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# The ~~194~~ ^ Best and Worst Planning Ideas for Your Client's Retirement Benefits

2018 edition

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# The 203 Best and Worst Planning Ideas for Your Client's Retirement Benefits

## INTRODUCTION

The purpose of this Seminar Outline and Special Report is to collect in summary form all the tax-saving and other planning ideas I have come across regarding IRAs and other retirement plan benefits. My goal is to put all the ideas out on the table, with an indication of where to find more information, plus my editorial opinion of each.

This Seminar Outline/Special Report is written for experienced estate planners, financial planners, investment advisers, trust officers, life insurance professionals, and others who advise individual clients regarding their retirement benefits. The Seminar Outline/Special Report assumes that you are generally familiar with the income and estate tax rules applicable to retirement benefits, and would appreciate a checklist of ideas to consider in various situations—thus the 203 Ideas, arranged in Groups by topic—and a quick way to zero in on planning ideas most helpful to your client's situation. The "Client Profiles" in the Appendix suggest which Ideas should particularly be considered for which clients.

## CAUTION, WARNINGS, AND DISCLAIMER

The "Best and Worst" categorizations are designed to catch your attention and generate discussion, and are NOT a blanket endorsement or condemnation of any planning idea. The BEST ideas are those I believe are (i) safe (or at least highly defensible) from the point of view of legality and government approval and (ii) useful for some individuals. However, the BEST ideas are not best in every case. The idea that is best for many clients may be the WORST idea for your client.

Similarly, the WORST ideas are those that in my opinion are either (i) risky or untested from the point of view of government challenge, (ii) based on an error of fact or law or (iii) unlikely to benefit the average client. But a WORST idea is not necessarily bad for everyone. An idea may be labeled WORST not because it is inherently bad but because of the possibility of abuse or misunderstanding. A WORST idea, properly executed, may be the BEST idea for your client, or might even become a BEST idea for many individuals when properly used or with further tweaking.

## THE TAX CODE, 2018 EDITION

This Seminar Outline/Special Report is written based on the Tax Code as it exists at the end of April 2018, including an estate/gift/GST tax exemption originally set at $5 million per person that is indexed for inflation but since increased (by Tax Cuts and Jobs Act of 2017) to over $11 million as of 2018) and "portable" between spouses; a top federal transfer tax rate of 40 percent; and a top federal income tax rate of 37 percent, plus a 3.8 percent extra income tax on compensation and investment income if total income exceeds a certain threshold.

## ACKNOWLEDGMENTS

I appreciate and thank all the practitioners who have shared their ideas and the ideas their clients have been presented with, whether best or worst.

## ABBREVIATIONS, SYMBOLS, TERMS

| | |
|---|---|
| § | The symbol "§" refers to a section of the Code unless otherwise indicated. |
| ¶ | The symbol "¶" refers to a section of the book *Life and Death Planning for Retirement Benefits* ($7^{th}$ ed., 2011); see "Resources," page 10. |
| ADP | Applicable Distribution Period. The life expectancy period over which benefits must be distributed under the minimum distribution rules. Reg. § 1.401(a)(9)-5, A-1, A-4, and A-5, discussed at ¶ 1.2.03 of *Life and Death Planning for Retirement Benefits*. |
| AMT | Alternative minimum tax. § 55. |
| BFD | Beneficiary Finalization Date. September 30 of year after year of Participant's death. See Reg. § 1.401(a)(9)-4, A-4(a). |
| Code | Internal Revenue Code of 1986, as amended through April 30, 2018. |
| CRT | Charitable remainder trust; see Idea #119. |
| DRAC | Designated Roth account inside a 401(k), 403(b), or 457(b) plan. See § 402A discussed at ¶ 5.7 of *Life and Death Planning for Retirement Benefits*. |
| IRA | Individual retirement account or individual retirement trust under § 408. |
| IRD | Income in respect of a decedent. § 691. |
| IRS | Internal Revenue Service. |
| LSD | Lump sum distribution. § 402(e). See Idea #4. |
| NIIT | 3.8% Net Investment Income Tax under § 1400. |
| NPS | Nonparticipant spouse. |
| NUA | Net unrealized appreciation. See Idea #4. |
| QRP | Qualified retirement plan under § 401(a). |
| RBD | Required beginning date for lifetime RMDs. See § 401(a)(9)(A). |
| Reg. | Treasury Regulation. |
| RMD | Required minimum distribution from a retirement plan under § 401(a)(9). |
| TCJA | The Tax Cuts and Jobs Act of 2017. |

**Retirement plan** means a pension, profit-sharing, or stock bonus plan that is "qualified" under § 401(a), an individual retirement account (IRA) created under § 408, a Roth IRA established under § 408A, or a tax-sheltered annuity (or mutual fund) arrangement established under § 403(b). The narrower term *qualified plan* or *qualified retirement plan* (QRP) includes *only 401(a) plans*. Note that in the Code itself "qualified plan" can be used to mean ALL types of tax-favored retirement plans; see, *e.g.*, § 72(t).

The **participant** is the person whose benefits we are dealing with: the employee who has benefits in a pension or profit-sharing plan, or for whom a tax-sheltered annuity was purchased; or the account-holder in the case of an IRA. For ease of understanding, the male pronoun is usually used for the participant and the feminine pronoun refers to the participant's spouse. Of course any statement would apply equally to a participant and spouse of either sex. There are certain matters that apply only to qualified plans; in discussing these matters, sometimes "employee" is used instead of participant. When discussing an issue from the point of view of advising an individual client I sometimes refer to the participant as "the client."

## RESOURCES: WHERE TO READ MORE

This Seminar Outline/Special Report is written for intermediate and advanced level planners. Many of the Ideas in this Seminar Outline/Special Report are followed by a "Where to read more" paragraph. In most cases, the Idea is just a starting point, and you must read the authorities and other resources cited if you want to pursue the Idea and evaluate it for a particular client. Certain frequently cited resources are abbreviated.

The most frequently cited resource is the author's book *Life and Death Planning for Retirement Benefits*, Ataxplan Publications, 7th ed., 2011, 624 pages. $89.95 plus shipping; order via 800-247-6553, amazon.com, or www.ataxplan.com. The book is also available in an electronic on-line edition, available by subscription at www.retirementbenefitsplanning.com (the e-book edition).

The Natalie B. Choate *Special Report: Ancient History* contains text from prior editions of *Life and Death Planning for Retirement Benefits* and/or from the author's past seminar materials covering rarely-applicable grandfather rules as well as tax rules that are no longer effective (but that you may need to know because when you are trying to clean up tax questions from a back year). This and other Natalie B. Choate *Special Reports* can be downloaded at www.ataxplan.com. Many of the Special Reports are also already incorporated into the e-book edition of *Life and Death Planning for Retirement Benefits* (www.retirementbenefitsplanning.com).

Top estate planning professionals rely on Steve Leimberg's *Employee Benefits and Retirement Planning Newsletter* (e-mail only). Monthly subscription price gets you this and as many of the other Leimberg Information Services, Inc., (LISI) e-newsletters as you wish (such as *Estate Planning*, *Elder Care Planning*, *Charitable Planning*, and *Asset Protection*), plus access to the enormous database of past newsletters, supporting material and longer articles. For free sample visit or to subscribe, go to www.leimbergservices.com.

Another indispensable newsletter for keeping current on all aspects of retirement distribution planning is *Ed Slott's IRA Advisor*, published monthly. Visit www.irahelp.com for information (subscription includes access to all back issues—an invaluable resource).

Denise Appleby's "IRA Quick Reference Guides" are highly recommended. These are laminated or spiral bound charts neatly summarizing such subjects as what plan can be legally rolled over into what other plan (see "IRA Portability Quick Reference Guide" and the "Rollover Chart" for the current year) and the current limits on contributions to every type of plan (see "Summary of Employee Benefit and Related Limits"). Purchase at http://www.applebyconsultinginc.com/.

*The Pension Answer Book* by Stephen J. Krass is the best one-volume law reference work about qualified retirement plans and IRAs. From Aspen Publishers (a division of Wolters Kluwers), www.aspenpublishers.com.

Conrad Teitell, Esq., is one of the country's top experts in the tax law of charitable giving, and fortunately for the rest of us he is also a prolific author and superb public speaker. Refer to his resources for all tax aspects of charitable giving. Visit http://www.taxwisegiving.com/

Articles from back issues of *Trusts & Estates* magazine can be obtained through a law library or the magazine's website, www.trustsandestates.com.

## THE IDEAS

## A. HOW TO TAKE DISTRIBUTIONS FROM YOUR RETIREMENT PLAN

Once the participant reaches a certain age, he must begin withdrawing "required minimum distributions" (RMDs) from his retirement plans (other than Roth IRAs). Distributions are required annually. See § 1.401(a)(9) and regulations thereunder, and ¶ 1.3–¶ 1.4 of *Life and Death Planning for Retirement Benefits.* Here are tips and planning ideas regarding how to take distributions from your retirement plan, whether required or not. Most of the Ideas in this Group A can also be used by beneficiaries when taking distributions from inherited retirement plans (see Groups R and S).

Note: RMDs were "suspended" (not required) for the year 2009. This fact is not repeated every time required distributions are referenced in this Seminar Outline/Special Report. For details on the one-year suspension, see ¶ 1.4.09 of *Life and Death Planning for Retirement Benefits*.

1. **BEST: Use withholding from IRA distribution to reduce estimated taxes.** Most IRA providers permit voluntary withholding of income taxes from IRA distributions. See IRS Publication 575 and IRS Form W-4P. Income taxes withheld from retirement plan distributions (just like income taxes withheld from wages) are treated (for purposes of computing whether a taxpayer owes the penalty for underpayment of estimated taxes) as if paid equally on the four due dates of estimated tax payments. § 6654(g)(1). Thus, an IRA distribution in December that is sent to the IRS by the IRA provider as withheld income taxes will be treated (for estimated tax purposes) as if paid in four equal installments on the preceding April 15, June 15, and September 15, and the following January 15. An individual who normally is required to pay estimated taxes quarterly, and who does not need his RMDs to pay living expenses, can kill two birds with one stone by using the required distributions to pay his estimated taxes. Similarly, *anyone* who normally pays estimated taxes quarterly, and who also takes annual distributions from his IRA, can use the IRA distribution to fulfill the estimated tax requirement. Here's how: Late in the year, the participant requests his usual (or required) distribution from the IRA, but (by filing Form W-4P) instructs the IRA provider to send the distribution to the IRS as withheld income taxes. Some planners prefer to take part of the distribution (1%?) in cash rather than having 100 percent of it withheld, because they think it looks better. By paying part of his estimated taxes late in the year through withholding, the participant gets a few more months' interest on money he would otherwise have had to pay to the IRS in April, June, and September. This becomes a WORST idea if the participant dies after skipping some estimated tax payments but before the withheld-taxes distribution occurs, because now (being dead) he won't be able to take the distribution, and his estate will owe the penalty for underpayment of estimated taxes.

Where to read more: See ¶ 2.3 of *Life and Death Planning for Retirement Benefits* regarding the tax-withholding rules for retirement plan distributions. See the next two Ideas for other uses of withholding from a retirement plan distribution.

2. **BEST: Use withholding from IRA distribution, followed by tax-free rollover, to scotch penalty for underpayment of estimated taxes.** By using a late-in-the-year IRA distribution that is sent to the IRS as withheld income taxes (see Idea #1) a participant may reduce or eliminate a penalty for underestimated taxes that he would otherwise owe if he has not paid sufficient estimated taxes on April 15, June 15, or Sept. 15. An IRA distribution (even one sent to the IRS as withheld income taxes) is included in gross income, and is subject to the 10 percent penalty on premature distributions if the participant is under age 59½; the participant can avoid these downsides by rolling over the same amount to the same or another retirement plan within 60 days after the distribution, thus making the distribution tax-free (assuming it is otherwise an eligible rollover distribution). Though it seems "impossible" to have taxes withheld from a distribution that "did not occur" (because it was rolled over), the IRS recognizes that a participant may do a tax-free rollover of a distribution sent to the IRS as withheld income taxes, by using substituted funds. Reg. § 1.402(c)-2, A-11. Thus this is a good strategy for avoiding a penalty on underpayment of estimated income taxes.

Caution: The ability to "roll over" an IRA distribution into the same or another IRA is limited by (and may be impossible due to) the once-per-12-months rule. See Idea #49.

Where to read more: See ¶ 2.6 of *Life and Death Planning for Retirement Benefits*, and Ideas #46 and #49, regarding requirements for tax-free rollovers, and ¶ 2.3 regarding income tax withholding.

3. **WORST: Use withholding from IRA distribution, followed by tax-free rollover, every year, to avoid ever having to pay estimated taxes.** Although using withholding from an IRA distribution, followed by a rollover-using-substituted-funds, is recommended when it's the only way to avoid incurring a penalty for underpayment of estimated taxes (Idea #2), this technique is NOT recommended as a regular practice to avoid paying estimated taxes. Tax-free rollovers are legal and good tools, but they can be hazardous due to the short 60-day deadline (see Idea #48) and once-per-12-months rule (see Idea #49).

4. **BEST: Take Lump Sum Distribution that includes appreciated employer stock.** If the client is a participant in a qualified retirement plan (QRP), and his account holds stock of the employer that sponsors the plan, the client can qualify for a special favorable tax treatment by taking a lump sum distribution (LSD) of his account. Under this special treatment, he is not taxed on the entire value of the stock when he receives the distribution; rather, the only portion of the stock value included in his gross income is the plan's "cost basis" for the stock (i.e, what the stock was worth when the plan acquired it). The rest of the value is called "net unrealized appreciation" (NUA) and is not taxed until the recipient sells the stock—at which time it is taxed as long-term gain (plus 3.8% NIIT under § 1400 if applicable) rather than as ordinary income. § 402(e)(4). If the participant's account has substantial NUA, the participant may make more money by taking a "taxable" LSD (only part of which is immediately taxable, and part of which will be taxed later as long-term capital gain) rather than either (1) selling the stock while it is still inside his plan account, or (2) rolling over his plan account to a traditional IRA, either of which actions would cause permanent loss of the

potentially favorable NUA treatment. See also Ideas #11 and #87. The NUA deal is also available to the beneficiaries of a participant who dies owning employer stock in his QRP, if the distribution otherwise qualifies; see Idea #175.

Where to read more: ¶ 2.4 of *Life and Death Planning for Retirement Benefits* explains the legal requirements of a "lump sum distribution"; ¶ 2.5 explains NUA treatment. Customers of the major financial institutions should check to see if the firm provides assistance in evaluating the choice between rollover (to continue tax deferral) versus cashout (to take advantage of the NUA deal).

5. **BEST: Take an LSD if born before 1936, to use special averaging.** Another special deal for lump sum distributions (LSDs): If the distribution meets numerous requirements, the distribution is taxed using a different rate schedule. For smaller distributions (up to approximately $400,000) the special averaging tax rate can be lower than the current maximum regular income tax rate. Also, there is a 20 percent maximum tax on the portion of the LSD (if any) attributable to pre-1974 participation; the pre-1974 participation portion is determined by a formula, *not* by tracing the actual pre-1974 balance. The primary requirements are that the participant was born before 1936, and that this is a distribution of his entire plan balance within one taxable year following separation from service, attaining age 59½, or death. § 1122(h) of the Tax Reform Act of 1986 [effective date provisions and transition rules for amendments to Code § 402(a), (e)], as amended by § 1011A(b)(13)–(15) of the Technical and Miscellaneous Revenue Act of 1988.

The ideal candidate for special averaging is overweighted in retirement plans (see Idea #23), is approaching retirement, and has among his many plans one smallish separate qualified plan that could be cashed out in an LSD. Special averaging gives him a way to get some money out of his retirement plans at a bargain tax rate. The special averaging rate is applicable to the LSD *regardless* of how much other taxable income the person has. For example, even if he is in the 39.6 percent bracket for all his other income, a qualifying LSD of $300,000 would be taxed at only approximately 22 percent. If the individual rolls over any part of the distribution, or if his distributions stretch over more than one taxable year since the most recent triggering event, he will lose eligibility for LSD treatment. That is why this option MUST be evaluated for born-before-1936 clients BEFORE they retire and start taking distributions; see the next Idea. Special averaging is also available to the beneficiaries of a born-before-1936 participant, if the distribution otherwise qualifies (death is a new triggering event); see Idea #175.

Note: Since individuals eligible for this deal are by definition over age 81, it is likely that few people who could qualify are still working.

Where to read more: Best free sources regarding special averaging are IRS Form 4972 (and its instructions) and Form1099-R (see payer's instructions for Box 3). There are no regulations. For more information, see the Natalie B. Choate *Special Report: Ancient History* ("Resources," p. 10).

6. **BEST: Analyze LSD options BEFORE starting RMDs from a QRP**. If the participant's QRP account includes stock of the employer that sponsors the plan, the participant may be

eligible for a special favorable tax treatment the Code affords to the "net unrealized appreciation" (NUA) in such stock; see Idea #4. This special deal for NUA is generally available *only* if the participant takes a lump sum distribution (LSD), which is a distribution of his entire plan balance in one calendar year following the most recent "triggering event." Similarly, if the participant was born before 1936, he may be eligible for "special averaging" treatment, which can result in a low rate of income tax (see Idea #5)—but that deal is also available only for an LSD. *Now is the time to evaluate whether the participant should take an LSD to qualify for those treatments.* If, instead of taking an LSD, the participant just takes the RMD following retirement, he will cease to be eligible for either of these deals the following year. An LSD means the distribution of all benefits in *no more than one calendar year* following separation from service (or other triggering event). This consideration does not apply to IRAs or 403(b) plans, as these special deals are available only for QRPs.

7. **BEST: Determine federal AND state "basis" before taking distributions.** Part of an individual's plan distributions may be "tax-free" for either federal or state income tax purposes as a "return of basis" (or "investment in the contract"). The "tax-free" portion is not really tax free; it represents the money the participant has already paid tax on. To determine federal basis in an IRA, examine the participant's most recently filed Form 8606. This form is required to be attached to the participant's federal income tax return (Form 1040) in any year the participant either makes a nondeductible contribution to his IRA or takes a distribution from an IRA that contains any after-tax money. The form shows the remaining after-tax balance as of the end of the year. Determining state basis may be more difficult; state basis will be different if the state did not allow deductions for some contributions that were deductible for federal income tax purposes and/or if the state has a different rule for how basis is "recovered" as distributions are taken. Some states, for example, such as Massachusetts, did not allow or do not allow a self-employed individual to deduct his/her contributions to a retirement plan, and/or allow basis to be withdrawn first. The participant MUST keep careful records of what was contributed and what contributions were deducted for federal and state purposes; otherwise he risks paying tax twice on the same money.

8. **BEST: Take employee contributions account out separately from your QRP.** A few QRPs contain after-tax contributions made by the employees. Usually, the employer keeps track separately, so each employee has two accounts, the "Employer Contribution Account" (containing the employer's contributions and earnings thereon; all pretax money) and the "Employee Contribution Account" (containing the employee's contributions and earnings thereon; partly pretax money and partly after-tax). The two accounts are treated as one account for RMD purposes, but treated as separate accounts for purposes of determining how much of each distribution is taxable. § 72(d)(2); Reg. § 1.401(a)(9)-8, A-2(a)(1). Thus, the employee determines the combined RMD (for both accounts), but can then take the entire RMD from the Employee Contribution Account, so that a portion of the distribution is tax-free. Tax-free distributions can be used to satisfy the RMD requirement just the same as taxable distributions. Reg. § 1.401(a)(9)-5, A-9(a). You can't do this with an IRA, generally, because all IRAs are "aggregated" (treated as a single account) for purposes of the "cream-in-

the-coffee rule" (see Idea #88) (but see Idea #40). Alternatively, do the opposite: Take your RMD (taxable) all from the employer contribution account first, *then* take distribution of the employee contribution account in the same year, incorporating a tax-free Roth conversion of the after-tax portion; see Idea #86.

Where to read more: ¶ 1.2.02(D) of *Life and Death Planning for Retirement Benefits* discusses use of tax-free distributions to satisfy the RMD requirement. See PLR 9840041 for an example.

9. **BEST: Take RMDs for *all* your IRAs from the smallest IRA.** If you have multiple IRAs, take advantage of Reg. § 1.408-8, A-9, to close out smaller accounts. Under this rule, a distribution from *any* IRA counts toward your RMD requirement for *all* your IRAs. So determine the total of your RMDs for all your IRAs for the year, then clean out smaller accounts as necessary to fill up the year's total RMD for all your IRAs. Eliminating multiple smaller accounts will make estate planning (as well as future RMD calculations) easier. The same thing works for multiple 403(b) plans. However, you can't use IRA distributions to satisfy 403(b) RMDs or vice versa; and you can't use an *inherited* IRA or 403(b) to satisfy the RMD requirement for *noninherited* IRAs or 403(b)s (or vice versa). A beneficiary cannot use distributions from an IRA (or 403(b)) inherited from one decedent to satisfy the distribution requirement for an IRA (or 403(b)) inherited from another decedent.

Caution: You cannot use IRA distributions to satisfy the RMD requirement for nonIRA plans! This is one of the most common mistakes people make. An individual who participates in a qualified plan (including a "Keogh" plan) must take applicable RMDs *from each such qualified plan*. IRA distributions do NOT count towards the required distribution from the qualified plan!

Where to read more: See ¶ 1.3.04 of *Life and Death Planning for Retirement Benefits* (for participants) and ¶ 1.5.09 (for beneficiaries).

10. **BEST and WORST: Take distributions in kind rather than in cash.** An RMD does not have to be distributed in cash. The plan can distribute stocks, bonds, or other investments in fulfilment of the RMD or for any other reason. See IRS Form 1099-R, Instructions (to the payer), Box 1. The value for income tax purposes (and, presumably, also for RMD purposes) is the fair market value of the securities on the date distributed. Reg. § 1.402(a)-1(a)(1)(iii). That value is included in your ordinary income for the year of the distribution, and it becomes your tax basis for the assets going forward. Rev. Rul. 80-196, 1980-2 C.B. 32 (holding no. 2). There are two situations (in addition to those discussed in Idea #12) where in-kind distributions are particularly recommended:

One is if your account is fully invested, taking your RMDs "in kind" rather than in cash saves commissions, compared with selling the investment inside the plan, distributing cash, and then rebuying the investment outside the plan.

The other: Consider removing from the plan an investment you consider most likely to provide long-term capital appreciation after the distribution (*e.g.*, a stock that you consider temporarily "undervalued," rather than a short-term bond). If the asset does appreciate, your post-distribution gain could be long-term capital gain or it could receive a stepped-up basis upon your death, neither of which is possible for appreciated assets held inside a retirement plan. Your holding period (for long-term or short-term capital gain purposes) begins the day after the investment is distributed to you (as if you had purchased the stock on the date it was distributed to you), not when it was purchased inside your IRA. See Rev. Rul. 70-598, 1970-2 C.B. 168; compare § 1223(2).

Now for the "rest of the story": Ed Slott and others have advised, "Keep a sufficient portion of your IRA liquid to cover anticipated RMDs for the next year or two." In past editions of "The Best & Worst Ideas," I have described this advice as a "worst idea," since "There is no requirement that RMDs be paid in cash" (see above). Then I had the experience of liquidating a retirement plan and distributing the assets in kind. What a pain! There is no official guidance on how you determine "fair market value" of securities on the date of distribution; do you use opening prices, closing prices, average prices, mean between high and low, or other? Ever try to get the fair market value of infrequently traded bonds? So in the end I concluded (as usual) that Ed Slott's advice is very sensible: Unless you have a good reason to do otherwise, pay RMDs in cash!

11. **BEST: Give NUA stock to charity**. The Code gives special favorable treatment to distributions of employer stock from a qualified plan; see Idea #4. A retired employee who holds stock with not-yet-taxed NUA apparently has the same options that other individuals owning appreciated stock have when they wish to diversify their investments and/or increase the income from their portfolios: Either sell the stock, pay the capital gain tax, and reinvest the net proceeds; or, contribute the stock to a Charitable Remainder Trust while reserving a life income, thus avoiding the capital gain tax and generating an income tax deduction besides. It is advisable to obtain an IRS ruling if using this technique.

Where to read more: See PLRs 1999-19039, 2000-38050, and 2002-15032 for examples of use of this technique. For more on Charitable Remainder Trusts, see ¶ 7.5.04 of *Life and Death Planning for Retirement Benefits* or see the *Special Report: Charitable Giving with Retirement Benefits* by Natalie B. Choate, downloadable at www.ataxplan.com. This Special Report is already incorporated into the e-book edition of *Life and Death Planning for Retirement Benefits* (www.retirementbenefitsplanning.com).

12. **BEST: Ideas for dealing with hard-to-value IRA assets.** If the IRA owns real estate, a business, or other assets that do not have a "readily ascertainable fair market value," the IRA owner needs to prepare for increased IRS scrutiny, and be extra cautious when computing required minimum distributions.

    A. Consider distributing (or selling) hard-to-value assets. Beginning with information returns filed in 2016 for the 2015 year, the IRS requires IRA providers to "flag," on Forms 5498 and 1099-R any hard-to-value assets that are held in the account (Form 5498) or distributed from the account (Form 1099-R). The IRS has added new boxes and codes to those forms to enable IRA providers to report such assets. An IRA participant or beneficiary who owns such assets in his/her IRA, especially one who has just a small percentage or small dollar amount of his IRA invested in such assets, should consider getting rid of the asset(s), so as to avoid triggering a possible IRS audit seeking to police the valuation. There are two legal ways an IRA can "get rid of" an IRA asset. One is to distribute it to the account holder; he or she will have to report the value of the asset in income, but that may not be onerous if the account is subject to paying RMDs and the value of the distributed asset is equal to or less than the RMD amount. The other way to "get rid" is to sell the asset. The sale must be to an unrelated party—on the open market in other words, not to the participant himself or a family member (in order to avoid a prohibited transaction). Following the distribution or sale, the IRA will hold no hard-to-value assets and can continue to live quietly below the IRS's radar.

