

- a) A distribution of principal from an IRA is subject to estate tax when received by the non-citizen spouse.
- b) Prop Reg. Sec. 20.2056A-4(c) provides that an IRA will be treated as a QDOT if the surviving spouse agrees to pay the deferred estate tax on the principal portion of each distribution or to rollover the principal portion to a QDOT.
  - (1) If possible, the non-citizen spouse should be the direct beneficiary. The spouse should then create a new IRA that qualifies as a QDOT and name a child as a beneficiary to extend the life expectancy so that less principal is being paid out to the spouse.
  - (2) The concept here is to have the benefits of the deferral outstrip the estate tax owed on the portion of principal distributions from the IRA to the spouse.

### 5. THE BY-PASS TRUST

- a) The By-Pass Trust is usually not a good candidate for an IRA, even when the beneficiary of the trust is the surviving spouse.
- b) The deferred tax liability of the IRA will substantially reduce the value of the IRA for the unified estate and gift tax credit purposes.
- c) Funds will usually be distributed in full in the year after the designated beneficiary's death (who is always the oldest beneficiary).

- (1) Usually, it is the wife who is the oldest beneficiary and under the rules regarding recalculation (the default provision) for the minimum distribution rules, the entire IRA is distributed one year after her death.
  - (2) Even if the recalculation rules are not used, there will not be much deferral unless the surviving spouse dies at a relatively young age (in which case the trust would receive the IRA distributions over her life expectancy).
- d) Sometimes, the IRA is the only asset which can be used to fund the By-Pass trust and in those instances, it should be considered.

## 6. CHARITIES

- a) Gifting an IRA to charity could be advisable in situations where the IRA will be terminated in the year following death. This can occur when the surviving spouse is the owner and the life expectancy is being recalculated.
- b) Leaving the entire IRA to a charity will avoid both the income and estate tax issues. But if there is an excess accumulations tax, that tax is not subject to the charitable tax deduction and will have to be paid.
  - (1) Check the tax allocation clause under such a situation. The client may not want the charity to pay this tax, but under California's tax apportionment law, the charity could be liable for the tax.

## 7. PLANNING CONSIDERATIONS:

### a) Full Use of Deferral:

- (1) Example: Husband owns IRA and names spouse as beneficiary. Joint lives are used to determine the minimum distribution (no recalculation).
  - (a) Husband dies and wife sets up a new IRA and names son as beneficiary. The joint life expectancy of wife and son is used, subject to the minimum distribution incidental benefit rule which limits the life expectancy of the son to no more than 10 years younger than the wife.
  - (b) Once she dies, this rule no longer applies and son receives the IRA distribution in accordance with the joint life expectancy tables.
  - (c) If a grandchild is used as the beneficiary, then use the joint life expectancy for the surviving spouse and grandchild. The GST exemption could be allocated to the IRA.
  - (d) If there were several children and if the spouse created separate IRA's for each child, each would get a different method of distribution. The oldest beneficiary's age is not used when separate IRA accounts are created.
  - (e) The surviving spouse can also create separate IRA's, naming a trust as the designated beneficiary for each IRA and one

grandchild as the beneficiary of each trust. She may then fund each IRA with \$10,000 to \$20,000. Because of the compounding affect of the IRA deferral, the IRA's growth could be substantial.

- b) USING THE RECALCULATION METHOD: If wife dies first, then no spousal rollover and all assets must be paid out on death of husband owner. If spouses are in excellent health, or if there are large age disparities, then recalculation may make sense.
- c) PLANNING WHEN THERE IS A TERMINAL ILLNESS: If spouse has a terminal illness, don't use the recalculation method. Name a child or grandchild as IRA beneficiary. Consider the consequences once both husband and wife die. Planning should be accomplished prior to the RBD. Use the unified gift and estate tax credit to shelter the gift to IRA child or grandchild.

## V. RECOMMENDED READING MATERIALS

1. CEB - A Practical Approach to Estate Planning for Retirement Benefits and IRA's, March-April, 1996. This 3-hour CEB lecture contains mathematical models and projections regarding the deferral benefits of IRA's, and a good discussion of the California community property issues involved with IRA's. The materials include forms for beneficiary designations and sample trusts for IRA distributions.
2. A Professional's Guide to the IRA Distribution Rules, by Seymour Goldberg, Foundation for Accounting Education. This guide uses a question and answer format, and is an excellent source for the technical rules and requirements involving IRAs.