Where to read more: See Instructions for IRS Forms 5498 and 1099-R.

B. Distribute the required percentage of the hard-to-value asset. If your IRA contains a hard-to-value asset (*e.g.*, a non-traded limited partnership, "LP"), you run the risk of undervaluing that asset in computing your RMD, and then the IRS will say that you didn't take the full RMD. For example, you estimate the LP is worth $200,000, the other assets in your account are worth $300,000, and your RMD percentage for the year is five percent, so you withdraw five percent of the $500,000 total, taking out $25,000 cash. The IRS later says the LP was worth $500,000, and therefore your RMD fell short: it should have been five percent of $800,000 or $40,000. The result is a 50 percent penalty on the $15,000 shortfall. Besides paying for appraisals every year, what should you do with a hard-to-value IRA asset once RMDs start? At the beginning of each year, take out of the IRA the required proportionate amount of (1) the hard-to-value asset (in this example, that would mean withdrawing 5% of the LP units), and of (2) the other (non-hard-to-value) assets (in this example, that would mean withdrawing 5% of the $300,000 non-LP assets, or $15,000). Now you are sure you have satisfied the RMD requirement. If the IRS later revalues the LP to $500,000, that means the LP units that were distributed to you were worth $25,000 (5% of $500,000), not $10,000 as you had thought. Therefore your total distribution was $40,000 ($25,000 worth of LP units plus $15,000 of other assets), and you fulfilled the RMD requirement. You will owe back income taxes (and possibly a late-payment penalty) because you under-reported the amount of your distribution, but at least you won't owe the 50-percent missed-RMD penalty. This Idea can be a WORST Idea if the distribution leaves the participant as a co-owner with his IRA of an asset that creates a high risk of a prohibited transaction. For example, if the participant and his IRA end up as co-owners of an apartment building, will each tenant write two checks for the rent each month? Will each expense be paid proportionately by the owners? The "partial distribution of the asset" technique might work only with totally passive investments, such as limited partnership units.

C. Distribute (or convert) the entire asset. Again, for how to take the RMD, use Reg. § 1.408-8, A-9 (see Idea #9) to take ALL of the hard-to-value assets out of the IRA sooner rather than later, so that, in the future, these assets will not complicate your RMD calculations and will begin generating capital gains (on post-distribution appreciation *only* of course!) instead of ordinary income. Or convert the asset to a Roth IRA so it stays in a retirement plan but you only have to value it once (upon the conversion), and never have to value it again for RMD purposes the rest of your life (because Roth IRAs do not require any distributions to be made during the owner's lifetime). Caution: The IRS does require all IRAs to be valued annually for purposes of Form 5498, regardless of whether an RMD is required for the year.

13. **BEST: Give your RMD to charity (directly from IRA maybe).** One way to reduce the income tax impact of RMDs is to give the distributions to your favorite charity. If you take the distribution, then write a check for that same amount to the charity, you *generally* get an income tax charitable deduction for the amount of your gift, BUT that deduction may not save you as much tax money as the distribution cost you for any one of a number of reasons, such as: You don't itemize deductions (so you have to report the distribution and include it in income, but you get no benefit from the deduction); or, the IRA distribution, by increasing your adjusted gross income (AGI), increases the taxability of your Social Security benefits (see Idea #26), decreases the deductibility of your medical expenses, and/or increases your Medicare premium (the charitable contribution has no offsetting effect on these tax increases); or, your *state* does not allow an income tax deduction for charitable gifts (but it does tax the retirement plan distribution); or you have already given to charity the maximum permitted percentage (under § 170) of your gross income that you are permitted to deduct; or the distribution pushes your AGI above the applicable "threshold" for purposes of the § 1411 extra 3.8% tax (NIIT) on net investment and compensation income. An individual over age 70½ can avoid all those drawbacks, and still fulfill the RMD requirement for his/her IRA, by having up to $100,000 per year transferred directly from his/her IRA to a charity. Such direct transfers are called "Qualified Charitable Distributions" (QCDs). Note however: a QCD is not guaranteed to save money compared with a cash distribution followed by an outside-the-IRA gift. Be sure to test both scenarios before proceeding.

Where to read more: For details on Qualified Charitable Distributions, see § 408(d)(8), IRS Notice 2007-7, 2007-5 I.R.B. 395, or the free update to *Life and Death Planning for Retirement Benefits* posted at www.ataxplan.com, or the Natalie B. Choate *Special Report: Charitable Giving with Retirement Benefits*, downloadable at www.ataxplan.com. This material is already incorporated into the e-book edition (www.retirementbenefitsplanning.com).

14. **WORST, for most people: Transfer money from IRA to HSA.** Health savings accounts (HSAs) are wonderful things. Contributions to an HSA are deductible from gross income in determining adjusted gross income; and distributions from the HSA are tax-free if used to pay medical expenses. § 408(d)(9) allows an individual to transfer money tax-free from an IRA to an HSA once in a lifetime. Though HSAs are great, there is no advantage for most

people in funding the HSA *with an IRA transfer*. HSA contributions are deductible from gross income; for most clients, that income tax deduction (by reducing taxes on their other income) is worth more than the ability to deplete their IRA tax-free. Even if you want to use the IRA as the source of funding your HSA contribution for some reason (for example, because your IRA is overfunded and you don't have much cash outside the IRA), there's no difference (for most people) between taking an IRA distribution (includible in gross income) and contributing a like amount to the HSA (deductible from gross income)—and you can do *that* every year, not just once in a lifetime. § 408(d)(9) does *not* increase the amount you can contribute to an HSA, and does *not* allow you to contribute to an HSA if you're not otherwise eligible. So why would anyone ever use the IRA-to-HSA transfer? It could be beneficial for:

A. A participant who is under age 59½, desperately wants to fund his HSA to pay some upcoming medical expenses, and has no other source of funds except his IRA. By using the direct IRA-to-HSA transfer he avoids the 10% penalty that would apply if he took a distribution from the IRA and recontributed it to the HSA; or

B. A participant who for some other reason needs to fund the HSA using IRA funds but wants to avoid having an IRA distribution appear in his bank account or on his tax return because of concerns about creditors, college-aid officers, ex-spouses, or state income tax effects.

<u>Where to read more</u>: For more on health savings accounts, see § 223 and § 408(d)(9).

## B. WHEN TO TAKE DISTRIBUTIONS FROM YOUR RETIREMENT PLAN

Once you've satisfied the RMD requirement, or even if you're not subject to it at all (because you're too young), are there reasons to forego income tax deferral and take money out of a traditional retirement plan when you don't have to? Even with RMDs, you have some control over the timing; so what's the best time? We've looked at HOW to take required and nonrequired distributions. Now let's look at WHEN to take RMDs…and when to take a distribution even if it is NOT required.

15. **BEST: Analyze whether to postpone the first year's RMD.** Normally, each year's RMD must be taken by December 31 of that year. However, the first year's lifetime RMD can be postponed until April 1 of the following year (this postponement of the first year's RMD does not apply to beneficiaries). Unless your income tax bracket is decidedly higher in the first year than it will be in the second, or Social Security considerations apply (see Idea #26), ignore the postponement option. Take the first year's RMD in the first year, so that you don't get stuck with a double distribution in the second distribution year (the second year's distribution must come out by the end of the second year), *and* to keep your second year's RMD lower (it will be higher if the prior-year-end balance on which it is calculated, *i.e.*, the end-of-the-first-distribution-year balance, still contains the first year's RMD, which you postponed).

Taking the first year's distribution in the first year also makes your life simpler: If you postpone the first year's RMD, your two RMDs in the second year will have *different deadlines* (the deadline for the postponed first year RMD is April 1 of the second distribution year, the deadline for the second year RMD is December 31 of the second distribution year). Also, the two RMDs will be computed using *different account balances* (the postponed first-year RMD is based on the account balance as of the end of the year preceding the first distribution year, the second year's RMD is based on the account balance as of the end of the first distribution year) and different divisors (the postponed first year's RMD is based on your age as of your birthday in the first distribution year, the second year's RMD is based on your age as of your birthday in the second distribution year). Whew!

Here's one more reason NOT to postpone the first year's RMD: To reduce the client's audit risk. In 2010, the IRS announced a major initiative to make sure people are taking their RMDs. The only way the IRS can figure out whether a person has taken his RMD (short of auditing the return of every person over age 70½) is to match Form 5498 with Form 1099-R. If the IRA provider has filed a Form 5498 for "John" checking the box to indicate that an RMD is required from the account because of John's age, but there is no corresponding Form 1099-R showing that the IRA provider made a distribution from the account to John, the IRS may smell blood and audit John, hoping to assess the 50 percent missed RMD penalty. There will be no penalty, of course, if John legitimately postponed his RMD until "Year Two" because "Year One" is the year in which he reached age 70½. But that will be small consolation if he has to take a lot of time and pay a lot of money to his accountant to handle the "no change" IRS audit.

Where to read more: For how to compute lifetime RMDs, see ¶ 1.2–¶ 1.3 of *Life and Death Planning for Retirement Benefits*; for when lifetime RMDs must begin, see ¶ 1.4. For the IRS's RMD enforcement program and audit methods, see the IRS's *Memorandum/Final Audit Report* on noncompliance with IRA contribution and distribution requirements (March 2010) posted at www.treas.gov/tigta/auditreports/2010reports/201040043fr.html.

16. **BEST: Take your RMDs early in the year**. Take the annual RMD early in the year so that, if you happen to die during the year, you won't burden your beneficiaries with the need to race around to get the RMD out before the end of the year just to avoid a penalty.

Where to read more: Regarding the RMD for the year of the participant's death, see ¶ 1.5.03(A) and ¶ 1.5.04(A) of *Life and Death Planning for Retirement Benefits* and Reg. § 1.401(a)(9)-5, A-4(a).

17. **BEST: Take your RMDs late in the year**! Several times in the recent past (in 2006, 2008, 2010, 2012, 2014, and 2015) Congress has changed the rules in the middle (or even at the end) of the year, creating a new more favorable way to take RMDs, namely, the "Qualified Charitable Distribution" (see Idea #13). The QCD was created in mid-2006 effective for the 2006 and 2007 tax years, but people who had already taken their 2006 RMDs prior to the enactment could not take advantage of the QCD for that year. QCDs then expired at the end of 2007…and were revived retroactively in mid-2008 for all of 2008 plus 2009! They expired again at the end of 2009…only to be revived (in December 2010) retroactively for 2010 and through 2011! They expired again at the end of 2011, 2013, 2014, and 2015…only to be

revived (at the very end of each such year) retroactively for such year. In each of those years people couldn't be sure until the end of the year that they would be able to use QCDs to satisfy their RMDs, and many chose to wait. (Only in the end-of-2015 legislation did Congress finally make QCDs a "permanent" part of the tax code.) So the best advice is, "Take your RMD early in the year (see preceding Idea), unless Congress is going to change the rules late in the year and add a new more favorable method of satisfying the RMD requirement!"

If the client is leaving his/her entire plan to an income tax-exempt charity as beneficiary (see Ideas #118–#120), and the client does not need to take minimum distributions for living expenses, the client should, first of all, use QCDs to fulfill his RMDs to the extent possible. If the client's RMD exceeds the $100,000 QCD limit, consider taking the rest of the RMD as late in the year as possible. If the client then dies before taking such balance of the RMD, the charity will have to take it, but the distribution will then be income tax-free, since it is paid to a tax-exempt charity. In case of death, this strategy would result in more money passing to the charity rather than the IRS.

Where to read more: See notes to Idea #16.

18. **BEST: Don't take more than the RMD.** Lifetime RMDs (as opposed to RMDs paid after your death to your beneficiaries) are computed using the Uniform Lifetime Table. Reg. § 1.401(a)(9)-9, A-2. This table is designed to liquidate the account over the joint-and-survivor life expectancy of the participant and a hypothetical beneficiary who is 10 years younger than the participant, recalculated annually. Thus, if the participant takes no more than the RMD from the account each year, the account is *guaranteed* to last beyond his lifetime (assuming it is not wiped out by investment losses of course). Barring catastrophic investment losses, *your IRA cannot run out of money during your lifetime if you do not take more than the RMD*. For retirees who need their RMDs to live on, this should be comforting, and a good reason not to take more than the RMD. A participant whose sole beneficiary is his spouse, and whose spouse is more than 10 years younger than he is, can use an even more favorable table for computing required distributions, so the account can last even longer. For the opposing viewpoint, see Idea #20.

Where to read more: The Uniform Lifetime Table is reproduced near the end of this Seminar Outline/Special Report. See ¶ 1.3–¶ 1.4 of *Life and Death Planning for Retirement Benefits* regarding lifetime RMDs; ¶ 1.1.03 explains the economics of the minimum distribution rules.

19. **Which is BEST? Stock sales or plan distributions to pay living expenses?** Suppose you need cash for living expenses and you have only two potential sources for raising this cash: taking nonrequired distributions from your IRA or selling some appreciated stocks in your taxable account. Which is better? There are two points of view:

    A. Sell Stock! Some advisers favor selling stock in the taxable account, which produces lower immediate taxes because part of the sale is tax-free return of basis and part is capital gain (generally taxed at a lower rate or not at all if the stock has been held over a year), while IRA distributions are virtually all taxable as ordinary income (generally taxed at a higher rate).

B. Take an IRA distribution! Other advisers point out that if you take an IRA distribution, and hold onto the stock, the stock may receive a new basis upon your death equal to its then fair market value. The IRA can never receive a stepped-up basis at death. Thus paying a higher rate of tax now (by taking money from the IRA) may produce lower overall taxes (if the stock's appreciation is never subject to income tax because it gets a stepped-up basis at your death).

20. **WORST? Defer, defer, defer!** This Idea deals not so much with when to take distributions but whether you should contribute to a retirement plan in the first place. One theory of the advantage of saving money inside retirement plans is that the tax rate will be lower when money comes out of the plan (after retirement) than it was when money went into the plan (during high-income working years). This assumption needs to be examined closely, as tax rates bounce around from year to year; and in any case a corollary principle is that withdrawals should be considered (see Idea #21) in any year when the plan owner is in a lower-than-usual bracket, either due to his personal circumstances, or to changes in the tax laws, or because he qualifies for some special tax deal (see Ideas #4 and #5). When figuring future tax brackets don't forget the Medicare premium increases that kick in at higher incomes.

Where to read more: See "The Deferral Trap," by Janet Novack, *Forbes* (Dec. 13, 2004), citing studies showing that contributing to a retirement plan can ultimately result in higher taxes for very low and very high income taxpayers. See "The Tax-Deferral Trap" by William Baldwin (Sept 7, 2009) at www.forbes.com with the same warning: "If you are 45 and prosperous, plan on…higher income taxes when you retire…." www.forbes.com.

21. **BEST: Take extra distributions (or convert to a Roth) when your tax rate is lower.** A taxpayer who is subject to the alternative minimum tax (AMT) may be in a lower-than-usual tax rate. If he is usually in the highest tax bracket, but in a particular year is subject to the AMT, then his real marginal tax bracket on additional retirement plan distributions may be only 26–28 percent (the AMT rate). If doing year-end tax planning, consider withdrawing enough from the client's retirement plans (or converting enough of the plans to a Roth IRA; see Idea #83(B)) to "soak up" the AMT exposure. If it turns out, after the final numbers are calculated, that too much was withdrawn, the excess can be rolled back into the IRA—*if* all the technical requirements of a tax-free rollover are met (and don't count on getting an extension if you miss the 60-day deadline; see Idea #46). Unfortunately if "too much" was converted to a Roth, the conversion cannot be reversed via recharacterization, since the option to reverse Roth conversions was eliminated by the TCJA for post-2017 Roth conversions. A Roth conversion is an excellent way to soak up lower than normal tax rates unless, possibly, the individual knows he wants to actually spend the money in a very short

period of time after the withdrawal. Also, a distribution usually won't make sense for someone under age 59½ because of the 10 percent penalty on premature distributions that applies in addition to income taxes, unless an exception applies, but a Roth conversion does not trigger that penalty (provided the Roth account is not distributed within five years after the conversion).

Where to read more: Regarding Roth conversions before age 59½, see ¶ 5.5.02.

22. **WORST: Take distributions early to avoid double tax.** Certain advisers focus the client's attention on the fact that, upon the client's death, the retirement benefits will be subject to a "double tax." First, estate tax is paid on the benefits, then the beneficiaries pay income tax when they withdraw the benefits from the retirement plan. These advisers recommend that the client remove the money from the plan as soon as possible "to avoid the double tax." The problem with this notion is that taking the money out of the plan does not, in and of itself, eliminate the double tax; in fact it accelerates the payment of one part of the double tax (the income tax). If the client takes the money out of the plan and thinks he has, just by that act, reduced the taxes his family will pay he is usually wrong. His family will still suffer the double tax. He paid the income tax and the family will pay the estate tax on what's left (instead of the other way around). Taking money out of the plan now, and paying income tax that otherwise could have been deferred for several more decades, does not save taxes UNLESS there is some other factor at work such as: the client will give away the money taken out of the retirement plan, thus reducing his future estate tax (Idea #24), or the income tax is very low (see preceding Ideas). Unfortunately, it is sometimes true that the adviser who urges the client to take money out now "to avoid double tax" has another motive (*e.g.*, to sell the client an investment that cannot legally be purchased inside the retirement plan).

23. **BEST: Take extra distributions if overweighted in retirement plans.** Even if the client's tax bracket is not especially low, a person whose wealth is overweighted in retirement plans should consider withdrawing funds to give him greater balance between retirement plan assets and other investments. Money inside a retirement plan is more subject than outside money to the government's ever-changing whims; thus, balance is desirable here as in other things. The government could: enact extra taxes on these assets (as they did with § 4980A, enacted in 1986 and later repealed, imposing a 15 percent extra tax on "excess" plan accumulations); change the minimum distribution rules to require faster distributions or eliminate the post-death "stretch" payout (as Senator Max Baucus proposed in January 2012 and President Obama proposed in his 2014 and 2015 budgets—they want to shorten the post-death payout period to five years for most accounts); add new investment restrictions (*e.g.*, require some portion of plan money to be invested in "socially responsible" investments, a proposal once advocated by a Clinton cabinet member); or give spouses greater inheritance rights (as occurred with the Retirement Equity Act of 1984). Money in retirement plans might even be nationalized: In 2008, Professor Teresa Ghilarducci testified before Congress that the way to save the Social Security system was for the government to take over all

401(k) accounts and IRAs, giving the participants (in exchange) a guaranteed government pension—a type of forced swap that was actually implemented in Argentina.

What does it mean to be "overweighted" in retirement plans? There is no magic percentage or dollar amount that equals "overweighting" for everyone. The answer depends on an individual's age, earning power, and goals, and how much is in the plan relative to his retirement needs and other assets. 100 percent of investable assets in retirement plans might be appropriate for an early-career, high-earning individual, or for anyone nearing retirement who has not accumulated enough to retire. On the other hand, a person who is approaching or past age 70½, and who has accumulated in his plans more than he needs to finance his retirement, and who is not planning to leave his benefits to charity upon his death, should consider this Idea if he has few assets outside a plan.

24. **BEST: Take extra distributions to make gifts to reduce estate taxes**. A wealthy client concerned about estate taxes will usually choose to make annual exclusion gifts of $15,000 per year (as of 2018; $30,000 for a married couple) to each of the client's children and maybe grandchildren and perhaps even spouses of the foregoing, to reduce the client's gross estate. Other lifetime gifts can also save estate taxes (such as gifts to use up the client's transfer tax exemption during life rather than saving it for death). If the estate tax-conscious client has no other source for making these gifts than his retirement benefits, he should consider withdrawing funds from the plan, paying income tax on the distribution, and giving away what's left. Even though this means giving up further income tax deferral on the retirement plan, the elimination of estate taxes on the gifted assets may compensate for that loss.

25. **BEST: Investigate state tax effects before taking nonrequired plan distributions.** Some states offer special tax deals for money inside a retirement plan. If your client lives in or is planning to move to such a state, the client could incur increased state taxes if he cashes out his retirement plan before moving there, or at all. Here are examples of state law "deals" that were true in recent years, and may or may not still be true: Florida, New Hampshire, and Tennessee have had taxes that apply to investments, but that exempted investments held inside a retirement plan. Certain states (Hawaii, Illinois, Kentucky, Mississippi, Pennsylvania) exempt all or a substantial portion of distributions from retirement plans from their income taxes. Some states (Ohio, Oklahoma, Kentucky, Pennsylvania) provide estate tax exemptions for benefits inside a retirement plan. New York had an income tax exclusion for periodic payments from a retirement plan but not lump sum distributions. Don't cash out a client's retirement plans without checking out the state tax impact! See also Idea #37.

26. **BEST: Integrate distribution planning with Social Security benefits.** Under an elaborate formula, part of an individual's Social Security (SS) benefits become taxable if his "provisional income" exceeds a certain base amount. § 86. "Provisional income" means the individual's adjusted gross income (with certain modifications), plus his tax-exempt interest income, plus one-half of his SS benefits. If provisional income exceeds $25,000 for a single person ($32,000 for married taxpayers filing jointly), then half of the SS benefits (or, if less, half the excess of provisional income over the base amount) must be included in the

individual's gross income. If provisional income exceeds $34,000 for a single person ($44,000 for married taxpayers filing jointly), then 85 percent of the SS benefits (or, if less, 85% of the excess of provisional income over the base amount) must be included in the individual's gross income. § 86.

For a taxpayer whose income will exceed the base amounts regardless of how much he takes out of the retirement plan, these rules for taxation of SS benefits are irrelevant to the decision as to when to take money out of a plan. However, for a low-income retiree, plan distributions (except tax-free Roth distributions) increase "provisional income," and can accordingly cause a greater portion of his SS benefits to be taxable. For a person in this situation, the RMD will be in a bracket higher than his nominal tax rate, as each dollar of RMD causes $.50 or $.85 of SS benefits to become subject to the income tax.

This person should analyze the effects on the taxability of his SS benefits in deciding whether to postpone the first year's RMD (Idea #15). He also might consider a Roth IRA conversion for the sole purpose of getting the income taxation over with in one year, if the effect will be to keep his SS benefits nontaxable for the rest of his life. For this person, the usual rule of thumb (take extra distributions in a low-income year, Idea #21) might be reversed: He might want to take extra distributions in a *high-income* year (when his SS benefits are already 85% taxable, due to his already-high income), to reduce the plan balance, so that perhaps RMDs in later, low-income, years will not be large enough to cause more of his SS benefits to become taxable.

## C. ROLLOVER ROADMAP: WHEN, WHY, AND HOW TO "ROLL OVER"

A participant who is entitled to take money out of a retirement plan can usually take it and roll it over to just about any other kind of retirement plan. See ¶ 2.6.02 of *Life and Death Planning for Retirement Benefits* regarding what distributions can and cannot be rolled over. What are the reasons someone should stay in or roll over to any particular type of plan? How do you accomplish a rollover? See also: Idea #61; for rollovers involving Roth plans, "Group G" Ideas; and for rollovers and transfers by beneficiaries, "Group R" and "Group S" Ideas.

27. **BEST: Before rolling out of any plan, consider any unique options offered by that plan you may be giving up.** If you are in a defined benefit plan, or any plan that offers you choices among annuity, terms-for-years, and/or lump sum payouts, or in a plan that is "frozen" (either because the employer has stopped contributing, or because you have already accrued the plan's maximum benefit) STOP, LOOK, AND LISTEN before you decide whether to leave funds in that plan or roll them to an IRA. Actuaries warn that big dollars can be involved in these choices. The late Ed Burrows of Boston, former President of the College of Pension Actuaries, pointed out that some plans subsidize spousal survivor annuities and/or early retirement options; by taking a lump sum you may simply forfeit the extra value in the subsidized option. Fred Lindgren, Vice President and senior actuary with Fidelity Investments, pointed out that, even though the plan is supposed to tell the retiree the equivalent values of all options, different interest rates and actuarial assumptions may be used to evaluate the options, and of course the plan's valuations don't consider the retiree's

individual health, finances, and goals (or the plan's own financial strength!). If you ignore this Idea, you could be making a "gift" to your employer's pension plan and/or jeopardizing your own retirement benefits. See also (before rolling out of a QRP) Ideas #4–#6, #85, and #86. Also be aware that an underfunded plan may be legally limited in its ability to pay out lump sum distributions.

Where to read more: For a quick and dirty way to compare the relative values of annuities and lump sums, visit www.immediateannuities.com.

28. **BEST: Roll from QRP to IRA to improve post-death distribution options.** Many QRPs offer a lump sum as the only form of death benefit. Even if a plan offers the life expectancy payout at the time the participant dies, and the beneficiary elects it, the plan itself could later be terminated by the employer, again resulting in a forced lump sum distribution. A lump sum is fine if the beneficiary is the surviving spouse (who can roll it over tax-free to her own retirement plan; Idea #116), or a charity (which is income tax-exempt, so pays no tax on the distribution; Idea #118–#120), or a "Designated Beneficiary" who is permitted to roll the distribution over to an "inherited IRA" (Idea #179). However, the participant should roll his QRP benefits over to an IRA as soon as he is permitted to do so (typically, upon retirement) if he is leaving the benefits to a…

A. Nonspouse designated beneficiary and he wants to be SURE that his beneficiary will be able to use the "stretch" (life expectancy) payout method. Even though plans are required to permit beneficiary rollovers (Idea #179), the beneficiary will still lose the right to use the life expectancy payout if the participant died before his RBD, the plan does not permit the life expectancy payout, and the beneficiary does not complete the rollover to an inherited IRA by the end of the year after the participant's death. See IRS Notice 2007-7, 2007-5 I.R.B. 395, A-17(c)(2), A-19. Also, even if the plan permits beneficiary rollovers and the designated beneficiary timely initiates a rollover to an "inherited" IRA, there is the chance of mistakes: If the money gets distributed to the beneficiary by mistake (rather than being directly rolled into the inherited IRA), the beneficiary is stuck with a taxable distribution, because (with the limited exception of *direct rollovers to an inherited IRA, Idea #179*) a nonspouse beneficiary cannot roll over an actual distribution from an inherited plan (but see Idea #196).

B. Other beneficiary: If the participant wants to leave his QRP benefits to his estate or to a non-see-through trust (*i.e.*, not to a "designated beneficiary"), *and* wants the beneficiary to be able to use the 5-year rule or the participant's life expectancy (depending whether he dies before or after his RBD) to stretch out the payments somewhat after his death, the participant should roll the benefits to an IRA before he dies. A beneficiary that is not a "designated beneficiary" cannot roll or transfer to benefits from a QRP to an IRA under any circumstances.

C. <u>But here's a reason to leave benefits in the QRP</u>! There is one factor that pushes in favor of leaving the money in the QRP: By leaving the benefits IN the QRP, the participant may be preserving a chance for the nonspouse beneficiary to roll the inherited benefits into an "inherited" Roth IRA. If the participant, while living, rolls the benefits to an IRA, then leaves the IRA to the nonspouse Designated Beneficiary, the beneficiary will not be able to convert the inherited benefits to an inherited Roth IRA. See Idea #96.

<u>Where to read more</u>: See ¶ 1.5.10 of *Life and Death Planning for Retirement Benefits* regarding the plan's ability to require a lump sum distribution. See ¶ 1.5.06 regarding the "5-year rule," ¶ 1.5.08 regarding payout over the deceased participant's life expectancy. See § 402 and ¶ 4.2.04 of *Life and Death Planning for Retirement Benefits* regarding the nonspouse beneficiary rollover.

29. **BEST: Choose between staying in your 403(b) or QRP vs. rolling over to an IRA based on investment choices and/or expenses.** A 403(b) plan can be invested ONLY in annuity contracts or mutual funds offered by the plan. Generally, an IRA offers more investment choices than a 403(b) plan, and also more investment choices than the typical 401(k) plan (which limits investment choices to a handful of mutual funds). Although some QRPs offer professional investment management that employees feel is superior to what they could do on their own, the client who wants to do his own investing will prefer rolling over to an IRA. Also, the Department of Labor allows QRPs to charge various plan expenses to the participants' accounts; some find these expense charges result in a higher cost of leaving benefits in the employer's plan. However, if the participant wants his account to hold a loan to himself, life insurance, or collectibles, he should leave the money in the QRP as these investments are not permitted in an IRA. § 408(a)(3), (e)(2), (m).

30. **BEST for some younger people: Roll from QRP to IRA for some pre-age-59½ penalty exceptions.** There is a 10 percent penalty, generally, on retirement plan distributions taken before the participant reaches age 59½. § 72(t)(1). Some of the exceptions to this penalty are available *onl*y to IRAs (health insurance premiums of the unemployed, § 72(t)(2)(D); qualified higher education expenses, § 72(t)(2)(E); qualified first-time homebuyer expenses, § 72(t)(2)(F); qualified reservist distributions, § 72(t)(2)(G)). One exception (series of substantially equal periodic payments, § 72(t)(2)(A)(iv)) is easier to qualify for and arrange with IRAs than with a QRP (see Idea #78). Thus, this can be a good reason to roll to an IRA.

<u>Where to read more</u>: Chapter 9 of *Life and Death Planning for Retirement Benefits* discusses all aspects of the 10 percent penalty on pre-age-59½ distributions and the exceptions thereto.

31. **BEST for some other younger people: Leave money in the QRP if retiring between ages 55 and 59½.** One exception to the 10 percent penalty (available *only* for distributions from QRPs) is for distributions following separation from service after age 55. § 72(t)(2)(A)(v). If the employee separates from service in or after the year he reaches age 55 but then rolls the funds to an IRA the exception ceases to apply, and he will not be able to withdraw the

funds penalty-free from the IRA until he reaches age 59½ (unless he qualifies for one of the other exceptions). The availability of this "early retirement" exception would be a reason NOT to roll from a QRP to an IRA for a person retiring between ages 55 and 59½, if he thinks he might need to withdraw funds from the plan prior to age 59½. (The age is "50" rather than "55" for distributions from government plans to certain police, firemen, and emergency medical workers.) Note: This exception is not a reason to leave money in a QRP until reaching age 55 (or 50) if the employee retires BEFORE the year he reaches the applicable age. The exception is available only if the *separation from service* occurs after the applicable year.

Where to read more: See ¶ 9.4.04 of *Life and Death Planning for Retirement Benefits* regarding this exception.

32. **BEST: Roll from QRP to IRA to eliminate federal spousal rights.** If the participant does not want his spouse to have the survivor's annuity rights granted by § 401(a)(11), the participant may be able to eliminate those rights by rolling the money over from the QRP to an IRA. While all QRPs must grant an employee's surviving spouse some rights to any death benefits under the plan (the spouse's entitlement ranges from 50% to 100% of the death benefits, depending on the plan), an IRA is not subject to the federal spousal rights.

A. Before marriage. If the participant is planning to marry, and does not want his future spouse to have these rights, he can eliminate those rights by rolling the money over from the QRP to an IRA before the wedding. A prenuptial agreement CAN limit a spouse's rights in an IRA. A prenup can NOT eliminate the spouse's "qualified joint and survivor annuity" (QJSA) and death benefit rights to the QRP (but can be effective to limit his/her divorce rights). However, not every participant is able to take a distribution from his/her company's plan for purposes of rolling money to an IRA; most plans prohibit any distributions prior to separation from service and/or prior to reaching a certain age. A participant in that position will have to choose between: (1) quitting the job so he/she can get married and still protect his/her retirement plan via a pre-wedding rollover to an IRA; (2) getting married and losing substantial rights in the retirement benefits; or (3) keeping the job, keeping the benefits, and nixing the wedding.

B. After marriage. Under all pension plans and some profit-sharing plans, the employee can take a distribution and roll it over to an IRA ONLY if his spouse consents to allow the benefits to be distributed in a form other than a QJSA under which the spouse has a survivorship benefit. § 417(a)(2). However, with certain other types of profit-sharing plans (including most 401(k)s), the employee can take the distribution and roll it over to an IRA *without* getting the spouse's consent (even though the spouse would be entitled to 100% of the plan benefits if the participant died while the money was still in the QRP). § 401(a)(11)(B)(iii)(I). Of course, after the money is rolled to an IRA, state law may give the spouse rights to it even if federal law doesn't.

Where to read more: ¶ 3.4 of *Life and Death Planning for Retirement Benefits* explains the federal spousal rights in retirement plans.

33. **BEST for older person still working: Roll to a QRP to stop RMDs.** Starting at the "required beginning date" (RBD) (April 1 of the year after the year he attains age 70½), an IRA owner over age 70½ must take annual RMDs from his IRA (except in 2009), even if he is still working. In contrast, a QRP participant does not have to take RMDs until the later of age 70½ or retirement, *provided* he does not own more than five percent of the employer that sponsors the QRP (and provided the QRP permits this delayed RBD). A person who is still working after age 70½ for a company in which he is not a five percent owner can roll money into that company's QRP from his IRA (or from the QRP of a company in which he IS a 5% owner; see PLR 2004-53026) to stop the flow of RMDs. § 401(a)(9)(C); Reg. § 1.401(a)(9)-2, A-2(e).

Where to read more: ¶ 1.4 of *Life and Death Planning for Retirement Benefits* explains the RBD that applies to each different type of retirement plan.

34. **WORST: Use year-end rollover to eliminate RMD.** Lifetime required minimum distributions (RMDs) for a nonannuitized traditional IRA are determined by dividing the prior year-end account balance of the IRA by a factor from the applicable IRS table. To minimize or eliminate RMDs, a participant may hit on the bright idea of taking a distribution of his entire balance shortly before the end of the year (so the year-end balance of the IRA is zero), then rolling the distribution back into the IRA at the beginning of the next year (but within 60 days after the distribution), so he doesn't have to pay tax on the distribution. Sorry, this bright idea doesn't work. The RMD for a year is indeed based on the prior year-end balance, BUT the balance is not just taken off your account statement: An adjustments may be required! Specifically, the "prior year-end balance" of the IRA must be increased by the amount of any "rollovers in transit" on the last day of the year (as well as, for distribution years prior to 2018, the amount of any Roth conversions made during the prior year that are recharacterized in the distribution year).

Where to read more: See ¶ 1.2.05 of *Life and Death Planning for Retirement Benefits* regarding adjustments to the account balance for purposes of computing the RMD.

35. **BEST, for creditor protection: Keep QRP rollovers in one IRA, "regular" IRA contributions in a different IRA.** Andrew J. Fair, Esq., in his seminar outline "Solving Business, Family and Tax Problems Using Qualified Plans" (Oct. 2003) pointed out that Federal bankruptcy and consumer protection law and/or state creditors' rights laws may make a distinction between IRA funds that arise from a rollover from a qualified plan and funds that represent "regular" IRA (or Roth IRA) contributions. To avoid losing out on greater

protections that may be available for QRPs and QRP rollovers, Fair suggested rolling QRP funds only to a "pure" rollover IRA (one that contains no "regular" IRA contributions)—and keeping the rollover IRA "pure" by not adding any contributions to it (other than rollovers from other QRPs). This 2003 prediction came true in 2005, when Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPACPA). Under BAPACPA, the debtor gets an unlimited bankruptcy exemption for IRAs that contain only funds rolled over from QRPs, while the exemption for IRAs funded with annual contributions is limited to $1 million. If the two types of IRAs have been commingled, the Act does not specify how the exemption-limit applies.

36. **WORST: Roll over without investigating creditor protection effects.** For most people, protection from creditors' claims may be best accomplished by purchasing a big "umbrella" liability insurance policy, to cover the biggest potential sources of tort claims, namely their homes, boats, pets, and cars. This will eliminate most creditors' claims risk for the typical salaried employee. However, business owners, doctors and other professionals, people who serve on boards of directors, and some others need to worry about claims that cannot reasonably be insured against. For them, "asset protection" is a high priority. There is a myth that all retirement plans are exempt from creditors' claims. They are not, unless you go into personal bankruptcy. It's true that under BAPACPA (see preceding Idea) all types of tax-Code favored retirement plans are exempt from creditors' claims (subject to a $1 million cap on the exemption for IRAs funded with annual contributions). However, this bankruptcy protection does not apply to *inherited* IRAs (see *Clark v. Rameker*, 134 S. Ct. 2242 (2014)); also, if you are merely sued by a creditor, and you are not bankrupt, the degree of protection of your retirement benefits depends on federal nonbankruptcy ("ERISA") law and on state law. ERISA's rule exempting "employee benefit plans" from attachment (29 U.S.C. § 1056(d)(1), which can be found in Title 29, Chapter 18, Subchapter I, Subtitle B, part 2) does not provide 100 percent protection. For example, it *does not apply* if the only participants in the retirement plan are the business owner and/or his or her spouse. The business owner and spouse are not considered "employees," therefore a plan that covers only them is not an "employee benefit plan"! Also, IRAs generally are not entitled to any ERISA protection. State law may shelter an IRA, but the state laws protecting retirement benefits are a patchwork quilt. A person who is concerned about creditors' claims that cannot reasonably be insured against must investigate the relative protection of the various types of plans before rolling over funds from one to another; consult a lawyer who specializes in asset protection.

Where to read more: Leimberg Information Services website, www.leimbergservices.com (see "Resources," page 10) has a chart summarizing all states' creditor protection laws applicable to IRAs. Under "Special Services," click the "State Law" tab, then select "IRA_Creditor_Protection_Guide." Each state's summary is written by an attorney who practices in that state. An excellent resource for Texas is the website of Noel C. Ice, Esq., www.trustsandestates.net, Subscribers to National Underwriter's *Advanced Sales Reference* have access to substantial material on creditors' rights.

37. **BEST: Investigate state tax effects before moving benefits from one plan to another.** Some states offer special tax deals for certain types of retirement plans. If your client lives in or is planning to move to such a state, the client could incur increased state taxes if he rolls money from the more favored type of plan into a less-favored type of plan. Here are examples; these were true in recent years, and may or may not still be true, so these are intended merely as examples of the type of deal you need to be aware of. Alabama exempted defined benefit plan distributions from its income tax (but not distributions from other types of retirement plans). Maryland exempted Keogh plan distributions from its income tax (but not distributions from other types of retirement plans). Don't move a client's money from one type of plan to another without checking out the state tax impact! See also Idea #25.

38. **BEST: Roll over plan loan offset amount.** QRPs are permitted to make loans to employees from their accounts in the plan subject to extensive limits and rules; see § 72(p)(2). When the employee leaves employment with the company that sponsors the plan, the plan can deduct the outstanding loan balance from the employee's account before distributing the balance of the benefits to the employee. This "plan loan offset" is considered a distribution to the employee for income tax purposes, just as if the employee had received cash and used the cash to pay off the loan. The employee can eliminate the income tax on the loan offset amount by rolling over other, substituted, funds of an equal amount to an IRA or other plan within 60 days. Reg. § 1.402(c)-2, A-9. As a result of the TCJA, the rollover deadline is extended to the extended due date of the employee's tax return if the cause of the "offset distribution" was termination of the plan or of the employee's employment. § 402(c)(3)(C).

<u>Where to read more</u>: See ¶ 2.1.07 of *Life and Death Planning for Retirement Benefits* for all tax effects of plan loans.

39. **BEST: Use direct rollover followed by IRA distribution to avoid mandatory withholding.** Linda is retiring at age 65 from Acme Co. She has $200,000 in her Acme 401(k) plan. She wants to take the entire $200,000 out of the plan right now to spend it on renovating an old house. She knows she will owe no income taxes on this distribution because of a business loss operating carryover she has. However, if she just requests a distribution to herself from the plan, the plan will be required to withhold 20 percent of the distribution for federal income taxes, leaving her with only $160,000. She will have to wait until next April 15$^{th}$ to get a refund of that withheld income tax back from the IRS. She can avoid this problem by requesting a direct rollover of the $200,000 from the 401(k) into an IRA (Ideas #44 and #45). Mandatory withholding does not apply to a direct rollover. Then once the money is in the IRA she can withdraw it immediately without having taxes withheld: An individual can opt *out* of income tax withholding with respect to IRA distributions (because mandatory withholding also doesn't apply to IRA distributions). Only "eligible rollover distributions" from qualified plans that are paid to the individual rather than being rolled directly into another plan or an IRA are subject to income tax withholding that the individual can *not* opt out of.

Where to read more: See ¶ 2.3 of *Life and Death Planning for Retirement Benefits* regarding mandatory income tax withholding.

40. **BEST: Roll pretax money directly from IRA to QRP, then distribute the after-tax money tax-free ("basis-ectomy").** See Idea #88 regarding how IRA basis is recovered as the participant takes distributions. This method of recovering basis is a pain in the neck for an individual who is taking annual IRA distributions over a multi-decade retirement, if (as many people do) he has a small amount of after-tax money in his IRA(s): Each year, a tiny proportion of the year's distribution is treated as a nontaxable distribution of after-tax money—and that proportion must be recomputed every year. A participant can use the following rollover technique to get the after-tax money out of his IRA tax-free *without* having to take a taxable distribution at the same time (or, even better, do a tax-free Roth conversion; see Idea #41).

The Code generally allows rollovers from any traditional IRA to a QRP or 403(b) plan for years after 2001—but only of the *taxable* money in the traditional IRA. § 408(d)(3)(A)(ii). While the cream-in-the-coffee rule (see Idea #88) applies to Roth IRA conversions, and to any distribution from a traditional IRA that is not rolled over to another retirement plan, it does *not* apply to rollovers from a traditional IRA *to a QRP or 403(b) plan*. Instead, a distribution rolled from a traditional IRA to a QRP or 403(b) plan is deemed to come entirely out of the *taxable* portion of the traditional IRA. That's because the Code prohibits the rollover of *after-tax money* from an IRA to a qualified plan. § 408(d)(3)(H).

If the IRA owner participates in a QRP that accepts rollovers, he can arrange to have the pretax money transferred directly from the IRA to the QRP. Under § 408(d)(3)(H), the entire amount of this rollover is deemed to come from the *taxable* portion of his traditional IRA. He can then cash out the remaining "stub" IRA tax-free because it is all after-tax money. Later (after the end of the year in which he took the IRA distribution that was rolled into the QRP), he can roll the QRP money back to the traditional IRA, if desired.

Unfortunately, most people will not be able to use this Idea, because few retirees participate in a qualified plan that accepts rollovers (plans are not required to accept rollovers); however, more plans may start accepting such rollovers now that the IRS has provided (in 2014) guidance for IRA to QRP transfers.

Where to read more: See Rev. Rul. 2014-9, 2014-17 IRB 975 (4/3/14) regarding how to do a direct rollover of pretax money from a traditional IRA to a qualified plan. See generally ¶ 2.2.08 regarding separating basis from pretax money in a traditional IRA.

41. **BEST: Add a tax-free Roth conversion to your basis-ectomy.** After carrying out the preceding "basis-ectomy" Idea (i.e., after rolling all the "pretax portion" of the money in your traditional IRA to a qualified plan by direct transfer pursuant to Rev. Rul. 2014-9), transfer the remaining funds in the traditional IRA (which should be all or almost all after-tax money at that point) directly to a Roth IRA. This Roth conversion will be either entirely or mostly tax-free. (See Idea #91 for how to do a tax-free Roth conversion of after-tax money in a

qualified plan). Be careful not to contribute any further money to the traditional IRA in the year you do the Roth conversion, since later contributions during the year (whether they are "regular" annual-type conversions, or rollovers from an employer plan) would mess up the ratios used to determine how much of the Roth conversion is tax-free.

Where to read more: See ¶ 2.2.08(A) of *Life and Death Planning for Retirement Benefits* regarding how to determine how much of an IRA-to-Roth-IRA conversion is taxable.

42. **BEST: Roll DRAC money to a Roth IRA.** There are two kinds of Roth plans, "Roth IRAs" (which are a type of IRA) and "designated Roth accounts" in qualified plans. Roth IRAs are not subject to the lifetime minimum distribution rules; thus there are no RMDs from a Roth IRA until after the owner's death. Designated Roth accounts (DRACs; also called "Roth 401(k)" or "Roth 403(b)" accounts), in contrast, are subject to both the lifetime and the post-death RMD rules. Thus, generally a DRAC participant should roll his DRAC money over to a Roth IRA as soon as possible (typically, upon retirement or separation from service, but basically anytime—even if still employed, if the plan permits in-service distributions)—UNLESS the next Idea applies! A participant can open a Roth IRA to receive a rollover from a DRAC even if not otherwise eligible to contribute to a Roth IRA.

Where to read more: See ¶ 5.7 of *Life and Death Planning for Retirement Benefits* regarding DRACs generally, and ¶ 5.7.03 for the differences between DRACs and Roth IRAs.

43. **WORST: Roll from a DRAC to a Roth IRA shortly before you meet the requirements for a "qualified distribution" from the DRAC.** This is tricky. In order to have tax-free "qualified distributions" from either a DRAC or a Roth IRA, the participant must satisfy a five-year holding period requirement and a triggering event requirement…but the holding period is computed *separately* for DRACs and Roth IRAs. Years accumulated in the DRAC don't count towards the five-year holding period requirement for the Roth IRA into which the DRAC distribution is rolled. If the DRAC distribution that is rolled into the Roth IRA is a "qualified distribution," then it comes into the Roth IRA as after-tax money (and so can later be withdrawn income tax-free at any time). But if the participant rolls out of the DRAC BEFORE he has met the requirements for a qualified distribution from the DRAC, he loses all benefit of the years accumulated in the DRAC. This can be quite a negative result if the participant was close to meeting all the requirements for a qualified distribution from the DRAC (unless the participant has already met the 5-year requirement for his Roth IRA).

Where to read more: See ¶ 5.7.08–¶ 5.7.09 of *Life and Death Planning for Retirement Benefits* regarding the rules for DRAC-to-Roth IRA rollovers and the planning implications.

44. **BEST: Use a direct rollover if you will need college financial aid.** There are two ways to roll money from a QRP to an IRA: direct rollover (money is sent directly from the QRP to the IRA) and 60-day rollover (money or property is distributed to the participant, who then, within 60 days, contributes the same assets he received to the same or another eligible plan).

According to Thomas P. Brooks, President of College Funding Advisors, Inc., (http://collegefundingadvisors.com/) in determining what income parents have available to contribute towards their child's tuition, money transferred in a direct rollover would never be considered "income," but money transferred in a 60-day rollover, because it appears as gross income on the parents' Form 1040 (even though it's not taxable, because of the rollover) WILL be counted as part of the parents' income by some financial aid offices.

Where to read more: I read this idea, and several other of Mr. Brooks's ideas about how to integrate retirement benefits with college funding-planning, in the October 2003 issue of the highly recommended newsletter, *Ed Slott's IRA Advisor* (www.irahelp.com). You can get that back issue by subscribing to the newsletter; see "Resources," page 10.

45. **BEST: Use a direct rollover even if you DON'T need college financial aid.** When transferring funds from a QRP to an IRA, there are three problems with using a "60-day rollover" instead of a "direct rollover" (see preceding Idea), even if you're not worried about how your income will look to a college financial aid office. *First*, the QRP must withhold 20 percent income taxes from any eligible rollover distribution made to the participant (meaning that to roll over 100% of the distribution the participant must supply the missing 20 percent by substituting other funds, then wait to receive a refund of the 20% withheld tax when he files his tax return; see Idea #39). § 3405(c). *Second*, the participant must roll over the same property he received in the distribution (or the proceeds thereof, if he sold it after it was distributed). § 402(c)(1)(C), (6)(A). This can create a headache in the case of a noncash distribution, namely, tracing the distributed assets. *Third*, the participant must complete the rollover within 60 days; see Ideas #46–#48 for problems with the 60-day rule. § 402(c)(3). The direct rollover *may* eliminate worries about the 60-day deadline, since the money in theory is not "distributed" at all, it goes directly from one plan into the other (even if that transition process takes more than 60 days); see PLRs 2010-05057 and 2010-35044, discussed at ¶ 2.1.03(A) of *Life and Death Planning for Retirement Benefits*. However, the PLRs are not consistent on this point. Let's just say if you use a 60-day rollover you KNOW you are under the gun to complete the rollover within 60 days. If you request a direct rollover, you *normally* don't have to worry about the 60-day deadline.

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46. **BEST: If necessary, "self-certify" or use Rev. Proc. 2003-16 to obtain hardship waiver of the 60-day rollover deadline.** With few exceptions, a rollover must be completed within 60 days to be tax-free. The IRS can waive this deadline if it was missed due to "hardship." § 402(c)(3), § 408(d)(3)(A), (I). In Rev. Proc. 2016-37, 2016-29 IRB 136, the IRS sets out a procedure you can follow to "self-certify" that you are eligible for a hardship waiver for one of 11 listed causes; if you indeed missed the deadline due to one of these causes, an IRA provider or plan administrator will accept your late rollover just based on your self-certification (precise instructions are contained in the Rev. Proc.). If you missed the deadline due to a hardship not included in the self-certification-eligible list of 11 causes, instead turn to Rev. Proc. 2003-16, 2003-4 I.R.B. 359, which allows that a waiver may be requested by following the same procedure as for a private letter ruling.

Hardships that justify self-certification include financial institution error and serious illness.

An executor can apply to complete the rollover of a distribution received by his decedent more than 60 days after the decedent received the distribution; however, the IRS will normally only grant such a waiver to the executor if there is evidence that the decedent intended to roll over the distribution or not to take it out in the first place, *and* even then the IRS won't allow the executor to name a beneficiary for an IRA created to receive such a post-death rollover of a pre-death distribution. "Death" is not one of the 11 hardships that justifies a self-certified hardship waiver.

The IRS has granted hundreds of hardship waivers since late 2003. The IRS has been generous in granting the waiver when the need for the waiver arose because of errors made by professional advisers or financial institutions, or when the participant suffered from natural disaster, health problems, illness or death of a family member, or similar difficulties. However, the waiver is NOT typically granted if the participant spent the money he withdrew from the IRA, thinking he could come up with replacement funds within 60 days but the replacement funds did not materialize by the deadline, or if the failure to meet the 60-day deadline was due to the participant's own error (see the next two Ideas).

<u>Where to read more</u>: See ¶ 2.6.07 of *Life and Death Planning for Retirement Benefits* regarding hardship waivers of the 60-day rollover deadline. See ¶ 4.1.04 regarding post-death rollovers of pre-death distributions.

47. **BEST: Get professional help if using a 60-day rollover.** The IRS has almost always granted a hardship waiver of the 60-day rollover deadline if the failure to complete the rollover within 60 days was due to an error by a professional financial advisor (such as telling the participant that she had 90 days to complete the rollover rather than 60) or by a financial institution (such as depositing the rollover money in a taxable account despite the taxpayer's instructions to place it into an IRA—and now financial institution error justifies self-certification of the hardship). BUT if the failure to complete the rollover within 60 days was due to YOUR OWN error, and you can't blame a financial institution, professional advisor, or act of God because it's all YOUR fault, the IRS may well NOT grant the waiver. See PLRs 2007-38027 (taxpayer filled in the wrong account number on a form; waiver denied) and 2007-36036 (taxpayer rolled the 401(k) distribution into a taxable account inadvertently; waiver denied). Very few PLRs grant waivers for what seem to be participant-originated errors. To avoid being at the mercy of the IRS's policies on this, unless you are confident that you will never make a mistake, either do not use a 60-day rollover (see Idea #45) or get a professional on the hook to take responsibility for carrying it out.

48. **WORST: The 60-day loan from your IRA.** This is a clever literary device gone bad. If you take an eligible rollover distribution from your IRA, that distribution is taxable, unless, within 60 days after receiving the distribution, you recontribute the distributed amount to the same or another eligible retirement plan. § 408(d)(3)(A). Then your "taxable distribution" becomes a tax-free rollover. Someone noticed that this rule basically allows you to "borrow" money from your IRA for 60 days, and so started describing the distribution-recontribution scenario as a "60-day loan from the IRA." This WORST idea actually works, and there is

nothing wrong with it if executed properly. The problem with the "60-day loan" description is that it encourages people to view the IRA as a source of short-term financing, misleads people regarding the nature of the transaction, and minimizes the perils of rollovers.

The 60-day deadline provides a very short time frame. If you miss it, you can't roll over the distribution. The IRS can waive the deadline in cases of hardship (see the two preceding Ideas); but the IRS has made it clear they generally will NOT waive the deadline if you spent the money that was distributed to you in the mistaken belief you would be able to get replacement funds within 60 days, or if it is otherwise clear that you used the IRA as a source of financing. See PLRs 2004-17033, -22053, -28034, -33022, and -33029 (all cases of "waiver denied" for this reason).

There are rare exceptions: in some cases the individual used his IRA as a source of short-term financing, but then, within the 60-day deadline, had the funds ready to replace into the IRA to complete the rollover, but was prevented from completing it by some *other* hardship.

Rollovers are subject to several other technical requirements, in addition to the strict 60-day deadline. There is the rule that there can be no more than one IRA-to-IRA rollover within 12 months. § 408(d)(3)(B); see the next Idea. Also, the property that is recontributed to the rollover IRA must be the same property that was distributed from the first IRA. § 408(d)(3)(A). The technicalities are easily complied with if proper care is exercised, but if the technicalities are handled improperly, the client is stuck with a taxable distribution (and 10% penalty if under age 59½).

Where to read more: ¶ 2.6 of *Life and Death Planning for Retirement Benefits* explains the requirements of tax-free rollovers. ¶ 2.6.06 explains the 60-day rule and its exceptions.

49. **WORST and BEST ways to fix violation of the "one-rollover-per-year" rule.** The 60-day deadline is not the only rule that applies to rollovers. Another one is that there can be only one tax-free IRA-to-IRA rollover in 12 months. § 408(d)(3)(B). Suppose "Jane" has an IRA. She took a $5,000 distribution from the IRA, used it to pay some bills, then (when she got her bonus) returned the distributed amount to the same IRA within the 60-day period. She then took a second IRA distribution of $50,000 a few months later, because she was planning to buy a small business. The business purchase fell through and now she wants to return the second distribution to the IRA. Unfortunately, because the two distributions were less than 12 months apart, the second distribution cannot be rolled over. Unlike the 60-day deadline, the IRS can NOT waive the one-rollover-per-year rule. What can Jane do to avoid having the second distribution treated as a taxable distribution?

A. WORST: One thing Jane can NOT do is retroactively elect to make the first distribution of $5,000 taxable so she can roll over the second, larger, distribution. When she rolled the smaller earlier distribution back in to the IRA, she had to elect, at the time of the contribution, to have the contribution be treated as either a "regular" or a "rollover" contribution. She chose rollover, and that election is irrevocable.

B. BEST, before 2015: IF the second ($50,000) IRA distribution came out of an IRA that was not involved in the first ($5,000) IRA distribution and rollover, i.e., it came out of a totally different IRA account, AND it was distributed prior to January 1, 2015, then Jane could have done the second IRA-to-IRA rollover. Prior to 2015, the IRS permitted two (or more) IRA-to-IRA rollovers within a 12-month period provided the later distribution came from an IRA that was not involved (as either the distributing or the receiving account) in the earlier rollover(s). See *IRS Publication 590* (2013 edition), p. 25. However, the IRS has changed its rule to conform with the Internal Revenue Code as interpreted in *Bobrow v. Comm'r*, TC Memo 2014-21 (1/28/14), effective for distributions after 2015: An IRA distribution cannot be rolled into an IRA if the participant had rolled over tax-free to an IRA *another* IRA distribution received within less than 12 months prior to the second distribution. See IRS Announcement 2014-15, 2014-16 IRB 973 (3/20/14).

C. BEST: If, in her workplace, Jane participates in a qualified plan or 403(b) plan that accepts rollovers, she can roll the $50,000 distribution into that plan. The once-per-12-months rule does not apply to a rollover from an IRA into any other type of plan. § 408(d)(3)(B).

D. NEXT BEST, BUT NOT THAT GREAT: Jane can roll the $50,000 distribution into a Roth IRA. The once-per-12-months rule does not apply to a rollover from a traditional IRA into a Roth IRA. Reg. § 1.408A-4, A-1(a). This is a Roth conversion and it is taxable—so she doesn't get out of paying the income tax on the second distribution from her traditional IRA. But at least by converting that distribution to a Roth she gets a valuable addition to her retirement plan portfolio, namely a Roth IRA. (Prior to 2018, she could have had her cake and eaten it too—she could have beaten the one-per-year rule by contributing the second distribution to a Roth IRA, then recharacterized her "Roth conversion" back to a traditional IRA so she didn't have to pay tax on the second IRA distribution. However, as a result of TCJA, recharacterizations are not permitted for post-2017 Roth conversions.)

Where to read more: Regarding the once-per-12-months rule for IRA-to-IRA rollovers, see ¶ 2.6.05 and ¶ 2.6.08 of *Life and Death Planning for Retirement Benefits*; see ¶ 5.6 regarding Roth recharacterizations.

## D. IDEAS FOR INVESTING YOUR RETIREMENT PLAN MONEY

These Ideas deal with investment concepts for money that is inside a retirement plan.

50. **WORST, says the Perfesser: Make nondeductible contributions to your traditional IRA.** Professor Christopher Hoyt of the University of Missouri (Kansas City) Law School, reminds us that nondeductible contributions to a traditional IRA get shabby treatment from the Tax Code when it comes time to withdraw from the account, because of the "cream-in-

the-coffee rule" (see Idea #88). If your IRA contribution will be nondeductible (because you or your spouse is a member of an employer-sponsored plan and you have income above a certain level), Professor Hoyt argues convincingly that (unless, possibly, you are being hounded by creditors) you will ultimately have fewer headaches and more money if you invest that money *outside* the IRA. Gains in your taxable account are deferred until the investment is sold; dividends and long-term gains will be taxed at relatively low rates under current law (versus the 37% maximum rate currently potentially applicable to IRA distributions); and may receive a stepped-up basis at death. More difficult to calculate is the effect on the 3.8% additional income tax on "net investment income" for high-income (over $250,000) taxpayers (the "NIIT"), added to the Code since Professor's Hoyt's article. Dividends and capital gains are subject to this additional tax, and IRA distributions are not, but large IRA distributions could cause the individual's income above the threshold making his other income subject to the NIIT.

<u>Where to read more</u>: See Hoyt, C., "Why Not to Invest in Non-Deductible IRAs," *Trusts & Estates*, Vol. 144, No. 9, p. 70 (Sept. 2005).

51. **BEST, say others: Make nondeductible IRA contributions.** Not everyone agrees with Chris Hoyt's views in the preceding Idea. For one thing, investing inside an IRA is easier than investing outside an IRA because you don't have to keep track of holding periods, qualified versus nonqualified dividends, etc. Also, having more in your IRA (whether it's pre- or after-tax money) gives you more that you can convert to a Roth IRA someday (see Idea #89). Finally, when you retire, you MAY be able to get that after-tax money out of the IRA tax-free (to avoid the hassles discussed in the preceding Idea) by using Idea #40 or #41.

52. **WORST: Sell loss security outside your IRA, purchase same security inside your IRA within 30 days.** It's the end of the year and you need tax losses. Your Company X stock has declined in value but you're sure it will go up again. So you sell the stock (to harvest the loss) and buy it right back (to benefit from the future gain). Of course that does not work: Under the "wash sale" rule, you cannot deduct a loss on the sale of securities if you repurchase substantially identical securities within 30 days before or after the loss-generating sale. § 1091(a). But what if the sale takes place *outside* your retirement plan (which it always does, since that's the only way you can recognize a loss) but the repurchase occurs *inside* your IRA? Rev. Rul. 2008-5, 2008-3 I.R.B. 1, holds that a purchase of securities inside an IRA or Roth IRA *will* be matched with an outside sale of securities within the applicable 30-day period for purposes of applying § 1091. Furthermore, says the ruling, the taxpayer does *not* get to increase his basis in the IRA by the amount of the disallowed loss, despite the fact that § 1091(d) allows such a basis adjustment when the wash sale rule is applied to outside-a-plan security sales. I believe this Revenue Ruling is wrong, but the best planning idea seems to be to avoid the problem.

53. **BEST and WORST ways to pay IRA investment expenses.** There is a unique choice regarding how to pay investment management expenses of an IRA. The owner can pay the

expenses using taxable (outside) assets, and that will not be considered a contribution to the IRA. Or, the owner can pay the expenses directly from the IRA account and that will not be considered a distribution. So:

A. **BEST for a Roth IRA:** The goal with a Roth IRA is to preserve and enhance it to the maximum extent legally possible. Paying a Roth IRA's investment expenses out of the Roth account is pure waste. Pay the expenses out of a taxable account!

B. **BEST for a traditional IRA:** Perhaps you have an "overfunded" IRA. You are over 70½ and your superlarge IRA is looming over you threatening ever-larger minimum distributions. Or you are administering a large inherited IRA ditto. Socking the account with its proper share of management expenses helps a little bit with that problem; do NOT pay the expenses using outside assets! (And also see Idea #69.) On the other hand, if you are still desperately trying to grow your IRA for your future retirement needs, using outside assets to pay the fees will help you maximize the IRA value.

C. **WORST for all IRAs:** Though it can be ok to pay certain investment management fees attributable to your IRA assets out of your other (nonIRA) assets, it doesn't work the other way round. If your IRA pays expenses that are not properly attributable to the IRA's assets, that's (at best) a distribution to the IRA owner (subject to income taxes and, if the participant is under age 59½, the 10% penalty), and at worst a prohibited transaction (disqualifying the IRA). I can't cite chapter and verse…it's just self-evident that an IRA cannot be used to pay expenses that are not properly chargeable to it! So don't pay the expenses of your Roth IRA or your taxable account out of your traditional IRA!

<u>Where to read more</u>: Also see #197 regarding trustees' expenses. See ¶ 8.1.04 of *Life and Death Planning for Retirement Benefits* regarding payment of investment expenses of an IRA.

54. **BEST: Hold nonmunicipal bonds in plan, stocks outside plan.** If the client wants to have a balanced overall portfolio, with some assets in stocks (held for growth and dividend income) and some in bonds (held for income and stability of principal), it makes sense to allocate them this way. Assets held primarily for production of current income are best held inside the retirement plan, where the taxes on that current income are deferred until the income is distributed from the plan. Assets held primarily for growth should be held outside the plan, because growth isn't taxed until the asset is sold anyway (a different form of tax deferral), and when the asset is sold the growth is taxed as long-term capital gain (if held for more than one year), which is taxed at generally-lower capital gains rates (subject to AMT adjustments), whereas retirement plan distributions are taxed at generally-higher ordinary income rates, even if the distribution represents long-term capital gain realized inside the plan. Special lower tax rates on dividends can add further reason to hold stocks outside the plan, though the NIIT on investment income may reduce this advantage.

55. **WORST: Have a margin account in your IRA.** IRAs and other employee benefit plans, like charities, are exempt from regular income taxes but are subject to income tax (at corporate rates) on "unrelated business taxable income" (UBTI). § 408(e)(1), § 511. UBTI can result from operating a business inside the tax-exempt entity (see next Idea), or from "unrelated debt-financed income." § 512(b)(4). Debt-financed income results from "debt-financed property"—property acquired with borrowed funds and held to produce income. § 514. Often (outside of retirement plans) an investor will have a loan to (and secured by) his securities account, from the brokerage firm. This is called a margin account, and if it is held in a retirement plan or IRA, a portion of the plan's investment income will be UBTI.

There is an exception to the debt-financed property rule for property that is more than 85 percent used for the exempt entity's exempt purpose (other than its need for funds). § 514(b)(1)(A)(i), Reg. § 1.514(b)-1(b)(1)(ii). One could argue that the sole exempt purpose of a retirement plan is to invest and accumulate funds for the owner's future retirement, and therefore the use of a margin account is in furtherance of the plan's exempt purpose. However, this argument was rejected in *Elliot Knitwear Profit-Sharing Plan*, 614 F. 2d 347 (3d Cir. 1980), which was followed in *Henry E. & Nancy Horton Bartels Trust*, 209 F. 3d 147 (2d Cir. 2000); Cert. Denied 531 U.S. 978 (2000), on the basis that "in furtherance" of the exempt purpose means inherent in or essential to the fulfilment of the exempt purpose, and borrowing on margin may be useful for accumulation of funds but it is not essential. It is a good idea to steer clear of the UBTI tax, which can entail the complications of figuring out the tax, filing returns (Form 990-T, if gross unrelated business income is $1,000 or more), and paying estimated taxes (if "adjusted" UBTI exceeds $500), with associated penalties if any of these filings or payments are late. If the UBTI for the year is under $1,000, however, there is no tax. § 512(b)(12).

<u>Where to read more</u>: Best free source is IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*.

56. **WORST: Operate a business inside your IRA (or Roth IRA), and take no salary, so all your profits are tax-deferred (or tax-free)...or *take* a salary if you want–you lose either way!** The first problem with this proposal is that an IRA (including a Roth IRA) is subject to tax at corporate rates on unrelated business taxable income (UBTI). § 408(e)(1). The IRA would pay this tax on any business it conducts, and then the owner (or beneficiary) would be taxed *again* when what's left after paying the UBTI tax is distributed from the IRA, so income taxes are doubled rather than deferred. Another concern: If the IRA owner is working "for free" for a business operated by the IRA, the question arises whether there has been an assignment of income. See Idea #59. Another issue is whether the participant is making an illegal noncash contribution to her IRA in the form of her services (§ 408(a)(1)), the effect of which might be to disqualify the entire IRA and/or result in imposition of the six percent annual excise tax for an excess IRA contribution. § 4973(a). I have found no authority or source discussing the contribution of services to an IRA. Furnishing services between a plan and a disqualified person (such as between the IRA and the IRA owner/manager) is a prohibited transaction in itself, which could disqualify the IRA. § 4975(c)(1)(C). This

problem doesn't go away if you pay yourself a salary, because then you have a definite prohibited transaction, according to the Tax Court, which disqualifies the IRA (see the *Ellis* case, discussed at Idea #72).

57. **BEST: Walk carefully on the UBTI tightrope: partnership income, life insurance loans, selling short.** If a retirement plan proposes to invest in anything other than plain vanilla publically traded stocks, bonds, and mutual funds, someone in charge has to have antennae sensitive to the issue of "unrelated business taxable income" (UBTI). An IRA (like a charity) is tax-exempt *except* on its UBTI. UBTI is taxable even when earned inside an otherwise tax-exempt entity. UBTI can sneak up on you, and some things you might not expect would create UBTI *do*, whereas some things that look suspicious do *not* create UBTI. For example:

A. Controlled entities; Partnerships. UBTI is not easily avoided by "layering" entities. If a retirement plan receives rental or interest income from a business entity that is *controlled* by the plan, that income could be UBTI, even though rental and investment income are not normally UBTI. § 512(b)(13). If a retirement plan is a partner in a *partnership* (or owns an LLC that elects to be taxed as a pass-through entity), and the partnership (or LLC) conducts a "trade or business," or has income from debt-financed property, the partnership's (or LLC's) income can cause the plan to be subject to the tax on UBTI (even if the plan does not control the partnership or LLC). § 512(c). Thus, an IRA can find itself filing a tax return and paying taxes!

B. Selling securities short involves two investors at the "selling" end: one investor (the lender) lends its securities (through the brokerage firm) to the second investor, and the second investor (the seller) sells the borrowed securities to the buyer. The lender receives various payments in connection with this transaction, but generally is treated as if it still owns the securities. The lender's side is exempted from the UBTI tax by § 514(c)(8)(A) and § 512(a)(5), assuming various requirements are met. According to IRS Publication 598 short selling also does not create debt-financed income for the "seller." Even though it does involve borrowing the securities to be sold, this borrowing creates an "obligation" but it does not create a "debt," says the IRS.

C. Owning mortgaged real estate. If an IRA owns real estate that is subject to a mortgage, the income from that real estate will be debt-financed income for purposes of the tax on UBTI. A qualified plan (but *not* an IRA) gets an exemption from the UBTI tax for income from *certain* (not all!) mortgaged investment properties. § 514(c)(9). Note: The UBTI debt-financed income problem arises only when the IRA *borrows* money (with a mortgage or otherwise); it does not arise when the IRA *lends* money. Interest income from a mortgage that is held as an investment of the plan or IRA generally is not UBTI. UBTI issues would arise in connection with a mortgage held by the plan only if the plan shared in the mortgagor's profits or controlled the mortgagor, or if the plan's lending activities were deemed a "business" rather than a passive investment.

D. Borrowing on life insurance. If the plan carries a life insurance policy to provide incidental death benefits, and the plan borrows on the policy, does the policy loan generate debt-financed income, taxable as UBTI? IRS Publication 598 says that property acquired for the production of income "includes rental real estate, tangible personal property, and corporate stock," but doesn't mention life insurance. A life insurance policy is typically not held as an "investment" (*i.e.*, to produce investment gains); rather it is held to pay benefits under the plan. Therefore *if the borrowing against the policy is solely for the purpose of paying the policy premiums* the rationale of *Elliot Knitwear* (see Idea #55) arguably does not apply, and the policy loan thus incurred arguably would not create debt-financed income, because it is incurred in an essential function of the exempt purpose of the plan. However, if the policy value is stripped out by means of a loan for the purpose of either (i) investing the loan proceeds in other investments or (ii) distributing the policy to the participant while retaining the policy's cash value inside the plan, it would appear that the loan would cause realization of debt-financed income and incur UBTI tax. I have found no authority supporting either of these statements or discussing this issue.

58. **BEST, says one author: Invest your IRA in real estate.** A commercial real estate broker thinks real estate is a great investment. He found he had to swim upstream to make this perfectly legal investment inside his IRA, because lazy? self-interested? IRA providers want us to think an IRA can hold only stocks, bonds and mutual funds. In *IRA Wealth: Revolutionary IRA Strategies for Real Estate Investment* (www.Amazon.com), Patrick W. Rice (with co-author Jennifer Dirks) provides a primer on real estate investing and on how to do it through your retirement plan. I came to this book as a skeptic, but was pleasantly surprised. Unlike some others, the author does not tell you how to skirt the law nor is he ignorant of the many rules applicable to retirement plan investing. I have reservations about some statements in the book, and I did not verify his computations of the UBTI tax. I personally think investing in real estate would be a massive headache (inside *or* outside a retirement plan), but if you disagree you should read this book.

59. **WORST: Contribute "sweat equity" to your IRA-owned real estate.** With some types of real estate investment, there exists the potential for the IRA owner to enhance the value of his investment not merely by his savvy investing and expert management but by his sweat and toil. The article "An IRA can invest in Real Estate," *Kiplinger's Retirement Planning: Your Guide to Securing Your Dreams*, Fall 2005, p. 72, discussed a "professional home remodeler" whose IRA purchased a run-down house for $62,000. He "spent $16,000 to remodel the house" and "sold it within the year for $98,000." In the Q&A section of one web site, another IRA owner asks if he can use his weekend time and some leftover building materials to fix up a house owned by his Roth IRA.

If an IRA owner personally swings the hammer to fix up a house owned by the IRA, he risks tax evasion charges. If the IRA's profits result from the owner's personal services, the owner may owe income and self-employment taxes on that income. The IRS could determine that he has assigned the income resulting from his own labor to another entity, the tax-exempt IRA, which of course cannot be done. Rev. Rul. 74-32, 1974-1 C.B. 22. Income that properly belongs on the owner's tax return but instead goes to the IRA could be treated as an excess IRA contribution, subject to penalty tax.

Alternatively, the IRS could treat the services performed for the IRA as a prohibited transaction (furnishing of services by a disqualified person), thus disqualifying the entire IRA. § 4975(c)(1)(C). Or, the IRS could say the IRA was running a home remodeling business, and tax the resulting UBTI.

Using the IRA owner's "outside" business tools and facilities to provide fixing-up services for IRA-owned real estate is dangerously similar to the abusive Roth IRA transactions the IRS attacked in Notice 2004-8, 2004-4 IRB 333, where (in transactions between the IRA owner's nonIRA business corporation and his Roth-IRA-owned LLC) goods, services, and shares were "not fairly valued," with the result that value was shifted improperly into the Roth IRA. See Idea #99. In the Notice, the IRS declared these maneuvers "tax avoidance transactions," to be treated as "listed transactions" under Treas. Reg. § 1.6011-4(b)(2) effective December 31, 2003. The notice covers any "similar transactions" involving Roth IRAs and business entities controlled by related parties.

60. **WORST: Have your IRA transact with related parties who are not "disqualified persons," on the assumption that such transactions cannot possibly be "prohibited transactions."** As "self-directed" IRA investing in real estate becomes more popular, web sites and magazine articles purporting to explain the applicable rules proliferate. Such sources sometimes offer misleading or simplistic advice. For example, an IRA can be disqualified if it engages in a "prohibited transaction." One type of prohibited transaction is a transaction between the IRA and a "disqualified person." § 4975 lists "disqualified persons," such as the IRA owner (as "fiduciary" of the account) and his/her spouse, ancestors, descendants, and spouses of descendants, as well as entities majority-owned by such parties. Some advisers conclude from this that an IRA can freely engage in transactions with anyone (such as the IRA owner's girlfriend, stepchild, or sibling) who is not a "disqualified person." However, the fact that a transaction between the IRA and "disqualified person" is automatically a "prohibited transaction" does not mean that a transaction between the IRA and someone who is *not* a "disqualified person" is automatically *not* a prohibited transaction. Other transactions may be prohibited transactions for other reasons, such as an indirect benefit to the IRA fiduciary. *Rollins v. Comm'r*, T.C. Memo 2004-260.

Where to read more: See ¶ 8.1.06 of *Life and Death Planning for Retirement Benefits* regarding prohibited transactions and IRAs or the author's *Special Report: Buyer Beware! Self-Directed IRAs and Prohibited Transactions*, downloadable at www.ataxplan.com. See also Marino, Vivian, "Wary of Stocks? Property Is an I.R.A. Option," *New York Times* 6/29/05 (p. C-10), and Ryan, Oliver, "Customize Your IRA," *Fortune 2005 Retirement Guide* (7/11/05), p. 83, for popular-press articles about self-directed IRA investing. Two web sites devoted to this topic belong to IRA custodians who specialize in holding real estate, Pensco (http://www.pensco.com/) and Entrust (http://www.theentrustgroup.com/).

61. **BEST? WORST? Proceed with caution! Finance startup business with an IRA rollover.** You want to start a business, and will need capital to do so. Your IRA has money, but your IRA cannot invest in your proposed business because that would be a prohibited transaction. So instead, you form a new "C" corporation, and have the corporation adopt an ESOP (Employee Stock Ownership Plan), the kind of qualified retirement plan that is specifically designed to invest in employer stock. Then you roll all your IRA money into your rollover account at the ESOP, which then buys all the stock of the new corporation as original issue (i.e., directly from the corporation, not from some other stockholder). *Voila* your corporation now has the needed capital and can start buying equipment and hiring employees; the business is owned by your rollover account in the plan. On its face, this Idea sounds plausible. The Tax Code DOES encourage ESOPs, and exempts ESOPs from various "prudent investment" and prohibited transaction rules that other retirement plans have to comply with, because Congress wants employees to own stock in the employer through their retirement plan, and the Tax Code DOES encourage rollovers ("portability").

However, this Idea is not an easy fix. The business must be incorporated (so start with that expense and bother, if you would otherwise have operated as a sole proprietor), then there are plenty of rules that ESOPs DO have to comply with, including the rules applicable to all "qualified" retirement plans, such as: The plan must be a permanent plan, primarily designed to provide retirement benefits, and operated in a nondiscriminatory manner exclusively for the benefit of the employees. Any qualified plan also involves annual expenses of IRS reporting, and the costs of periodic updates to comply with changes in the law.

The IRS has weighed in with its opinion on this idea, which the IRS calls "rollovers as business startups," or "ROBS." The IRS is hostile. See the memorandum to IRS auditors at http://www.irs.gov/pub/irs-tege/rollover_guidelines.pdf.

So does the idea work or not? It is definitely a new use of the Code provisions allowing retirement plans to own employer stock, but there is nothing about it that seems to me either inherently abusive or to violate the spirit or the letter of the tax law. My take is that if Congress wants to outlaw this use of retirement plans Congress should amend the statute to make its position clear. The IRS should not "go after" these plans hoping to destroy the plans and the businesses they are financing unless it is clear this use violates the law. But I'm not in the ERISA business these days, so please don't call me looking for a tax opinion on this one. My verdict: This Idea is worth exploring, but hire an experienced tax/ERISA lawyer to vet the deal and make sure everything is done correctly.

Where to read more: See Choate, Natalie B., "ROBS?....or J-O-B-S? IRS Directive Addresses 'Rollovers as Business Startups,'" posted at the Leimberg Services website (see Resources, page 10) as Archive Message #471 (12/3/08). Consult *The Pension Answer Book* (see "Resources," page 10) for the requirements applicable to qualified plans.

62. **WORST: Use IRA cross-loans to finance your business.** A practitioner told me her client had read this Idea in an article. Joe and Al (who are not related to each other) both have IRAs and both need financing for their respective businesses. Joe's business can't borrow money

from Joe's IRA because that would be a prohibited transaction (loan to a disqualified person or "DQP"), causing the IRA to be disqualified. But Joe's IRA can invest in Al's business because neither Al nor Al's business is a DQP. So Joe's IRA lends money to Al's business. So far no problem. Now Al's IRA lends money to Joe's business. This idea perfectly illustrates the error of relying on "mechanical" tests to determine whether there is a prohibited transaction (see Idea #60). The fact that each person's IRA is making a loan to an unrelated party and therefore on its face there is no PT is NOT the only test of whether a PT exists. In addition to that purely mechanical test, you need to determine whether there is any indirect benefit to a DQP from the transaction. This deal flunks that second test. Joe's business (which is a DQP) is getting an *indirect benefit* from Joe's IRA's loan to Al's business, namely, it gets the quid pro quo loan from Al's IRA. A reciprocal deal like this is NOT going to fool the IRS. Not only will Joe's IRA be disqualified by this prohibited transaction, it's also a bad business deal: Al's business might go under, leaving Joe's IRA holding an uncollectible loan. Joe's business will still have to pay Al's IRA back for its loan, but Joe has lost his retirement funds!

63. **WORST: Buy disability or long-term care insurance in your IRA.** Use of IRA funds to pay personal expenses is a prohibited transaction, namely, the "transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan." § 4975(c)(1)(D). It is not safe to assume that because one type of insurance (life) is specifically prohibited (by § 408(a)(3)), all other types of insurance are permitted investments. The taxpayer in *Gerald M. Harris*, TC Memo 1994-22, made a similar argument: that the purchase of a retirement residence by his IRA was a permitted investment because the residence was not a "collectible" (a form of IRA investment prohibited by § 408(m)(1)). The Court said, "Petitioners' reliance on section 408(m) is totally misplaced. The purpose of that provision was to remove collectibles from the category of otherwise permissible investments of IRA funds. It...was not intended to expand that category to include investments that were previously not permitted." PLR 2000-31060 did permit the purchase of individual disability insurance policies by self-directed accounts in a 401(k) plan, BUT the purpose of those policies was to enable plan contributions to continue despite the employee's disability: The plan was the sole beneficiary of the disability policy, and the employee could not withdraw any funds resulting from policy payments to the plan until age 65. Also, a profit-sharing plan such as the 401(k) plan involved in PLR 2000-31060 is permitted to use a participant's account funds "to provide for him or his family incidental life or accident or health insurance." Reg. § 1.401-1(b)(1)(ii). There is no such permission for IRAs.

64. **Not the BEST or the WORST: the "CHIRA™."** In PLR 2007-41016, the IRS blessed the following deal: A self-directed IRA makes a loan to a charity (a church in this PLR). The loan would be evidenced by a 20-year promissory note, bearing interest at five percent *per annum* payable annually. The principal was due in a balloon payment at the end of the 20-year term or upon the participant's earlier death. The loan was to be secured by collateral assignment to the IRA by the church of a permanent life insurance policy on the participant's life. The church was the owner and beneficiary of the policy, subject to the security interest

granted to the IRA, and was to pay the policy premiums. The participant (who was apparently approaching or had reached age 70½) expected to pay his required minimum distributions attributable to this IRA out of the interest payments and/or by distributions from other IRAs (see Idea #9). The participant was neither a board member nor an employee of the church, nor did he control, own, or have a financial interest in the church. The IRA was not the owner or beneficiary of the life insurance policy, and had no rights to any death benefits; its rights were limited to collecting the loan. For additional extensive details on the arrangement, see the PLR. Two rulings were sought and obtained: That the arrangement did not constitute a prohibited transaction for the IRA, and that it did not constitute an IRA investment in an insurance contract forbidden under § 408(a)(3).

This PLR has been hailed as finally showing how IRAs can legally be used to (1) benefit a charity and (2) finance a life insurance purchase. Despite the fact that no one other than the person who obtained it can rely on a PLR, this PLR is being used to sell similar arrangements (now dubbed the "CHIRA™," for "charitable IRA"). I find no fault with the conclusion of the PLR based on the facts of this particular ruling, but I do not see the CHIRA™ as the salvation of charities, IRAs, and life insurance agents. Here are my concerns:

A. How does this help the charity? The benefit to the charity, presumably, is that it is getting a loan at a lower interest rate than it could get in an arms' length transaction with a bank. So the charity gets some immediate cash on relatively favorable terms—but the charity does have to pay back the entire loan principal, *and* it must pay the interest, *and* it must pay the premiums on the life insurance policy, so how much of this cash will actually trickle down to the objects of the charity's bounty? It makes sense, presumably, only for a charity that is looking to borrow money, not for a charity that is looking for contributions.

B. Below-market loan. The PLR did not rule on or even discuss whether the loan was a below-market loan subject to § 7872. Presumably, the five percent interest rate specified in the ruling was equal to or greater than the applicable federal long-term rate (AFR) at the time of the loan. If the loan rate were *less than* the AFR, the loan would have been a "gift loan" from the IRA to the church because the "forgoing of interest is in the nature of a gift." § 7872(f)(3). A gift-loan would be treated as a deemed transfer from the IRA to the church, which would of course result in immediate deemed income to the participant (equal to the "bargain" element of the loan on the date it was made), and a deemed charitable gift from the participant to the church. Thus realistically this deal should only be done if the applicable federal rate (or higher) is used for the loan.

C. What if participant doesn't die? Like all life insurance illustrations, the plan works great (for everybody except the participant) if the participant actually dies within 20 years. Maybe the church will get a windfall in that case, if the face amount of the policy exceeds the loan amount. I guess if the participant is already over 70 when the deal starts there are pretty good odds that he will die within 20 years. But what if the participant doesn't die? Where is the church supposed to get the money to pay back the principal to the IRA in 20 years? If the church defaults on the loan, the participant will have to foreclose on the policy. At that point, his IRA definitely will own the policy, thus disqualifying the IRA under § 408(a)(3) and causing an immediate income tax bill…not what someone likes to receive at age 90.

D. Church's annual obligation. Where does the church get the money to pay the loan interest and the insurance premium? Is there an "understanding" that the participant will contribute that much in cash each year to the church? What if he fails to do so? What if he doesn't like the new pastor and resigns from the church? I'm all for charitable gifts, but this amounts to a 20-year "marriage" and lots of marriages don't last that long.

E. Participant not a board member. In this PLR, the participant was neither a board member nor an employee of the church. If the participant later becomes a board member, will that invalidate his PLR? How useful is the Idea if the only person who can use it is someone who is *not* a board member of the charity? Isn't the person who is most likely to be interested in this type of deal also most likely to be someone involved in the governance of the charity?

F. Prohibited transaction analysis limited. In 2007 (when this PLR was issued), the IRS was not very expert on prohibited transactions (PTs). In this PLR, they appeared to analyze only whether there was a "direct" PT (transaction between the IRA and a disqualified person (DQP)). They did not discuss whether there was an "indirect" PT (IRA transaction that *benefits* a DQP). Although there does not appear to be any indirect benefit to a disqualified person in the PLR, that question should at least have been analyzed. For the record, the IRS's PT expertise seems to be growing; see, *e.g.*, the *Ellis* case discussed at Idea #72.

Where to read more: For an article about the PLR, see "Briefing: Breakthrough to Benefit Charities," *Trusts & Estates* Nov. 2007 page 14. Regarding IRAs and prohibited transactions, see ¶ 8.1.06 of *Life and Death Planning for Retirement Benefits* or the author's *Special Report: Buyer Beware! Self-Directed IRAs and Prohibited Transactions*, downloadable at www.ataxplan.com.

65. **BEST: Three good reasons to buy life insurance in a QRP.** If the participant is rated or uninsurable, he may be eligible for group policies through his retirement plan that can be obtained without evidence of insurability. Even if he is insurable, the plan may be eligible to buy insurance at a lower cost than he can get outside the plan. Finally, if the participant is a business owner with an overfunded defined benefit pension plan, it may be possible to absorb some of the excess funds by adding an insured death benefit to the plan.

Where to read more: Regarding the last reason, see the article "Fully Insured 412(i) Pension Plans Offer Simplicity and Low Risk," by John J. McFadden and Stephan R. Leimberg, *Estate Planning*, April 2003, Vol. 30, No. 4, Pg. 155.

66. **WORST: Buy life insurance inside a business entity owned by an IRA without getting a PLR or DOL advisory opinion or doing your own research.** This Idea supposedly enables the client to have his IRA indirectly buy life insurance. Essentially, the IRA contributes its assets to a family partnership (FLP) or limited liability company (LLC) and the entity buys the insurance. Under § 408(a)(3), an IRA is prohibited from investing in life insurance. Although there are numerous "look-through" rules that apply to IRA-owned entities for purposes of the "prohibited transaction" rules and unrelated business taxable income (UBTI), the IRS has never spelled out any look-through rule for purposes of § 408(a)(3). I consider this a "worst" idea because if it becomes widespread or publicized the IRS or a court is bound to apply a look-through rule to IRAs for purposes of § 408(a)(3). However, if the client wants to proceed with the idea, the practitioner should either demand a guarantee of the results from the company that is promoting them, or get a private letter ruling confirming them.

Where to read more: The leading article supporting this type of arrangement is "Purchasing Insurance Inside a Qualified Plan," by Andrew J. Willms, Esq., published in Steve Leimberg's Employee Benefits and Retirement Planning Newsletter 11/21/2002 (or other articles by Mr. Willms). To find the article, go to LeimbergServices.com and search under "Willms." While Willms's article deals primarily with QRPs, he also states that "in my opinion, an IRA may participate" in the recommended type of family partnership. Regarding life insurance and retirement plans, see the Natalie B. Choate *Special Report: When Insurance Products Meet Retirement Plans*, downloadable at www.ataxplan.com.

67. **WORST: Have your IRA contribute its assets to a not-wholly-owned FLP or LLC without getting a PLR or advisory opinion or doing your own research.** The idea here is to get, for the client's assets *inside* a retirement plan, the same valuation discounts (for estate tax purposes) that clients get for their assets *outside* a retirement plan, by contributing assets to an FLP or LLC. The idea is that the IRA custodian contributes the IRA assets to a family limited partnership managed by the account owner and his spouse as general partners (owning 1% each). The IRA receives limited partnership units representing a 98 percent interest in the partnership. Then, when the custodian makes required distributions to the IRA owner (§ 401(a)(9)), the custodian distributes limited partnership units rather than cash. The values of the limited partnership units are discounted for lack of marketability, lack of control, etc., so assets are moved out of the plan for a lower income tax cost. The required distributions will be smaller than they would have been without the existence of the entity, because the required distributions are computed as a percentage of the total value of the IRA which is allegedly less because of the valuation discounts, resulting in lower income taxes for the IRA owner (and eventually lower estate taxes).

The arguments supporting the validity of this transaction (and supporting the idea that it does not involve a "prohibited transaction") are based on certain precedents, such as *Swanson v. Comm'r*, 106 T.C. 76 (1996). These arguments are not necessarily wrong, but the questions are far from settled. If important tax results are to be based on these arguments, then the practitioner should get a private letter ruling confirming them. At the very least, do your own research.

Where to read more: This is discussed in "Estate Planning Strategies for Clients with Large IRA Assets," by Brooks J. Holcomb, *Probate and Property* (the Journal of the American Bar Association Real Property, Probate and Trust Law Committee), May/June 2002, 16-JUN Prob. & Prop. 41, published by the American Bar Association and Westlaw. Regarding IRAs and prohibited transactions, see ¶ 8.1.06 of *Life and Death Planning for Retirement Benefits* or the author's *Special Report: Buyer Beware! Self-Directed IRAs and Prohibited Transactions*, downloadable at www.ataxplan.com.

68. **BEST say some (but with RMD drawbacks): Buy a 10-year fixed annuity in your IRA, invest the rest of the account for long-term growth.** The INVESTMENT idea here is that, by providing yourself with a secure stream of income for 10 years (with the annuity contract), you free up the rest of your IRA portfolio to make riskier investments appropriate for a longer time horizon. The RMD regulations have a rule about what happens when part of an IRA is used to buy an immediate annuity: Beginning the year AFTER the purchase, the IRA and the annuity contract are considered separate plans for RMD purposes. For the annuity contract, the annuity payments themselves are "the RMD." For the rest of the account, RMDs are determined in the usual way, based on the prior year-end account value (exclusive of the value of the annuity) divided by the applicable factor. Thus, an individual who is over age 70½ and using this strategy will have to continue taking RMDs from the "long-term aggressive" portion of his portfolio, in addition to receiving the annuity payments, and will have higher taxable income (and lower plan balance) than he might have expected.

Where to read more: See the Natalie B. Choate *Special Report: When Insurance Products Meet Retirement Plans*, downloadable at www.ataxplan.com regarding the RMD rules for an IRA that is annuitized. This material is already incorporated into the e-book edition of *Life and Death Planning for Retirement Benefits* (7th ed. 2011) (www.retirementbenefitsplanning.com).

69. **BEST: Buy a "qualified longevity annuity" (QLAC) inside your IRA.** Many retirees are worried about running out of money in their later years. One solution is to hoard money and spend less today because you *might* live well beyond the "average" life expectancy. The problem with that solution is that it causes *everyone* to live below their possible standard of living even though only some people will actually live long enough to have the problem. The insurance industry's solution: Buy an annuity now, for a lump sum payment that is relatively small while you are only in your 50s or 60s, that doesn't start paying out to you until you reach age 85. This enables you to spend a realistic amount each year during your "young old years" based on your "average" life expectancy without worrying that you will run out of money if you live too long. The minimum distribution rules for "annuitized" IRAs normally

require that the payments under the annuity begin no later than the required beginning date (roughly age 70½). The IRS changed the rule on this effective 7/2/14 to the extent of allowing "qualified longevity annuities" (QLACs) to be purchased inside an IRA. A QLAC provides a level payment annuity beginning no later than age 85, has no cash surrender value, and can provide only limited types of death benefits (such as a return of premium guarantee, or a survivor annuity, but not both). The most that can be spent on a QLAC is the lesser of $125,000 or 25 percent of the participant's traditional IRA balances. (These limits don't apply to Roth IRAs which can purchase longevity annuities without restriction.) The value of the QLAC is excluded from the account balance for purposes of determining the participant's RMDs; thus, an individual with a large IRA who is approach age 70½ may wish to buy a QLAC not only for more income in old age but also to slightly reduce RMDs in the near term. Of course the QLAC payments will be *added to* his RMDs starting at age 85.

Where to read more: See Regs. § 1.401(a)(9)-5, A-3, and § 1.401(a)(9)-6, A-17. See Reg. § 1.401(a)(9)-6 and the Natalie Choate *Special Report: When Insurance Products Meet Retirement Plans*, downloadable at www.ataxplan.com (already included in the e-book edition of *Life and Death Planning for Retirement Benefits*; see www.retirementbenefitsplanning.com).

## E. MINIMIZE TAXES AND PENALTIES ON YOUR RETIREMENT BENEFITS

Retirement benefits are a sitting duck for estate and income taxes. The participant cannot give away pieces of the retirement plan to reduce his future estate taxes (unless he first takes the money out of the plan and pays income tax on the distribution). Furthermore, when the participant reaches age 70½, he will have to start taking RMDs computed on the entire bloated value of his plan. Participants and advisers are searching for the holy grail: how to reduce that swollen value for purposes of computing future RMDs and estate taxes (without reducing the benefits that flow to the participant and his family)?

Here are planning ideas that have been proposed on this topic. These Ideas must be approached with caution, especially if the promoter of the Idea (1) will gain a commission or other remuneration from the transaction and (2) does not propose to guarantee the tax results that he tells you are the main attraction of the Idea. See also Idea #67.

This section also contains Ideas for minimizing the threat of IRA penalties and audits.

70. **WORST: Take a valuation discount for built-in income taxes.** It has been suggested that the value of a retirement benefit should be discounted because the asset is subject to unpaid income taxes. The proponents of this theory assert that a "willing buyer" would pay less for a retirement plan benefit because subsequent distributions from the retirement plan or IRA to the willing buyer would be taxable. Although § 2053 allows an estate tax deduction for debts, expenses and taxes, it specifically provides that "Any income taxes on income received after the death of the decedent...shall not be deductible under this section." § 2053(c)(1)(B). However, the proponents of this theory believe that the taxes you are specifically prohibited from deducting by one Code section can nevertheless be deducted under another Code section, as part of the valuation process.

This belief is erroneous. Even if the owner of a retirement plan benefit could assign the benefit to a buyer, the owner could not assign the built-in income tax liability. The retirement plan owner typically has a zero basis in the benefit. For example, if the owner of an IRA "sells" his IRA, the IRA is "deemed" distributed to him and he immediately realizes income. Reg. § 1.408-4(a)(2). The "willing buyer" then has a basis equal to what he paid for the benefit, so the willing buyer can liquidate the entire benefit immediately with no income tax whatsoever (except to the extent he receives more from the plan than he paid for it). If the sale of the retirement benefit occurs after the death of the original owner, the seller's recognition of income upon sale is mandated by § 691(a)(2) (recognition of income upon assignment of the right-to-receive income in respect of a decedent).

Cases recognizing a discount for future income taxes in the *valuation of corporate stock* have no relevance to the *valuation of a retirement plan benefit*. If a willing buyer buys a share of corporate stock, and the corporation owns appreciated assets, the buyer gets a basis *in the stock* equal to his purchase price for the stock—but does not get to "step up" the *corporation*'s basis for *the assets held inside the corporation*. Thus, when the corporation eventually sells those assets, the corporation will have to pay part of the sale proceeds to the IRS in the form of corporate income taxes. In buying stock of an entity that owns appreciated assets, the buyer is taking the assets subject to this built-in debt to the IRS, similar to taking assets subject to a mortgage. The buyer of the stock will take that built-in tax liability into account in figuring how much the stock is worth, especially if the buyer expects the corporation to sell the appreciated assets. This "willing buyer" discount is recognized for estate tax valuation purposes. *Estate of Jameson v. Comm'r*, 267 F. 3rd 366 (5th Cir., 2001).

A retirement plan benefit, however, has no such built-in tax liability that can be taken over by the "willing buyer." Accordingly, taking a valuation discount on retirement benefits for built-in income taxes is not a defensible position. The IRS has confirmed its agreement with this conclusion in PLR 2002-47001. A U.S. District Court in Texas gave summary judgment to the IRS on this point in *Estate of Smith v. U.S.*, 93 AFTR 2d 2004-556 (1/16/2004).

<u>Where to read more</u>: Choate, N.B., "Estate Tax Valuation of Retirement Benefits: Selected Issues," *Trusts & Estates* magazine, Vol. 141, No. 5, p. 18 (May 2002), from which this Idea is excerpted.

71. **WORST: Buy life insurance in plan to reduce plan value ("Pension Rescue").** Insurance is sometimes purchased inside a retirement plan as a way of (temporarily, it is hoped) depressing the value of the retirement plan, in order to reduce income taxes. For at least the first few years of the policy's existence, the cash surrender value of a whole life insurance policy is typically less than the amount of the premiums paid to purchase the policy, due to the commissions and other up-front costs involved. Thus, the value of this plan asset is typically less than the value of other investments that could have been made with the same amount of money. When the policy value reaches a low point relative to what has been invested, the policy is distributed or sold to the participant. The distribution (or sale) transaction (often called the "rollout" of the policy) is less costly than it would have been had the plan invested in something other than life insurance, or had the plan distributed cash to the participant to enable him to buy the policy outside the plan. The expectation is that ultimately the death benefit paid under the policy to the participant's family will be worth the money spent on the policy. The essence of the tax-saving idea is that "the retirement plan

pays the acquisition costs of the life insurance, but without there being a taxable distribution."

Although the core idea is legitimate and makes perfect sense, it was unfortunately abused.

The general rule is that, when property is distributed to the employee by a qualified retirement plan, he must include the "fair market value" (FMV) of that property in his income. § 402(a). Before 2004, the regulations provided that, when the property distributed was a life insurance policy, the amount includible in the employee's income was the policy's cash surrender value (or, in some cases, the "policy reserves"). This valuation standard was abused, apparently. Agents and/or life insurance companies offered products with unrealistically low cash values, just to capture a low tax valuation upon distribution of the policy. The IRS criminally prosecuted a life insurance agent (Mr. Lichtig) in connection with sales of this type of scheme, and has named Pension Rescue as a "listed transaction" (a status which triggers certain substantial mandatory penalties).

Under the post-2004 rules, the FMV rule applies to any transfer of a life insurance policy from the qualified plan, just as to other types of property distributed by a plan. Furthermore, "the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed) are included in determining the fair market value of the contract." Reg. § 1.402(a)-1(a)(1)(iii), as amended 8/29/2005. Rev. Proc. 2005-25, 2205-17 I.R.B. 962, provides guidelines (including a safe harbor formula) regarding how to determine a policy's FMV. Some insurance professionals welcomed the new rules as providing a safe harbor valuation system for insurance policies. The IRS has cracked down on this technique, by changing the rules regarding valuation (for purposes of computing the employee's gross income) of a life insurance policy that is distributed or sold to the employee or his beneficiaries by a qualified retirement plan.

My view: If the participant needs insurance, he is better off buying it outside the plan if at all possible. If he doesn't need insurance, he should not buy it just for the purpose of attempting to reduce the value of his plan.

Where to read more: See J. Maxey Sanderson, "Pension Rescue: Why it Makes Sense to Buy Life Insurance with Money Trapped Inside Retirement Plans," *Trusts & Estates*, Vol. 142, No. 5 (May 2003), p. 46, from which the quote at the end of the first paragraph was taken. The problems with buying life insurance in a plan as a way of reducing taxes were explained in Natalie B. Choate, "Life Insurance in the Retirement Plan: Understand the Drawbacks," *Trusts & Estates*, Vol. 142, No. 5 (May 2003), p. 50. The Natalie B. Choate *Special Report: When Insurance Products Meet Retirement Plans*, downloadable at www.ataxplan.com, explains the tax and other consequences of owning life insurance in a retirement plan for both participant and beneficiaries. Steve Leimberg's newsletters and articles are an excellent source of information regarding life insurance planning techniques (and abuses); see his LISI newsletters (see "Resources," page 10).

72. **BEST: Do not rely on IRS Publication 590 for tax advice.** *IRS Publication 590* (*IRAs*) for many years, including the 2005 and 2006 editions, warned that there would be a prohibited transaction (PT) if the IRA owner took "*unreasonable* compensation" from his IRA for his management services (emphasis added). That's certainly true...but don't be misled by that statement into thinking that it's perfectly ok to take *reasonable* compensation from your

IRA! The IRS successfully went after Mr. Ellis, and got his IRA disqualified, for the PT of taking compensation (for services as general manager) in the years 2005 and 2006 from the used car dealership he owned inside his IRA; there was no apparent claim that the compensation was *unreasonable*. (As of the 2013 edition *IRS Publication 590* has gone silent on the question of payment of compensation to the IRA owner.) Similarly, *IRS Publication 590* for many years (including the 2008 edition) stated unequivocally that the limit of "once-per-12-months" applicable to IRA rollovers (see Idea #49) only applies to a purported second rollover if it will involve one or both of the same IRAs involved in the first rollover....the IRS has even ruled favorably (allowed a second rollover within 12 months) as long as the two rollovers involved different accounts; see PLR 2013-48017. Notwithstanding that statement and such PLR, however, the IRS successfully went after Mr. Bobrow (and denied tax-free rollover treatment for his attempted second rollover) for attempting to do IRA-to-IRA rollovers with respect to more than one distribution received within the same 12-month period...even though such would-be rollover distribution came from a different IRA that was not involved in the first rollover! So always remember: The IRS guys who are out there collecting taxes don't talk to the IRS guys who write *IRS Publication 590*!

Where to read more: *Ellis v. Comm'r*, T.C. Memo 2013-245, docket No. 12960-1 (10/29/13). *Alvan L. Bobrow, et ux. V. Comm'r*, TC Memo 2014-21 (1/28/14).

73. **WORST: Place IRA assets in a Restricted Management Account.** Some practitioners argue that an investment manager should be hired for a fixed term such as five years, rather than on the more customary at-will terms. An investment manager who knows he has a five-year time horizon will produce better investment results, the theory goes, because he will not have to focus on producing short-term quarter-by-quarter results. By promising your investment manager that you won't fire him for five years, and that you won't even LOOK at his investment returns until the five years are up, you will supposedly benefit from the superior investment results produced by a long-term investment horizon. Oh, incidentally, proponents argue, your account will be entitled to valuation discounts for estate and gift tax purposes because of the lack of marketability created by your restrictive contract with the investment manager. The proponents add that the RMA is a superior vehicle to other "discount" entities (such as the family limited partnership) because it requires fewer state law formalities and no business purpose.

A skeptic would suspect that RMAs are entered into only to obtain the supposed valuation discounts, not to obtain the supposed superior investment results. I would ask the investment manager these questions: Are you really saying that you invest most of your clients' money only to produce the best quarter-to-quarter results? Is it true that I must lock my money up for five years to get the benefit of your best investment wisdom? Is that what your advertising brochures say? Can you show me some portfolios that have and have not used RMAs, to demonstrate that the RMAs have had superior investment results? Can you show me two typical client portfolios, one that is subject to an RMA and one that isn't, and show me how they are invested differently? If the investment manager cannot show any difference between the investment processes, choices, and results applicable to RMAs and those applicable to other accounts, the entire argument (for both investment and tax results) falls apart. The articles that have appeared on RMAs do not address this point.

The IRS does not think RMAs "work" as value-reducers: "The fair market value of an interest in an RMA for gift and estate tax purposes is determined based on the fair market value of the assets held in the RMA without any reduction or discount to reflect restrictions imposed by the RMA agreement on the transfer of any part or all of the RMA or on the use of the assets held in the RMA." Rev. Rul. 2008-35, 2008-29 I.R.B. 116.

Where to read more: David A. Handler and David Sennett, "Avoid FLPs: Try restricted management accounts instead," *Trusts & Estates*, Vol. 142, No. 5 (May 2003), p. 30; Owen Fiore and David A. Handler, "FLPs vs. RMAs," *Trusts & Estates*, Vol. 142, No. 8 (Aug. 2003), p. 24; Randy A. Fox and Scott Hamilton, "Experts Discuss the Transfer Tax Benefits of Restricted Management Accounts Owned by FLPs," *Insights & Strategies*, Vol. 14, No. 5 (May 2003), p. 2**.**

74. **WORST: Leave IRA to CRT, have life beneficiaries sell their interest to the charity for capital gain treatment.** Mike Jones, CPA, is a brilliant and extremely knowledgeable expert on all aspects of taxation of retirement benefits, but I happen to disagree with him on this idea he's published. The idea is that you can convert the ordinary income of a retirement plan benefit into capital gain (for your beneficiaries) by leaving the benefits to a charitable remainder trust (CRT) for the life benefit of your children. Then your children sell their life interest to the remainder beneficiary (the charity). According to Rev. Rul. 72-243, 1972-1 C.B. 233, sale of a life interest in a trust results in capital gain income to the seller/life beneficiary, and this has been followed in several PLRs dealing with commutation of a CRT. However, there is no ruling yet where the CRT's assets consisted of IRD such as a retirement plan death benefit. I wouldn't recommend being the first to try it.

Where to read more: See Jones, Michael J., "A Brass Ring for IRD," 145 *Trusts & Estates* No. 2 (Feb. 2006), p. 20, also published under the title "Trading on Interests in Trusts Holding Unrealized IRD" in 107 *Tax Notes* 211 (April 11, 2005), p. 211.

75. **BEST: Protect your IRA and yourself with annual checkup, self-audit, and filing Form 5329!** The General Accounting Office reports that 1,100 American taxpayers owned IRAs valued in excess of $10 million as of 2011. How do the owners of the biggest IRAs pro-actively guard against potential IRA penalties and IRS audit threats?

   A. **BEST: Have an annual checkup for your IRA.** Every IRA deserves an annual checkup. The larger the account, the more important the checkup. The client, investment manager, estate planning or tax lawyer, IRA provider, and accountant should participate in the process—anyone with an interest in the financial health of this account. Subjects to discuss include: Review tax reports (such as Form 5498) that have been filed: Are they accurate and properly completed and timely filed? Start the draft of the current year's information returns (Forms 5498, 1099-R if applicable, 990-T if there is unrelated business taxable income). Assign responsibility for preparation, review, and filing of these forms. Compute then consider how and when to take this year's minimum required distribution if applicable. Consider whether there are any particular assets that should be distributed in kind—for example, to fulfill the RMD with an asset that is "undervalued" in the current market, or that could pose prohibited transaction concerns in the future. Consider any anticipated changes in the laws (for example the proposed "repeal" of the stretch payout) or other circumstances (such as a beneficiary who is coming of age) that should be planned for. Update prohibited transaction avoidance procedures. Consider how to pay applicable expenses. The idea is to manage all compliance issues and proactively plan for potential changes.

**B.** **Audit yourself!** Review and document the history of your IRA so you will be prepared in case the IRS asks any questions. If the IRA seems "unusually large," be prepared to explain and document how it got that way. If the IRA is a Roth, save the income tax return(s) for the year(s) in which conversions or contributions occurred, to demonstrate that the IRA owner was eligible to do that conversion or contribution and that any conversion was properly reported on Form 1040 or 1041. If you are claiming basis (after-tax money) in your IRA, preserve the evidence regarding how the basis was established–for example, find and keep handy all of the participant's Forms 8606. 8606 is the tax form (filed with Form 1040) that tracks the amount of after-tax money in the participant's IRAs. Though generally one does not need to keep copies of income tax returns beyond the standard three or six year statute of limitations, IRAs depend for their "fiscal health" on actions that took place in prior years, regardless of whether the "normal" statute of limitations has run with respect to those years.

**C.** **BEST: File form 5329 every year.** Form 5329 must be filed for any year that you owe an IRA-related penalty. That's the form you use to report missed required minimum distributions (50% penalty), premature distributions (10% penalty), and excess contributions (6% penalty). So why should you file it even if you believe you do NOT owe any penalty? Because the statute of limitations with respect to these "excise taxes" does not start to run until you file a return…and the Tax Court has held that Form 5329 is the form that must be filed to start the statute running! It is not enough to file your regular income tax return (Form 1040), with a "zero" or blank entry on the line for IRA-related penalties. If you don't file form 5329, the IRS could come after you 20 years from now and say you didn't calculate your minimum distribution correctly so you owe a 50% penalty, or your rollover contribution was not done correctly so it was actually an invalid rollover combined with an excess IRA contribution and you owe a cumulative annual 6% penalty for that plus a 10% premature distribution penalty for the year of the failed rollover!

Where to read more: Regarding the statute of limitations and Form 5329, see *Paschall, Robert, et ux.*, 137 TC 8 (2011).

76. **BEST: Use distributions or Roth conversions to keep income level and low.** Income tax rates increased smartly in 2013, as the "Bush era" tax cuts expired and new taxes kicked in. The top federal income tax bracket of 35% (as of 2012) increased to 39.6% (for 2013–2017) on income over $450,000 (for married filing jointly; $400,000 for singles; $12,150 (as of 2014) for trusts). Qualified dividends were taxed at 20 percent for high-income taxpayers (the 15% rate is reserved for lower incomes) (with income thresholds the same as for the 39.6% tax rate). A new 3.8% additional income tax on "net investment income" and compensation of individuals making more than $250,000/year ($200,000 for singles, $12,150 for trusts) was added. § 1411. Despite the sharply higher tax rates on "high income," there has no restoration of "income averaging." Trump-era changes reduced the top rate to 37%—but the 3.8% NIIT is still there (along with a now-weakened AMT)—and the system of itemized/standard deductions has radically changed. These changes put a premium on the ability to keep income *level* and *low*. IRA distributions are not subject to the 3.8% additional income tax, but an IRA distribution does count towards the income threshold, so a large IRA distribution can cause the individual's other income to be subject to the 3.8% additional tax. Taking larger-than-required IRA distributions (or better yet using a Roth conversion) in lower-income years may smooth out income enough to avoid hitting top bracket and/or 3.8% additional tax level in other years.

## F. WAYS TO ACCESS BENEFITS BEFORE RETIREMENT

See also Idea #48 (the "60-day loan from your IRA") and Ideas #40 and #61.

77. **BEST: Take a loan.** Your 401(k), profit sharing, or other employer qualified plan may permit employee loans. Such loans are subject to strict rules. For example, the maximum loan amount is $50,000 (less, if your vested balance is under $100,000), and the loan must be repaid within five years. If you need to borrow money, a plan loan is a good deal, because you are paying interest to yourself instead of a bank. However, you cannot borrow from your IRA or Roth IRA; such a loan would disqualify the entire account.

Where to read more: Regarding plan loans, see § 72(p) and Chapter 14 of *The Pension Answer Book*, by Stephen J. Krass, Esq. (see "Resources," page 10).

78. **BEST: Use Series of Substantially Equal Periodic Payments (SOSEPP) to take penalty-free pre-age-59½ distributions.** A client younger than age 59½ can take a series of substantially equal periodic payments (SOSEPP) from his IRA. § 72(t)(2)(A)(iv). Provided the series is constructed in compliance with IRS rules set forth in Rev. Rul. 2002-62, 2002-42 I.R.B. 710, and provided the client does not "modify" the series (by increasing, decreasing, or skipping payments, or by transferring funds into or out of the IRA(s) supporting the series) prior to reaching age 59½ (or within five years of the first series

payment, whichever comes later), the payments will be free of the 10 percent penalty (though still subject to income tax).

An actuary or other expert should be hired to help design the series. Ideally, the series should be constructed using one IRA that contains only part of the client's retirement benefits, with the rest of his benefits left in another IRA that will not be subject to the no-modifications rule applicable to the IRA supporting the SOSEPP. Then this other IRA can later be used for a second SOSEPP, or for other distributions, without the necessity of "modifying" the first SOSEPP. If (as is unfortunately often the case) the client must use all of his IRA in order to generate a large enough SOSEPP to support the financial need, still consider setting up multiple concurrent SOSEPPs using multiple IRAs; that way, if further financial problems strike, the client can take extra distributions from one of the IRAs (thus "busting the SOSEPP" with respect to that IRA) without busting ALL of his/her SOSEPPs. A SOSEPP can be used to finance early retirement, an estate tax-reducing gift program (Idea #24) or purchase of life insurance, or to balance assets between in-plan and out-of-plan assets (Idea #23).

<u>Where to read more</u>: ¶ 9.2 and ¶ 9.3 of *Life and Death Planning for Retirement Benefits* explain SOSEPPs in detail, including the three IRS-approved methods of calculating the payments, and what constitutes a forbidden modification of the series.

79. **BEST: Take a corrective distribution.** "Louie" loses his job unexpectedly in July of 2014. Suddenly he's not as wealthy as he thought, money is tight, and every penny counts. He does not feel he can afford to make an IRA contribution this year after all—but he already made one! Fortunately for Louie, the Tax Code allows him to change his mind about an IRA contribution at any time up until the "extended due date" of his income tax return for the year of the contribution. Suppose Louie contributed \$5,000 to his traditional IRA in 2013 (for the year 2013) and contributed \$5,500 in early 2014 (for the year 2014). Assuming his 2013 income tax return is timely filed, he can withdraw the 2013 contribution any time up until October 15, 2014, and can withdraw the 2014 contribution until October 15, 2015. A "corrective distribution" is not taxable (of course the IRA contribution being withdrawn cannot be deducted). There is one wrinkle—the "earnings" on each contribution must be withdrawn along with the contribution, and the "earnings" are taxable (and subject to the 10% premature distributions penalty, if Louie is under age 59½ and no exception applies). But here is a ready source of \$10,500 of cash, which could be a big help to Louie.

<u>Where to read more</u>: For details on the requirements and tax treatment of "corrective distributions," see ¶ 2.1.08 of *Life and Death Planning for Retirement Benefits*.

80. **BEST: Take a distribution.** If you really need money you may just have to take a distribution from one of your retirement accounts. Which one? Read on:

Even if you haven't met the requirements for "retirement," you can withdraw money from an IRA or Roth IRA, or some profit sharing plans. 401(k) plans can permit distributions in case of hardship or after age 59½. After 2006, even defined benefit and other pension plans are permitted to make pre-retirement distributions to workers age 62 and older. § 401(a)(36). Ideally you want a distribution that is nontaxable and not subject to the 10 percent penalty on "premature distributions" generally applicable to distributions prior to age 59½ (§ 72(t)). Here are angles to play to minimize taxes on your distribution:

A. Income tax. All distributions from your *Roth IRA* are free of income tax if you are over 59½ (or disabled) and you've had a Roth IRA for five years or more. Even if your Roth IRA is less than five years old, or you are under age 59½ and not disabled, you can withdraw everything *you* contributed to a Roth IRA free of income tax. That applies to both "regular" contributions and "rollover" (conversion) contributions. Regarding a traditional retirement plan, see Idea #40 for how to access the after-tax money first. Finally, even if the distribution you propose to take is not income tax-free, the tax may be very low if you have little income (because you are unemployed for example).

B. 10% premature distributions penalty. An individual who is younger than age 59½ generally is subject to a 10 percent "penalty" ("additional tax" or "excise tax") on all retirement plan distributions he/she receives. But: Distributions that are income tax-free [*e.g.,* the return of Roth IRA contributions] are also penalty-free, with one exception: A distribution that comes from an amount that was converted to a Roth within less than five years is subject to the penalty even though not subject to income tax (see ¶ 5.5.02 of *Life and Death Planning for Retirement Benefits* for details on that). How can you avoid the penalty? Individuals who are *over age 59½* can typically take a distribution any time from their IRAs and be subject only to income tax. In the case of a qualified plan, an employee who separates from service in or after the year he reaches age 55 can take money from that employer's plan without penalty even before age 59½ (see Idea #31). Distributions from an *inherited plan or IRA* are always penalty-free, even if the beneficiary is younger than age 59½ or the decedent died before age 59½. There are at least 14 statutory exceptions to the 10 percent penalty on pre-age 59½ distributions; for example, IRA distributions are penalty-exempt to the extent they can be matched with certain types of medical and education expenses incurred in the same year. Suppose Marge, age 45, is forced by financial necessity to withdraw $25,000 from her IRA. Even if she can't exempt all of it from the penalty, it is worth looking carefully to see if she incurred any medical or education expenses in the distribution year that could be used to shelter part of her distribution from the penalty. But remember, every penalty exception has detailed requirements. For example, some apply only to IRAs (such as health insurance premiums for the unemployed, § 72(t)(2)(D), and distributions for higher education expenses, § 72(t)(2)(E)) and some only to QRPs (such as separation from service after age 55, § 72(t)(2)(A)(v), Idea #31). If seeking to rely on any exception, read the Code and other sources very carefully. The IRS and courts are rigid in applying the exceptions and do not accept sad stories or near misses. Finally, in some cases the individual has no income taxes at all (because he/she has no income) and the 10 percent penalty may seem like a small price to pay for taking the needed distribution.

<u>Where to read more</u>: Chapter 9 of *Life and Death Planning for Retirement Benefits* explains most of the exceptions to the 10 percent penalty on pre-age-59½ distributions.

81. **WORST: Borrow from, or sell assets to, your plan.** Except for permitted plan loans (Idea #77), these are "prohibited transactions" which would result in disqualification (IRAs) or severe penalties (other plans). These are prohibited even if done *indirectly*, by dealing with an LLC or other entity *owned by* your plan, rather than with the plan itself. However, if what you propose is a "good deal" for your retirement plan (such as selling an asset to your plan for a fair price and terms), you may be able to get a "prohibited transaction exemption" from the Department of Labor. Congress has authorized the DOL to exempt transactions that are in the best interests of the plan and the plan participants.

<u>Where to read more</u>: See ¶ 8.1.06 of *Life and Death Planning for Retirement Benefits* regarding the prohibited transaction rules applicable to IRAs. See also Chapter 24 of *The Pension Answer Book*, by Stephen J. Krass, Esq. (see "Resources," page 10).

## G. ROTH PLANNING IDEAS

Here are Ideas regarding whether, when, why, and how to convert or contribute to a Roth IRA or other Roth retirement plan, or why NOT to do so, plus Ideas on investing or otherwise maximizing the value of a Roth plan. See also Ideas #42, #43, #111, #137, #147, #181, and #202.

82. **BEST: After retiring, before age 70½, do partial Roth IRA conversions each year, to use up lower income tax brackets.** This is an idea for the individual who retired after age 59½, has not yet reached age 70½, and has a substantial IRA; whose income dropped significantly following retirement; and who is living comfortably on his Social Security benefits or other small taxable income. This person is now, for the first time in his life, in a very low tax bracket, and is thrilled about that fact. But in a few years, when he turns 70½, he will be in a high tax bracket again, when the RMD rules start forcing distributions out of his IRA. He will not be happy when his taxable income skyrockets once RMDs start at age 70½. Now is the time to blunt the future force of RMDs (and take advantage of the low income tax brackets) by doing partial Roth IRA conversions each year.

83. **BEST: Other reasons to contribute or convert to a Roth IRA.** Here are other reasons why a participant SHOULD contribute or convert to a Roth IRA, or contribute to a designated Roth account under his company's cash-or-deferred plan. See also Idea #96.

A. Zero tax bracket. If you can duck the "pay tax now or later?" question by not paying taxes *either* when the money goes into the Roth plan *or* when it comes out, then you can get the advantages of a Roth retirement plan "free." That deal is irresistible. An otherwise eligible individual can get that deal if he is in a zero tax bracket (due, for example, to a net operating loss from a business); or in some cases by converting only after-tax money (see Ideas #41 and #86).

B. Low tax bracket/AMT/excess deductions. Generally a Roth conversion will be a good deal if the income tax paid on the conversion is less than the income tax you WOULD have had to pay on the same dollars if left in the traditional IRA and withdrawn at a later date. In other words, if your tax bracket is expected to be HIGHER in the future, consider a Roth conversion NOW if it can be done at a lower bracket. Here are some people who would convert for this reason: Someone convinced that income tax rates must go up in the future to finance the retirement of poverty-stricken aging baby boomers will want to pay taxes at today's "cheap" rate and get it over with by converting to a Roth. Someone subject to AMT is effectively taxed at a 26%/28% percent marginal rate, not the nominal highest top rate; if he thinks his rate will go up later, he should go Roth. Roth conversion can also be a good way to use up an excess charitable contribution carryforward that will otherwise expire unused. Finally, a husband and wife enjoying the benefits of "married filing jointly" tax status should consider what will happen when one of them dies; the surviving spouse may well jump into a much higher bracket when he/she has to file as "single"—especially if the annual income will probably continue to be about the same amount and/or one spouse is in very poor health right now.

C. Help your beneficiaries. See Idea #111.

D. Maximize inside-plan investments. Money can stay in a Roth IRA much longer than in a traditional IRA, because there are no distributions required until the participant's death (unlike with a traditional IRA which requires annual distributions starting at age 70½). Thus more tax-free compounding can occur in a Roth IRA during the owner's life than is possible with a traditional IRA. Also, since taxes on a Roth plan contribution can be paid with money that is not in a retirement plan, outside assets can in effect be used to increase the relative amount inside the retirement plan.

E. Diversification. A person with substantial funds accumulated in traditional retirement plans can hedge his bets by placing some funds in a Roth plan. See also Idea #23.

F. Minimize tax on Social Security benefits. See Idea #26.

G. Other reasons. "Ms. X" has her retirement income carefully projected for the next 10 years. If she needs extra cash, it would be nice to be able to take it out of a Roth plan tax-free so as not to upset the income tax projections. "Ms. Y" tends to spend all dollars not inside a retirement plan; by using her out-of-plan dollars to prepay the taxes on her IRA (by converting it to a Roth), she protects herself from overspending. The Wall Street Journal points out that paying taxes is easier when you're young and working than when you're old and retired, so do the "Roth" when you're young so you won't have the stress of paying taxes when you're old.

Where to read more: Regarding Roth IRA conversions, see ¶ 5.4 of *Life and Death Planning for Retirement Benefits*; regarding contributions to other types of Roth plans, see ¶ 5.3 and ¶ 5.7.02. For an excellent article analyzing six reasons why someone should contribute or convert to a Roth IRA, see Keebler, Robert S., and Bigge, Stephen J., "To Convert or Not to Convert, That is the Question," *Journal of Retirement Planning*, May–June 2007, p. 51 (posted at www.ataxplan.com).

84. **WORST: Reasons you should NOT convert or contribute to a Roth IRA.**

A. Distributions same date, same tax rate. There is no advantage to paying taxes earlier rather than later. If you take $A, pay income tax on it at B percent, deposit the net after-tax amount in a Roth IRA, earn an investment return of C percent and withdraw the accumulated funds ($D) on date E, the amount of money you will have ($D) will be *exactly the same* as if you had deposited $A in a traditional IRA, earned a return of C percent, withdrawn the accumulated funds on date E, and paid income tax on that distribution at B percent. For the Roth approach to *produce more dollars* than the traditional plan one or more of the factors in the equation must be different as between the Roth and traditional options.

B. Investments or tax rates decline. It would be a shame to pay income tax on today's stock values, only to find out later that this was the all-time market high. The Roth deal also turns bad if the benefits would be subject to income taxes at a substantially lower rate when they come out than the rate the participant paid when he contributed to the plan. Prepaying the income tax would also presumably turn out to be a bad deal if the federal income tax is replaced by a value-added tax. One adviser told me he won't "waste his money" paying income taxes now to convert his IRA to a tax-free Roth because he expects that retired baby boomers will eventually use their electoral clout to cause Congress to make *all* pensions wholly or largely tax-free; that reason seemed ridiculous to me when I heard it, but in the 2008 Presidential campaign both major-party candidates promoted the idea of making some or all retirement plan distributions tax-free.

C. Congress changes the rules. Congress could change the minimum distribution rules to require that all benefits be distributed within some much shorter period of time after the deaths of the participant and spouse. Some recent presidential budget proposals have included a provision to "kill" the stretch IRA and replace it with a five-year payout period applicable to most retirement plan death benefits and requiring Roth IRAs to pay RMDs just like other IRAs.

D. For the beneficiaries' sake? David Hulstrom recommends that clients leave their children traditional IRAs rather than Roth IRAs, if the client is concerned about the children squandering the money. The theory is that having to pay income tax on any distributions they take would be enough of a disincentive to keep the children from cashing out the plans, whereas they would have no such disincentive with a tax-free Roth. Another situation where NOT converting may help beneficiaries: Parent is a participant in a traditional qualified plan which he is going to leave to his children as beneficiaries. Parent has a shortened life expectancy; he wants the children to have a Roth IRA. Children are in a lower tax bracket than Parent. Parent leaves the children the traditional QRP so they can convert it to a Roth (see Ideas #28(C) and #96), rather than converting it pre-death at Parent's higher tax bracket.

E. You may need the money! Later in life, the participant may have medical and/or disability problems that cause him to have no compensation income but plenty of medical expenses. If medical expenses are high enough they are tax deductible (typically that is the case if the individual is living full time in a nursing home). The deduction can substantially reduce the tax on even large distributions from a traditional retirement plan. "We have seen a number of clients spend down relatively large IRAs during their last years 'tax-free' due to the medical expense deduction. Some of these clients would have run out of money during their lifetime if they had given away 35 percent [the maximum federal income tax rate at the time of this quote] of the value of their IRAs by converting to a Roth," said Alan S. Gassman, Esq., *et al.*, in "One Good Reason Not to Do a Roth Conversion," *Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter* (see "Resources," page 10), Archive Message #549, 11/10/2010.

85. **BEST: Roll directly from qualified plan to Roth IRA.** Since 2008, it has been possible to contribute to a Roth IRA by direct rollover from a qualified retirement plan (QRP). § 408A(e). Prior to 2008, if you wanted to roll money from (say) a 401(k) plan to a Roth IRA, you first had to roll the money into a traditional IRA, then convert the traditional IRA to a Roth IRA. Suppose you have after-tax money inside your QRP, and you also own one or more traditional IRAs. By converting your entire QRP balance *directly* from the plan to a Roth IRA, the proportion of the conversion that will be tax-free is: [after-tax money in your QRP account]/[total value of your QRP account]. In contrast, if you first roll the money from the QRP to your traditional IRA, then convert all or part of your traditional IRA to a Roth IRA, the proportion that will be tax-free is only [after-tax money in *all* of your traditional IRAs]/[combined total value of *all* your traditional IRAs] (also known as the "cream-in-the-coffee rule"; see Idea #88). Thus, the direct plan-to-Roth-IRA rollover will facilitate less-

expensive Roth IRA conversions for some people. See also Ideas #90 ("in-plan" Roth conversions) and #86.

86. **BEST: When retiring, request the plan administrator of the employer's qualified retirement plan to send a direct rollover of all pretax money in your account to a traditional IRA and a direct rollover of the after-tax money to a Roth IRA.** Though the merits of paying taxes now to create a forever-tax-free Roth IRA can be endlessly debated (see Ideas #83–#84), *tax-free* Roth IRA conversions are *always* good. In 2008 and later years, an individual can roll an eligible rollover distribution directly from a QRP to a Roth IRA (see preceding Idea). Can an individual who has after-tax money in his QRP use this provision to "cherry pick" and convert *only* the after-tax money, if he wants to do a tax-free Roth IRA conversion? In some cases YES, according to a 2014 IRS pronouncement.

This is one more variation of the holy grail of doing a tax-free Roth conversion by isolating basis (see, *e.g.*, Idea #41). The participant has after-tax money in a qualified plan, and wants to convert ONLY that after-tax money to a Roth IRA. Although at one time the IRS did NOT approve of these split direct rollovers (see IRS Notice 2009-68, in which the IRS said each transmission to a distinct IRA would be treated as a "separate plan distribution"), they have now specifically blessed this method of sending the after-tax money tax-free to a Roth IRA and the pretax money tax-free to a traditional IRA, provided it is all part of the same distribution event.

<u>Where to read more</u>: See IRS Notice 2014-54, 2014-41 IRB (9/18/14) regarding "rules for allocating pretax and after-tax amounts among disbursements that are made to multiple destinations from a qualified plan," Example 4.

87. **WORST: Roll an LSD of NUA stock directly to a Roth IRA.** The idea: A retiring employee requests, from his employer's qualified plan, a lump sum distribution (LSD) that includes appreciated employer stock (see Idea #4). He directs that the LSD be rolled directly into a Roth IRA, as permitted by § 408A(e) (if he is eligible; see preceding two Ideas). The effect of this "Roth conversion" is that he is taxed as if he took the distribution outright, meaning that he will be liable for current tax on only the plan's "basis" in the stock. The NUA is transferred into the Roth IRA without current tax…and then it is NEVER taxed, assuming that later distributions from the Roth IRA are taken as tax-free qualified distributions! Based on the statute, this appears to work, <u>BUT the IRS says it will NOT work</u>. In Notice 2009-75, the IRS says this transaction will be taxed "as if": the LSD were transferred first to a traditional IRA; the hypothetical traditional IRA were the employee's only traditional IRA; and the hypothetical traditional IRA were then transferred to the Roth IRA. Result says the IRS: the entire transfer is taxable since there is no "NUA" deal for distributions either to or from a traditional IRA.

<u>Where to read more</u>: See Jones, Mike, "Do Roth IRA Conversions Offer a Brand-NUA Opportunity?," *Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter* (see "Resources," page 10), Archive Message #390, 11/1/2006.

88. **WORST: How not to do a tax-free Roth IRA conversion.** Here's another idea that does not work: Joe made a nondeductible contribution of $3,000 to a traditional IRA in Year 1. He also owns another traditional IRA, worth $200,000 (all pretax money). In Year 2 he decides to convert the small traditional IRA he created in Year 1 (now worth $3,100), on the theory that he will only have to pay tax on $100 if he converts this account because the balance of the account is after-tax money (*i.e.*, the nondeductible $3,000 contribution he made to this account in Year 1).

This does not work because of the "cream-in-the-coffee rule": *Generally,* all of an individual's traditional IRAs are *aggregated* for purposes of allocating his basis to distributions from any particular traditional IRA (including a distribution that is converted to a Roth IRA); and also, generally, any distribution (including a distribution that is converted to a Roth IRA) is deemed to come proportionately from the nontaxable and taxable portions of participant's aggregated IRAs (determined as of the end of the year). § 408(d)(2). Ed Slott, CPA (see "Resources," page 10) calls this the "cream-in-the-coffee rule," because every time you take a "sip" (distribution) from any one of your IRAs, the sip contains proportionate amounts of "coffee" (pretax money) and "cream" (after-tax money). (For exception to the cream-in-the-coffee rule, see Idea #40.)

So the $3,100 that Joe converts to a Roth is deemed to come proportionately from the aggregated total ($203,100) of all his IRAs, not just from the one account it actually came from. He will be taxed on ($200,100/$203,100) times $3,100, or $3,054, not on just $100 as he had hoped.

To do a tax-free Roth conversion, see Idea #41 instead of this Idea.

89. **BEST for some, WORST for others: Make nondeductible IRA contributions, then convert them "tax-free" to a Roth.** Client wants to have a Roth IRA. He is not eligible to make a "regular" (annual-type) contribution to a Roth IRA because his income is too high. He is eligible to make a nondeductible regular contribution of $5,500 to a traditional IRA. So he contributes $5,500 to a traditional IRA, then a month later converts it to a Roth. This Idea makes sense IF the client wants a Roth, and either: That's the only way he will have a retirement plan that he CAN convert to a Roth (for example, because he doesn't have a traditional IRA now that he could convert); or, even though he already has an IRA, he wants to convert absolutely as much as possible to a Roth, so he will convert the entire existing IRA plus these additional contributions. If the client *already has* a traditional IRA (or other traditional plan) that he can convert to a Roth, and the existing traditional IRA or plan contains more money than the amount he wants to convert, adding an after-tax annual contribution now will not improve his position to a meaningful degree; see Idea #88. This Idea #89 is sometime nicknamed a "back door Roth contribution." Is it legal? The Joint Committee on Taxation, in its report on the Tax Cuts and Jobs Act of 2017, favorably mentioned this idea *four times*! See the "Joint Explanatory Statement of the Committee of Conference," footnotes 268, 269, 276, and 277.

90. **BEST for some: In-plan Roth conversion.** With an "in-plan Roth rollover," certain participants in "cash or deferred" (salary reduction) plans (401(k), 403(b) and 457(b) plans) can effect a Roth conversion by having funds transferred from their traditional accounts in

the plan to a designated Roth account (DRAC) in the same plan. This can be a BEST idea for someone who wants to do a Roth conversion but has strong motivation to keep his money inside the employer's plan (usually because of creditor concerns, or because of investment options not available if the money moves outside of the employer plan, or because he is forbidden to take the money out of the plan prior to separation from service). It is also a great idea if the individual can make additional nondeductible contributions to the employer plan, because that gives the individual additional tax-free Roth conversion money.

Where to read more: see ¶ 5.7.11 of *Life and Death Planning for Retirement Benefits*. See § 402A(c)(4). IRS Notice 2010-84, 2010-51 (11/29/10) provides guidance on in-plan Roth rollovers.

91. **BEST: When taking an LSD of NUA stock, roll stock equal in value to the "plan basis" directly to an IRA, distribute only stock equal to the NUA value to taxpayer.** The client who is leaving his job and who has "NUA stock" (see Idea #4) should consider this possible tax-planning opportunity: Roll over (to a traditional IRA) enough of the stock to eliminate the taxable portion of the distribution altogether, while keeping the NUA stock "outside" for later long-term capital gain-eligible sale. This type of split rollover occurred in PLR 2011-44040 and the IRS did not object to it. The result seems correct under the Code: § 402(c)(2) clearly says that, if the employee receives a distribution from the plan, then rolls over only *part* of the distribution, the part rolled over is deemed to come first from the pretax money included in the distribution. See also Regs. § 1.402A-1, A-5(b), and § 1.402(c)-2, A-8; PLRs 8538062 and 9840041; and IRS Publication 575, *Pension and Annuity Income* (2013), p. 27, which says: "If you roll over only part of a distribution that includes both taxable and nontaxable amounts, the amount you roll is treated as coming first from the taxable part of the distribution." Despite this authority, some in the IRS assert this does not work.

92. **BEST tips for converting to a Roth IRA.** Here is a collection of tips for how to make your Roth conversion as pain-free and convenient as possible.

    **A.** **Take the RMD first!** In the year you attain 70½ (and all later years) you must take your IRA RMD prior to converting the rest of the account to a Roth IRA, because of the rules that (1) an RMD cannot be converted to a Roth IRA and (2) the first distribution in any year is deemed to come from the RMD. So if you convert your entire IRA without having taken out the RMD, you've in fact made a "regular" Roth IRA contribution (as opposed to a valid rollover/conversion contribution) to the extent of the RMD. This will in most cases be an "excess Roth IRA contribution" to the extent of the RMD you were supposed to keep out but didn't. Reg. § 1.408A-4, A-6. An excess IRA contribution is subject to a six percent cumulative annual penalty.

    **B.** **Opt out of withholding!** Remember to opt OUT of the 10 percent income tax withholding the IRA provider will otherwise apply to your Roth conversion.

C. **Minimize income in the conversion year!** Investigate ways to offset the taxable income generated by the Roth conversion. For example, make larger donations to a donor-advised charitable fund (DAF), generating a larger-than-normal charitable deduction to offset the conversion income (fund the DAF with appreciated stock for even more savings); then distribute from the DAF to your favorite charities gradually in later years. Or invest in depreciating assets that generate large deductions in the year of the initial investment.

D. **Update estate plan.** Name a beneficiary for your newly-created Roth IRA(s); see Idea #127. If your Roth IRA is not payable to exactly the same beneficiaries (in exactly the same proportions) as the rest of your estate, amend your will and/or beneficiary designation to provide your executor and other survivors with guidance regarding the recharacterization election.

93. **WORST, formerly BEST but complicated: Do separate Roth conversions for each asset or asset class.** When a participant converts his traditional IRA to a Roth IRA, the value of the converted IRA is included in his gross income. If the assets in the IRA then decline in value, the participant will regret having to pay income tax on the pre-decline value. Prior to 2018, the law allowed him a certain period of time to undo the conversion by recharacterizing the transaction as a nontaxable transfer to a traditional IRA. If only some of the assets in the converted IRA declined and others appreciated, and if he had transferred different assets or asset classes into separate Roth IRAs, he could recharacterize ("unconvert") just the Roth IRA(s) holding the assets or classes that declined in value, and leave the other Roth IRAs alone. Since recharacterization is not allowed for post-2017 Roth conversions as a result of TCJA, this idea is now obsolete.

<u>Where to read more</u>: Reg. § 1.408A-5, A-2(b), (c)(5), and (6), Example 2 is now obsolete.

94. **WORST: Buy puts and calls on the same stock in separate Roth IRAs, then recharacterize the loser.** This idea is now also obsolete as a result of the elimination of the ability to recharacterize Roth conversions, but unlike the preceding Idea this one never worked! Here was the Idea: An individual who is eligible to contribute to a Roth IRA establishes two Roth IRAs in Year 1, making nondeductible after-tax contributions of $1,000 to each. Company X stock is selling at $100 per share. Roth IRA No. 1 invests its $1,000 in an option to "put" stock of Company X at today's price. Roth IRA No. 2 invests its $1,000 in an option to "call" option Company X stock at today's price. The options will expire prior to the deadline for recharacterizing the Roth IRA contribution. If Company X stock has increased in value by the deadline, the put expires worthless, so the participant recharacterizes Roth IRA No. 1 as a traditional IRA; Roth IRA No. 2 has value, so it is allowed to stand. If Company X stock has declined in value by the deadline, the call option expires worthless, so the participant recharacterizes Roth IRA No. 2 as a traditional IRA; Roth IRA No. 1 has value, so it is allowed to stand. This Idea is a "Worst" not because it's somehow abusive or a shady tax dodge but rather because from an investment standpoint it

just plain doesn't work. First of all you're guaranteed to lose $1,000—one or the other of the options will definitely be worthless! Second, you might well lose *both* $1,000 contributions, for a total loss of $2,000; that would happen if Company X stock neither appreciates nor depreciates. In order for the participant to make money with this approach, Company X stock would have to gain or lose enough value so that the winning option doesn't just come out ahead, it comes out enough ahead to compensate for the guaranteed $1,000 loss on the other option. In short, while it's nice that the tax law gives us the ability, for a limited period of time, to recharacterize a Roth IRA contribution if the Roth IRA has declined in value during that time, there is still no advantage to losing money! Recharacterizing reduces the pain of the loss but it's still a loss!

95. **WORST and BEST ideas for converting variable annuity contract held in an IRA to a Roth IRA.** Converting an IRA to a Roth IRA is a taxable event, with the amount converted being includible in gross income just as a distribution would be. Once upon a time, if the asset that was "converted" or "rolled" from a traditional to a Roth IRA was a variable annuity contract, the amount that was taxable was the cash surrender value of the contract. This rule led to two planning ideas, one of which was abusive. The IRS reacted by issuing Temporary and Proposed Regulation § 1.408A-4, A-14, holding that for Roth IRA conversions on or after August 19, 2005 (and perhaps before that date also), the amount of gross income resulting from conversion of an IRA-owned annuity contract is the *fair market value* of the contract, not its cash surrender value. ALL features of the contract must be valued; the IRS may issue guidelines for how to value various features at a later date. Here are the planning ideas involving conversion of an IRA-owned variable annuity contract to a Roth IRA:

**A.** **The WORST version:** According to the IRS, some companies marketed, to IRA owners, specially-designed variable annuity contracts with temporary high surrender charges. The surrender charges artificially lowered the cash surrender value, to reduce taxes on converting that IRA to a Roth IRA. The IRS has labeled this practice as abusive, and the new valuation rule should put an end to it.

**B.** **The BEST version** is a little more complicated. Some insurance companies offer variable annuity contracts with a guaranteed death benefit equal to either the purchase price of the contract or (if higher) the contract's cash value as of any anniversary date. These are nicknamed "high-water mark contracts." The anniversary values on some contracts got very high. When there is a substantial market decline, contracts with anniversary-value death benefit guarantees based on pre-crash market levels became a valuable asset for the customer (and a nightmare for the issuer). Furthermore, some such contracts permitted the holder to strip out virtually all the cash value while leaving the excess death-benefit value intact. Someone holding such a contract in his IRA can strip out the cash value, place the stub contract in a separate IRA, then convert that separate IRA to a Roth. Under the new regulation, he will have to value the death benefit fairly and pay income tax on that value, but it may still be worthwhile, since it does allow the beneficiaries ultimately to collect the high death benefit income tax-free as a "qualified Roth IRA distribution" when the participant later dies. This planning idea is self-limiting, since (I believe) insurance companies no longer issue contracts that allow the owner to strip out the cash value while leaving the death benefit intact. Furthermore, no one would deliberately seek out this situation, buying an annuity in the hopes that the cash value would skyrocket, then crash, leaving a high death benefit with a low cash value, so this Idea is not subject to abuse.

96. **BEST, for some beneficiaries: Convert inherited QRP to inherited Roth IRA.** Under IRS Notice 2008-30, the nonspouse designated beneficiary of an inherited traditional QRP (such as a 401(k) plan) can direct the QRP to transfer all or part of the inherited plan balance directly to an "inherited" Roth IRA (which is actually not inherited—it's opened after the participant died—but it's titled as an inherited account). This type of conversion may be relatively inexpensive if there is after-tax money in the inherited plan (see Idea #86) or if there is a substantial IRD deduction associated with the inherited plan (see Ideas #183–184). Ideally, the beneficiary should be able to pay the income tax on the conversion out of other assets. If an individual named as beneficiary can afford to convert his own IRA, or the inherited plan, but not both, to Roth status, he should probably convert his own IRA rather than the inherited plan. The inherited plan will enjoy less potential tax-free accumulation since it must be entirely distributed over the beneficiary's single life expectancy; distributions from the beneficiary's *own* Roth IRA can be deferred until after the beneficiary's death, and then paid out over the life expectancy of the beneficiary's beneficiary. The availability of this Roth conversion option for beneficiaries may be a reason for a participant who is leaving his QRP benefits to a nonspouse beneficiary to leave the benefits in the QRP rather than rolling them over to a traditional IRA; a beneficiary still is <u>not</u> permitted to convert an *inherited* IRA to an inherited Roth IRA. See Ideas #28(C) and #181.

<u>Where to read more</u>: See IRS Notice 2008-30, 2008-12 I.R.B. 638. Regarding the IRD deduction, see ¶ 4.6.04–¶ 4.6.08 of *Life and Death Planning for Retirement Benefits*.

97. **WORST: Give $6,500 to an "old person" to set up a Roth IRA.** If you would like to make a "regular" (annual-type) contribution to a Roth IRA from your compensation income, but your income is so high you are ineligible; or maybe even if you have already maxed out your Roth IRA contributions and you want yet another Roth IRA; some advisers suggest that you can get your wish by turning $6,500 over to someone who is very old (and thus likely to die before you reach retirement age) and who would like to benefit you as part of his/her estate plan. $6,500 is the maximum IRA contribution for 2018 for an elderly person ($5,500 base plus $1,000 catch-up for participant age 50 or older). Your donee will then use the money to establish a Roth IRA and name you as beneficiary.

This is a worst idea if: the donee's estate will be subject to estate taxes which will be increased by this Roth IRA you are giving him/her; or if the donee has no compensation income (and so is ineligible to contribute to any IRA); or if you put legal restrictions on the "donee" to protect yourself (making it a sham transaction and a fraud); or if there is risk that the donee will lose the money to creditors, medical expenses, or nursing home expenses; or if there is a risk the donee will surprise you and leave the money to someone else, forget to fill out the beneficiary designation form, or just spend the money him/herself.

So we are probably talking about an idea that is realistic only for the following situation: Parent is still working (so he or she has compensation income), but cannot afford to set up a Roth IRA him/herself, but is willing to do so if child pays for it; child can afford it; and Parent, even though he/she is too poor to create the Roth IRA him/herself, is unlikely to have his/her estate wiped out by nursing home expenses or to need to qualify for Medicaid. We're probably also talking about an only child so that sibling problems do not arise when Parent leaves the Roth IRA just to the child who gave Parent the money to set it up.

Where to read more: Regarding regular/annual contributions to an IRA, see ¶ 5.3.02 of *Life and Death Planning for Retirement Benefits*.

98. **BEST, though untested: Have your traditional IRA and your Roth IRA enter into partnership with each other, with the traditional IRA's interest "frozen."** This idea came from the article "Access Your IRA Funds Tax and Penalty Free!" by Tim Berry, Esq. Read about this idea and more in the book "The IRA Recovery℠ System," obtainable through the web site www.thetaxacademy.com.

This is a variation of the old "family partnership freeze" popular prior to enactment of Chapter 14 of the Code, under which the parents' partnership interest would be worth a "frozen" dollar amount corresponding to the amount of capital they contributed plus a predetermined annual income rate; they would have a liquidation preference for that amount, but no right to demand liquidation. The younger generation would make a modest contribution; they would have the right on liquidation to receive any increase in value that had occurred over the parents' liquidation preference amount. Pending eventual liquidation, the parents would have the right to the current rate of income, with children having the right to any income that the partnership generated over that amount. The goal was to freeze the value of the parents' interest, shifting excess future growth to the children transfer-tax free. This type of freeze was banned *for transfer tax purposes* by the special valuation rules of Chapter 14 (§ 2701).

However, Chapter 14 does not apply for income tax purposes. The traditional IRA-Roth IRA partnership would take advantage of this gap. The traditional IRA would have the frozen interest and the Roth IRA would have the growth interest. Both IRAs should have the same beneficiaries. The goal is to have all the future growth be income tax-free since it is in the Roth IRA. Since both IRAs would have exactly the same owner, and exactly the same beneficiaries, no possible transfer tax issue can arise and Chapter 14 is irrelevant.

This idea is sold with the come-on "Is it possible to convert your regular IRA to a Roth and pay taxes on only ten cents on the dollar for the conversion?" The answer to this question turns out to be: "No." You convert only 10 percent of the IRA to a Roth IRA, that's why it only costs "10 cents on the dollar." But aside from this hype, it's a very interesting idea.

In a nutshell, the idea is this. The traditional IRA contributes its assets to an LLC in exchange for preferred and common units. Following this formation, the LLC is wholly owned by the IRA. The features and relative values of these classes are similar to the old family partnership freezes. Then the "growth" units (with a professionally appraised value equal to 10% of the total value) are converted to a Roth IRA. The owner pays tax on 10 percent of the value of his IRA to convert that 10 percent to a Roth. The goal is that the tax-free Roth IRA will enjoy fantastic growth while the preferred units held by the (eventually taxable) traditional IRA don't grow very much. The success depends on (1) correct valuation of the two classes at the time of the Roth conversion and (2) investment success in excess of the income rate assigned to the traditional IRA units.

Does this make sense? If the IRA owner is confident that he is an extremely successful investor, able to "beat the market," and expects to earn (say) a 15 percent annual return while the rest of the world expects to earn only (say) 5 percent, this plan should be explored. It does not involve any prohibited transaction risk or anything else that is shady or doubtful, *provided* that the LLC units are correctly structured and appraised. It's just a way of leveraging the IRA. It is not a sham; the owner takes the risk that if his investments are *less* successful than he expects, all the risk falls on the Roth IRA (that he has already paid tax on). But until Congress enacts a "Chapter 14"-type provision that applies for income taxes as well as transfer taxes, it looks to me like it works.

99. **WORST: Shift business income into your Roth IRA to make it tax-free.** In a blatant abuse of the Roth IRA retirement savings vehicle, some individuals have attempted to shift income into their Roth IRAs by such means as having the Roth IRA form a wholly-owned entity (such as an LLC), then shifting value into that entity by (for example) selling property to it at bargain prices. The goal of these schemes is to shelter future (even existing) gains and income in the tax-exempt Roth. In Notice 2004-8, 2004 I.R.B. 333, the IRS declared war on these devices, attacking them as disguised IRA contributions (in violation of the limits on annual IRA contributions and in violation of the requirement that only cash may be contributed to an IRA); as listed transactions for purposes of the anti-tax-shelter regulations (see Reg. § 54.6011-4); and possibly as prohibited transactions under § 4975 (which would disqualify the IRA). The IRS will dismantle the transactions through denial of deductions (for, *e.g.*, excessive payments from a business to the IRA-owned entity) or re-allocation of income, deductions, etc. among the persons and entities involved pursuant to § 482. All I can say is...I told you so! See my article "Retirement Benefits: Unexpected Drama," 143 *Trusts & Estates* 1 (Jan. 2004), p. 40, in which I predicted this development.

100. **WORST: Intentional excess Roth IRA contribution.** Here's the "planning idea": You intentionally contribute to your Roth IRA much more than the permitted annual maximum ($5,500/$6,500 as of 2018). An excess IRA contribution attracts a six percent annual penalty until the contribution is withdrawn (or "absorbed" as part of a legal contribution in a later year), *unless* the contribution (together with any earnings thereon) is withdrawn by the extended due date of the individual's tax return for the year the excess contribution occurred. See Idea #79. As that deadline for a "corrective distribution" approaches, you determine whether your investment of the excess contribution has made money or lost money. If it has lost money or not earned much, you simply withdraw it to avoid the penalty and you're

"done." If it has gained a profit, you pay the six percent penalty for that year; then later, after the corrective distribution deadline has expired, you withdraw the contribution (to avoid accruing additional annual excess-contribution penalties), but you leave the "earnings" inside the Roth IRA to grow forever tax free. In my opinion this is a worst idea. It may disqualify the Roth IRA. Or the IRS may say that earnings on an excess contribution can never constitute tax-free "qualified distributions." Though the IRS has not yet on record indicated that these punishments will apply, it has stated that excess IRA contributions will be a major enforcement target for the IRS.

Where to read more: ¶ 5.3.05 of *Life and Death Planning for Retirement Benefits* discusses excess IRA contributions. See also Choate, Natalie B., "The Intentionally Excess IRA: Worst Roth Planning Idea Yet?," *Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter* (Archive Message #532, 7/14/10; www.leimbergservices.com); and "IRS Stepping Up IRA Enforcement," posted as a "column" on the MorningstarAdvisor website (9/10/10); *http://advisor.morningstar.net/c.html?rtr=on&s=255s,9980,9s,46bm,h53m,ljzd,kp0eMorningstarAdvisor.com* under *Retiring with Natalie Choate*.

101. **BEST: Establish Roth IRAs for low-earning young family member.** For the teenager who has a summer or after-school job, use part of the annual exclusion gift you would normally make to that child to establish a Roth IRA for him or her. Most teenagers are well under the income limit ($118,000-$133,000 for 2017; § 408A(c)(3)(A), (C)) for eligibility to contribute to a Roth IRA. The maximum annual IRA contribution for 2017 for someone under age 50 is $5,500 (or the child's compensation income for the year, if less). § 408A(c)(2), § 219(b)(1), (5)(A). With no RMDs during the child's life, the potential for tax-free growth is enormous. The main drawback is that the child can withdraw the money at will.

Here's how to turn this into a WORST Idea: An individual must have "compensation" income during the year to be eligible to contribute to a Roth (or traditional) IRA. Don't get so carried away with the idea of establishing a Roth IRA for your youngster that you invent compensation income for him or her. The weekly allowance is not compensation income even if the kid has to clean her room or mow the lawn to get it. Do you want your child to have a criminal record? Well maybe not a criminal record but an excise tax for an excess IRA contribution, which is almost as bad.

Where to read more: § 219(b)(1)(B); see Reg. § 1.408A-3, A-4, and Rev. Proc. 91-18, 1991-1 C.B. 522, for definition of "compensation." For annual limits on contributions, consult your Denise Appleby *Quick Reference Guide* (see "Resources," page 10).

## H. PLANNING FOR PARTICIPANT'S DISABILITY

Just as estate (death) planning for retirement benefits involves special considerations, so does disability planning for these benefits.

102. **BEST: Sign a power of attorney dealing with retirement benefits.** There are certain predictable needs regarding the retirement plans in case of disability. The power of attorney should cover these. The power-holder should be authorized to make investment decisions for and take distributions from the grantor's retirement plans, create new IRAs or other retirement accounts for the grantor, recharacterize IRA contributions, make new contributions to any retirement plan on behalf of the grantor, and roll or transfer money from one retirement plan to another. The power of attorney form should specify that the power-holder can have full access to all of the client's information and all account data.

Where to read more: See sample Form 5.1 in Appendix B of *Life and Death Planning for Retirement Benefits*, which unfortunately doesn't have the info-access-authorization language (that'll be in the next edition). Thanks to Susan Welber, Esq., for that suggested addition.

103. **BEST: Specify the desired beneficiary in the power of attorney.** Creating new plans or contributing to new or existing plans for a disabled person raises the question of who will be named as beneficiary of those plans. If the power of attorney does not cover this point, the power-holder may have difficulty naming a beneficiary of a newly-created IRA. The IRA provider may require that the beneficiary be the participant's estate, or that a legal guardian be appointed with authority to name a beneficiary. Giving the power-holder blanket authority to name a beneficiary for retirement plans gives him too much power. Controversy on this point can be avoided, in some cases, by having the power of attorney specify who is to be the beneficiary. Then the power-holder and IRA providers and plan administrators don't have to worry that their actions are somehow changing the estate plan of the disabled person. If it should appear, after disability strikes, that the disposition specified in the DPOA is no longer a good plan, a guardian can be appointed and the usual legal procedures for changing a disabled person's estate plan can be followed, just as could have been done if there had been no power of attorney.

104. **BEST: Get advance approval of DPOA from plan administrator.** The biggest danger with durable powers of attorney (DPOA) is that the IRA provider or plan administrator will not honor the document when the need arises. Find out *in advance of need* the policy of the administrator of your client's retirement plans. Some IRA providers have their own form of DPOA; if so, use that form. With the high-end market ($1 million and over IRAs at a private bank or full-service brokerage firm), it should be possible to get the provider's pre-need approval of a custom-drafted DPOA; then keep the DPOA on file at the provider's office with the other account documents.

105. **BEST: Consider a restricted IRA agreement or IRT.** In PLR 2011-50037, the IRS approved a custom-drafted IRA agreement for an individual who had bipolar disorder. The agreement basically imposed a waiting period on any withdrawals by the participant and required certain notices to her attorney if withdrawals or amendments were requested. Though the particular restrictions in this agreement are not likely to be of widespread use for other participants, this ruling points the way to possibly using a restricted IRA agreement (or individual retirement trust; see Idea #172) to help protect the participant in case mental deterioration makes him/her vulnerable to poor financial decisions/actions.

Where to read more: See Choate, Natalie B., "PLR 201150037: Disability Planning for IRAs," *Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter* (www.leimbergservices.com; see "Resources," page 10), Archive Message #597, 2/15/12.

[There is no "Group I"]

## J. ANTICIPATING INACTION BY SURVIVING SPOUSE

Many estate plans depend on naming the participant's surviving spouse as beneficiary of the benefits, with the expectation that she will roll the benefits over to her own retirement plan. See Idea #116. The greatest risk with these plans is that the spouse will survive the participant, but then, due to disability, inertia, or lack of time, fail to complete the rollover. The distribution options for the benefits at that point are typically much less favorable than if the spouse had completed the rollover and named a new designated beneficiary for her rollover IRA. Here are some Ideas addressing this problem; see also Idea #119(D). Unfortunately, there is no fool-proof method to guarantee that if the spouse survives she will complete the rollover of the benefits.

Where to read more: For explanation of the minimum distribution requirements that apply to benefits that are payable to the surviving spouse after the surviving spouse herself dies, see ¶ 1.6.03(E) and ¶ 1.6.05 of *Life and Death Planning for Retirement Benefits*.

106. **BEST: Spouse's power of attorney authorizes rollover.** This can help if the power-holder is on top of the situation and able and willing to take action while the surviving spouse is disabled. However, if the only holder of the spouse's power of attorney is the participant, who is now deceased, this idea will not help! For more on powers of attorney, see "Group H" Ideas.

107. **BEST, for under-age-70½ (or charitably inclined) participant: Name an individual (or charitable) successor beneficiary to the spouse.** If the participant dies before the end of the year in which he would have reached age 70½, his spouse survives him, and the spouse ALSO dies before the end of that year, without having withdrawn the benefits (or, in the case of an IRA of which the surviving spouse is the sole beneficiary, without having elected or being deemed to have elected to treat the IRA as her own), the minimum distribution rules are applied to the benefits remaining in the account "as if the spouse were the participant."

> Thus, the benefits must be distributed over the life expectancy of the *spouse's* designated beneficiary, if any, otherwise by the end of the year containing the fifth anniversary of the *spouse's* death. § 401(a)(9)(B)(iv)(II), Reg. § 1.401(a)(9)-3, A-5, A-6. The problem is, in a close-in-time deaths situation, the spouse probably didn't get around to naming her own designated beneficiary. If she had had time for that, she probably would have used the time to roll over the inherited benefits to her own IRA (unless perhaps she was under age 59½; see Idea #186(A)). So the benefits will probably become payable to the spouse's estate, and the 5-year rule will apply.

The participant can try to head off this result by naming a successor beneficiary, to take the benefits if the spouse survives him but then dies without either withdrawing the benefits or naming her own successor beneficiary. A "successor beneficiary" is not the same as a "contingent beneficiary." Reg. § 1.401(a)(9)-5, A-7(c). A contingent beneficiary takes the benefits *only* if the primary beneficiary does not survive the participant (or survives but then disclaims the benefits). The participant should of course name a contingent beneficiary (Ideas #149–#150); what we are talking about here is going a step further and specifying what happens if the primary beneficiary survives, then dies while money is still in the inherited plan.

If the participant names a successor beneficiary to take the benefits in that situation, the benefits would pass at the surviving spouse's later death to the participant's successor beneficiary. This will improve the tax situation if either (a) both spouses died before the end of the year in which the participant would have reached age 70½, and the successor beneficiary is an individual or see-through trust (because in that case the life expectancy payout *might* be preserved); HOWEVER, see PLR 2006-44022, suggesting (incorrectly in my view) that this technique would not work because the successor beneficiary is not named "by" the surviving spouse; or (b) the successor beneficiary is a charity or charitable remainder trust (CRT). Since charities and CRTs are income tax-exempt, the benefits pass to these successor beneficiaries free of income tax.

This Idea has limited usefulness (even aside from the doubt created by PLR 2006-44022), for two reasons:

First, some plan administrators will not allow the participant to name a successor beneficiary, either because they think it would violate state probate laws for the participant to name a successor for his spouse (since the account belongs to the surviving spouse absolutely on the participant's death) and/or because their computer systems are not able to track specifications in the participant's beneficiary designation (which gets thrown out once the account ownership is transferred to the surviving spouse as beneficiary on the participant's death). Both of these issues should go away if the IRA is in the form of a trust (Idea #172).

Second, the solution of naming an individual (or see-through trust) as successor beneficiary doesn't work if either spouse dies AFTER the end of the year in which the participant would have reached age 70½. In that case, the participant can still name a successor beneficiary but it won't matter for minimum distribution purposes, because the benefits will have to be paid out over what is left of the spouse's life expectancy. However, naming a charity or CRT as successor beneficiary in that situation still works.

Where to read more: See ¶ 1.6.03(E) and ¶ 1.6.05 of *Life and Death Planning for Retirement Benefits* for explanation of the minimum distribution rules that apply when a surviving spouse is named as beneficiary, then dies without having withdrawn all the benefits.

108. **WORST: Have spouse pre-elect to treat participant's IRA as her own.** The regulations specify that this spousal election must be made *after the participant's death*, so having the spouse pre-elect will not work. Reg. § 1.408-8, A-5(a).

109. **WORST, maybe? Require spouse to survive a certain time.** A requirement that a beneficiary survive the client by a certain amount of time always appears attractive, in the sense that the client doesn't want to leave his property to someone who is going to die a few hours or days later. Rather than run the same property through two estates in case of close-in-time deaths, why not require the beneficiary to survive for some period of time? An unexplored potential problem/issue is whether having a requirement of survival will cause loss of "designated beneficiary" status: As of the date of death there is no one who is entitled to receive the benefits. Could the IRS argue there is no designated beneficiary at all? To date they have not done so, but it seems advisable to avoid the issue by not having any requirement that a beneficiary survive by a particular period of time. Another drawback is, suppose at the participant's death the spouse is healthy and eager to do the rollover, but he/she is forced to wait until the survivorship period is up...and dies the day before it expires.

Where to read more: See Choate, N., "Double Deaths," *Trusts & Estates*, Vol. 144, No. 9, p. 76 (Sept. 2005).

## K. DYING CLIENT

There are times when an estate planner is called upon to advise a client with a severely shortened life expectancy. Some clients in that situation want to know what can be done to improve the financial situation for their surviving families. See also Ideas #138 and #139.

110. **BEST: Cash out benefits that will otherwise be cashed out soon after death.** When a retirement plan will have to be cashed out shortly after the participant's death (either because of minimum distribution requirements, or to pay estate taxes, or just because the beneficiaries will want the money), *and* the estate will be subject to estate taxes, there are several reasons why it is better to cash out the account immediately *before* death rather than immediately after. First, if the plan is cashed out before death, the income taxes on the benefits are removed from the estate for estate tax purposes—in effect, both the federal *and* state income taxes on the benefits become 100 percent deductible for estate tax purposes. If the plan is cashed out *after* death, the recipient of the benefits gets a federal income tax deduction under § 691(c) for the *federal* estate taxes on the benefits (see Idea #183)—but *not* for the *state* estate taxes. Second, the § 691(c) deduction is an itemized deduction, and as such may not be fully deductible because of the reduction of itemized deductions that applies to high-income individual beneficiaries under § 68(a) (but see Idea #125 for a way to avoid this

haircut). Finally, the recipient may not be able to take the § 691(c) deduction in determining his *state* income tax. For all these reasons, paying the income taxes "first" and the estate taxes "second" may produce a lower tax burden overall than doing it the other way round. On the other hand, if the death benefits are going to be paid to charity (so they will not be subject to income taxes), or will be paid to a designated beneficiary over a long life expectancy (so the income taxes can be deferred for a long time) this arbitrage advantage disappears. Similarly, if the beneficiary is in a lower bracket than the participant, that may reduce the arbitrage advantage. Finally, if the estate will not be subject to any estate tax, there is no known *tax* advantage to cashing out the plans before death.

111. **BEST: Convert to a Roth IRA.** Converting to a Roth IRA before death can reduce *estate taxes,* by removing the income taxes due on the Roth conversion from the gross estate. The beneficiaries can then take a life expectancy payout of the Roth IRA after the participant's death, income tax-free. Of course, the participant's heirs will lose other assets (the money that was used to pay the income taxes on the Roth conversion), but their lives will be much simpler this way than if they inherit a regular IRA, because they will not have to deal with the valuable but complicated IRD deduction (§ 691(c); Idea #183).

Where to read more: Chapter 5 of *Life and Death Planning for Retirement Benefits* explains Roth IRAs, including eligibility requirements for a Roth conversion. For the economics of the Roth conversion decision, see Robert Keebler, CPA, MST, *A CPA's Guide to Making the Most of the New IRAs* (published by the AICPA), and *Roth to Riches* by John D. Bledsoe (Legacy Press, $19.95). Also visit www.RothIRA.com (sponsored by Brentmark Software).

112. **BEST: Take LSD of NUA stock.** If the client is a participant in a plan that holds appreciated employer stock, consider whether a lump sum distribution should be taken before death (see Idea #4). This MIGHT enable his beneficiaries who inherit the NUA stock from his estate to get a stepped-up basis for that stock on his death. See PLR 2000-38050 (*contra* Rev. Rul. 75-125, 1975-1 C.B. 254). If the stock is still in the plan at the employee's death, the beneficiaries can get NUA treatment by taking an LSD from the plan, but would have no chance of getting a stepped-up basis.

Where to read more: For treatment of NUA stock distributed during life and held until death, see ¶ 2.5.04 of *Life and Death Planning for Retirement Benefits*.

## L. CHOICE OF BENEFICIARY

Here we look at the client's estate planning choices. Who should be named as death beneficiary of the client's retirement plans? The choices are easy from an income tax perspective: there are three tax-favored and three not-favored possibilities. Favored are young individuals (including see-through trusts for same), surviving spouse, and charity. Not favored, usually, are older individuals, a trust for the surviving spouse, and the participant's estate. Everyone should consult an estate planning attorney in connection with the best disposition of his or her retirement benefits at death, and pay the attorney to draft or at least review all beneficiary designation forms.

113. **BEST: Young individual (or "see-through trust" for a young individual).** A young individual beneficiary can enjoy many decades of continued income tax deferral after the participant's death if he/she takes advantage of the deferred life-expectancy ("stretch") payout. Thus, there is an attraction to naming, *e.g.*, grandchildren as beneficiaries. To make sure they take advantage of the life expectancy payout option (the "stretch IRA"), use the type of IRA that permits you to specify a restricted payout option (Idea #172), or name a see-through trust ("Group P" Ideas) for the benefit of the young person as beneficiary. If naming beneficiaries more than one generation younger than the participant (such as grandchildren who have living parents), bear in mind the generation-skipping transfer (GST) tax that applies to transfers in excess of the GST exemption amount ($5.49 million as of 2017) to such "skip person" beneficiaries. If using this Idea, be prepared for....

**But be prepared for the "death of the stretch?"**

Some in Washington have in recent years proposed eliminating the "life expectancy payout" and replacing it with a 5-year payout term for most retirement plan death benefits. If that proposal becomes law, this Idea would no longer have great appeal. Thinking ahead, consider naming a charitable remainder trust as beneficiary to get similar approximate effects (Idea #119) or buying life insurance in an irrevocable trust to benefit family members in a way that would be more tax-advantaged than leaving them income tax-laden retirement benefits that have to be cashed out a short time after the participant's death.

Where to read more: The single life expectancy table, showing the applicable distribution period for beneficiaries of various ages, is in IRS Publication 590-B and in the back pages of this Seminar Handout/Special Report. Chapter 1 of *Life and Death Planning for Retirement Benefits* explains the requirements that must be met to qualify for the "life expectancy payout method."

114. **WORST (in many jurisdictions): Name a minor directly as outright beneficiary.** In some states, funds payable to a minor can be accessed only if a legal guardian is appointed, a costly and time consuming procedure in many states. Even if state law permits funds payable to a minor to be transferred to a custodian for the minor's benefit under the "Uniform Transfers to Minors Act" (UUTMA), the court may require the custodian to post a bond (another expense). When leaving retirement benefits to a minor who does not have an already-appointed legal guardian, leave the funds instead to a custodian for the minor UUTMA or to a trust for the minor.

115. **WORST: Older nonspouse individual.** If your beneficiary is an older individual, he/she can use the life expectancy payout method, but will get less tax deferral benefit because of his/her shorter life expectancy. For example, if your chosen beneficiary is your 80-year old aunt, she has only a 10.2-year life expectancy according to IRS tables, even if females in your

family routinely live to age 120. Consider whether the plan benefits would do her more good if paid in the form of a charitable split-interest gift (Ideas #119(A), #120).

116. **BEST: Surviving spouse.** The participant's surviving spouse gets more tax breaks than any other potential beneficiary. Other beneficiaries must start taking required distributions (RMDs) by the end of the year after the year of the participant's death; the spouse (if she is sole beneficiary, and continues to hold the account as beneficiary) can defer distributions until the year the participant would have reached age 70½. Any other individual beneficiary must take RMDs over his fixed-term single life expectancy; the spouse (if holding as beneficiary) can take RMDs over her single life expectancy recalculated annually, so the term of distributions actually stretches out over her lifetime rather than ending at some point in her late 80s.

Best of all, the spouse (unlike other beneficiaries) does not have to hold the account merely as "beneficiary": She can take any benefits left to her and roll them over tax-free to her *own* retirement plan; no other beneficiary can do this. The effect of a spousal rollover is to: defer the commencement of RMDs until the surviving spouse reaches age 70½; and then, once RMDs start at the surviving spouse's RBD, the spouse can take those RMDs using the Uniform Lifetime Table, the effect of which is to stretch out distributions beyond the spouse's lifetime (see Idea #18). If the spouse inherits a Roth plan or IRA and rolls it over to her own Roth IRA, she can defer distributions not just until age 70½ but for the rest of her life, since there are no required distributions from a Roth IRA until the owner's death.

The spouse can name a designated beneficiary for the rollover plan, thus achieving further income tax deferral (over an additional lifetime) after her death. Adding to the incentives to leave benefits outright to the spouse are the estate tax treatment (no estate tax on the participant's death because of the marital deduction); the requirement (in a QRP) that the spouse MUST be named as beneficiary for part or all of the benefits (depending on the type of plan) unless she consents to the naming of some other beneficiary (see Idea #32); and the participant's ability to take smaller RMDs during his life if his spouse is more than 10 years younger than he and is named as sole beneficiary.

<u>Where to read more</u>: See ¶ 1.6 of *Life and Death Planning for Retirement Benefits* for the minimum distribution rules applicable to a surviving spouse named as beneficiary, ¶ 1.5 for rules applicable to other beneficiaries; ¶ 3.2 regarding the spousal rollover/election; ¶ 3.3 regarding the federal estate tax marital deduction and how to qualify for it; and ¶ 3.4 for when benefits MUST be left to the spouse under federal law.

117. **WORST: Trust for spouse (including bypass or QTIP trust).** There are many reasons why a participant might prefer to name a trust for his spouse as beneficiary of his retirement benefits rather than naming the spouse outright: save estate taxes (by leaving benefits to a credit shelter trust; see "Group M" Ideas); protect children of a prior marriage (by leaving benefits to a QTIP trust; see "Group N" Ideas); protect the benefits from the spouse's excessive spending, financial inexperience, gambling habit, overly kindhearted generosity, drug addiction, or creditors. A trust for the spouse's life benefit can accomplish these

things...at a price. The price is the loss of the deferral opportunities offered by the spousal rollover (see Idea #116). A trust for the benefit of the surviving spouse generally must start distributions the year after the year of the participant's death; in contrast, with a rollover IRA the spouse would not have to take any distributions until reaching age 70½ (or ever, in the case of a Roth IRA); and must take RMDs over the spouse's single life expectancy (it may not use the Uniform Lifetime Table, which the spouse would use to calculate lifetime RMDs from her rollover traditional IRA); and cannot flip over to a payout period based on the life expectancy of the next generation when the spouse later dies (which a rollover IRA could do, if the spouse had named the next generation as her designated beneficiaries).

Adding insult to injury, traditional retirement benefits paid to a trust will generally be taxed at a higher rate than benefits paid to an individual beneficiary; see Idea #165. These drawbacks make "a trust for the benefit of the surviving spouse" a WORST beneficiary choice from an income tax point of view compared with leaving benefits to the spouse outright. It's a WORST choice even if the account is a Roth IRA (so distributions are not subject to income tax) because it wastes the tax-free accumulation opportunity that the spousal rollover of a Roth IRA would have.

But a trust for the spouse's benefit may still be a BEST choice if the price for leaving benefits outright to the spouse would be even higher than the price of leaving the benefits to a trust—for example, if the spouse is highly vulnerable to making poor financial decisions.

Where to read more: See ¶ 3.3.02 of *Life and Death Planning for Retirement Benefits*.

118. **BEST: Charity.** Leaving benefits to charity is a double tax win: There are no income taxes because charities are income tax-exempt (except for the tax on UBTI; § 501(a)) and no estate taxes (because of the estate tax charitable deduction, § 2055). Therefore, if a client has a charitable intent as part of his estate planning goals, consider using the retirement benefits to fund that intent: the retirement benefits are generally worth more to the client's charitable beneficiaries than to the client's individual beneficiaries.

The two exceptions to this general rule are: First, if the benefits are left to a younger beneficiary who is eligible for, and who takes advantage of, a long-term life-expectancy payout, that individual beneficiary may find that the inherited retirement benefits are worth more than a bequest of after-tax assets, despite the built-in tax bite in the retirement plan, due to the value of long-term income tax deferral. Second, the rule of thumb does not apply to Roth IRAs, distributions from which are income tax-free even to noncharitable beneficiaries.

Where to read more: Chapter 7 of *Life and Death Planning for Retirement Benefits* covers all aspects of charitable giving with retirement benefits, including which types of charitable entities are or are not income tax-exempt. Or see the Natalie B. Choate *Special Report: Charitable Giving with Retirement Benefits*, downloadable at www.ataxplan.com, which is an expanded version of Chapter 7; it is already incorporated into the e-book edition (www.retirementbenefitsplanning.com).

119. **BEST: Charitable remainder trust.** A charitable remainder trust (CRT) pays income to one or more individual beneficiaries for life or for a term of years (up to 20), then terminates and passes outright to one or more charities. The "income" must be in the form of a fixed dollar amount (charitable remainder annuity trust) or a fixed percentage of the trust's assets revalued annually (charitable remainder unitrust). If the CRT meets the rigid requirements of § 664, it is income tax-exempt, and bequests to it will qualify for a partial estate tax deduction (for the present value of the remainder interest passing ultimately to charity). The CRT as beneficiary of retirement benefits is attractive to a client who has some charitable intent but also wants to benefit some humans. A CRT can help solve some of the problems in planning for benefits. For example:

A. To benefit an older individual. Naming an older nonspouse person outright as beneficiary of retirement benefits (Idea #115) has the effect of dumping the benefits out of the plan and into the beneficiary's gross income rapidly (over the beneficiary's short life expectancy), so the income taxes get paid up front and the elderly person will have less money available in his/her later years. In contrast, if the benefits are left to a CRT for the life benefit of that same elderly person, he/she will enjoy a more-or-less steady income from the CRT that will last for his/her entire life (not run out at the end of some artificial life expectancy from an IRS table); plus, the participant's estate will get an estate tax charitable deduction which may free up some other funds that can be given to the same or other beneficiaries. The downside is that the individual beneficiary cannot take out more than the pre-set income stream from the CRT regardless of need. See also Idea #120.

B. To benefit multiple adults. Naming a non-CRT trust for multiple adult beneficiaries of varying ages produces a nightmare from the point of view of required minimum distributions (RMDs): Either the trust must use the oldest beneficiary's life expectancy to measure RMDs, or must name multiple separate trusts, one for each beneficiary, which could have the effect of chopping up the assets into too many too-small pots. By naming one CRT that will pay a unitrust payout for life to several adult beneficiaries, the participant avoids all RMD problems: The CRT does not need to use a "life expectancy payout." It can cash out the plan benefits immediately upon the participant's death with no income taxes because the CRT is income tax-exempt. The trust produces a more-or-less steady income which can be split among the human beneficiaries. As the older ones die, their income share passes to the younger members of the group, thus providing a crude form of inflation protection. Because the value of the charity's remainder interest (determined actuarially using IRS tables) must exceed 10 percent of the total trust value as of the date of the participant's death, this will only work with a small group of older beneficiaries (*e.g.*, a group of 50-something siblings or friends and 80-something parents). § 664(d)(1)(D).

C. For a lump-sum-only plan, or to anticipate "repeal of the stretch." Many QRPs pay death benefits only in the form of a lump sum distribution. A surviving spouse as beneficiary can roll that lump sum over to her own IRA to continue tax deferral. A nonspouse "designated beneficiary" can also roll over such lump sums (by direct rollover only) to an "inherited IRA" in order to take advantage of the life expectancy payout (Idea #179). However, if the participant is concerned that his beneficiaries might not carry out such a rollover correctly or might choose to take a lump sum; and wants to be absolutely sure the beneficiaries to take a life income-type option rather than a lump sum distribution; the participant can enforce his wishes by leaving the lump sum to a CRT that pays a life income to his chosen individual beneficiaries. The CRT will similarly attractive for all clients who want to use the stretch payout for their beneficiaries, if the stretch payout is repealed; see Idea #113.

D. <u>To benefit spouse</u>. A participant might look at all the previously-discussed ways he can leave his retirement plan to benefit his surviving spouse and discover that each of them has drawbacks. Leaving benefits outright to the surviving spouse has major tax advantages (Idea #116), but only if the spouse rolls the benefits over to her own retirement plan after the participant's death, and there is no way to guarantee that she will actually do that (see "Group J" Ideas). Also, if he leaves benefits outright to the spouse, she might blow the money during her life on expenditures the participant wouldn't approve of, or leave the benefits at her death to a beneficiary the participant wouldn't approve of. If he ties the money up in a trust to head off these outcomes, there are significant income tax drawbacks (Idea #117). If he annuitizes the benefits to provide life income for the spouse, there will be nothing left when she dies. Leaving the benefits to a CRT for the spouse's life benefit solves many of these problems. The spouse will get an income stream for life, without the drawbacks of leaving benefits to a noncharitable trust. There will be no need for the spouse to roll benefits over on the participant's death, so that worry is eliminated. The participant can choose the ultimate beneficiary (which has to be a charity of course). And, if the spouse is the only noncharitable beneficiary there will be no estate tax on the benefits either at the participant's death or at the spouse's death (due to the combination of the charitable and marital deductions). § 2056(b)(8).

E. <u>To benefit a disabled beneficiary</u>. If a disabled beneficiary who receives government benefits becomes the life beneficiary of a charitable remainder trust, the unitrust or annuity payments from the trust would constitute income and/or countable assets of the disabled beneficiary and would disqualify him/her from eligibility for the government benefits. To avoid this problem, the charitable remainder trust can specify that the unitrust or annuity payments will be paid to a supplemental benefits trust. If the requirements of Rev. Rul. 2002-20, 2002-1 I.R.B. 794, are complied with (both as to the disability and the supplemental benefits trust), the CRT will be considered a qualified charitable remainder trust under § 664 even though the unitrust or annuity payments are not paid to the individual—and the disabled individual's eligibility for government benefits will be preserved.

Where to read more: The charitable remainder trust is the workhorse of tax-advantaged charitable giving. It is also something that the typical average estate planning lawyer should be able to advise on and draft, but ONLY if he/she consults proper experts and authorities to do it right. The CRT is not the place to begin a creative writing experiment or try to wing it by reading something as brief as this summary. There are many readily available resources that can guide the drafter. For an excellent one-volume treatise, see *Charitable Trusts* by George B. Jewell, $212 at CCH's online store (http://onlinestore.cch.com/default.asp?bu=fast&view=expand); the book includes a CD with forms. See publications of Conrad Teitell (see "Resources," p. 10). There are two great software programs that will perform the required calculations and tests for CRTs with ease, *NumberCruncher*® by Steve Leimberg (www.Leimberg.com; click "Software, Estate Planning") and *Tiger Tables*® by Larry Katzenstein (www.tigertables.com).

120. **BEST: Charitable gift annuity.** Under a charitable gift annuity, a sum is left to a charity and the charity agrees to pay a fixed income to a human beneficiary for life. This could be a good way to provide an income for an older beneficiary. The participant's estate gets an estate tax deduction for the value of the retirement benefits left to the charity minus the value of the annuity (determined using IRS tables). The benefits are paid to the charity free of income tax. See PLR 2002-30018. This approach has several advantages compared with the charitable remainder trust or a life expectancy payout directly from the retirement plan: The human beneficiary would receive a fixed predictable income (which many prefer to the fluctuating income provided by a charitable remainder unitrust or a life expectancy payout from a retirement plan). There is no need to draft a CRT. The income is guaranteed to last for the beneficiary's life, not run out at the end of her IRS-defined life expectancy.

Where to read more: For an excellent explanation of charitable gift annuities, including what is known about funding this type of transfer with retirement benefits, see "Charitable Gift Annuities" by William Finestone, 29 *ACTEC Journal* 37 (Vol. 29, No. 1), Summer 2003 (www.actec.org).

121. **WORST, probably: Charitable lead trust.** A charitable lead trust is the mirror image of a charitable remainder trust: a "unitrust" or "annuity" income stream is paid to a charity for a term of years, then the underlying property passes to the donor's chosen individual beneficiaries. The term "charitable lead trust" does not appear in the Code, but this type of entity is described in § 170(f)(2)(B). Unlike a CRT, however, the CLT is not exempt from income taxes. Thus the CLT must include the benefits in its income when they are distributed from the retirement plan to the CLT.

Because of this, leaving retirement plan death benefits to a CLT is a disadvantageous way to fund such a trust. Generally, the planning advantage of a CLT funded at death is that, in addition to satisfying the donor's charitable intentions, it may allow funds to pass to the donor's descendants (or other noncharitable beneficiaries) free of gift or estate taxes. This phenomenon occurs if the investment performance of the trust "beats" the IRS's § 7520 rate. When the initial bequest is made to the CLT, the IRS § 7520 tables are used to value the charity's and family's respective interests in the trust. The decedent's estate then pays estate tax on the value of the interest passing to the family.

If the trust's investments outperform the § 7520 rate, the amount by which the investments outperform the § 7520 rate eventually passes to the family beneficiaries. Since the IRS rates did not predict that this value would exist, the excess value is never subjected to estate tax.

If the CLT is funded with retirement benefits, however, the CLT will generally start out at a disadvantage, since some of the principal that the IRS assumed the trust would have has in fact been used up paying income taxes. This makes it that much *less* likely that the trust will "beat" the IRS's § 7520 rate, because in effect the trust starts out with a loss. The client may well end up paying estate tax on *more* than the family beneficiaries eventually receive. The CLT thus appears generally an unattractive choice as beneficiary of retirement benefits, though there could be some combination of circumstances in which it would work.

122. **WORST: Pooled income fund.** With a pooled income fund (see § 642(c)(5)), the donor makes his gift to a fund maintained by the charitable organization that ultimately will receive the gift. The fund invests the gift collectively with gifts made by other donors, and pays back to the donor (or to another beneficiary named by the donor) a share of the fund's income corresponding to the relative value of the donor's gift. When the donor (and/or the beneficiary he nominated) dies, the share of the fund attributable to that donor's gift is removed from the fund and transferred to the charitable organization. The pooled income fund has been called the "poor man's Charitable Remainder Trust," because it provides many of the same benefits as a Charitable Remainder Trust (irrevocable gift of remainder interest to charity generates charitable estate tax deduction, while preserving a life income to the donor's chosen human beneficiaries), without the expense of creating and operating a stand-alone Charitable Remainder Trust. Unlike Charitable Remainder Trusts, however, pooled income funds are not exempt from income tax. Reg. § 1.642(c)-5(a)(2); compare § 664(c). Therefore, generally retirement plan death benefits paid to a pooled income fund will be subject to income tax in the year received by the fund to the same extent they would be taxable to an individual beneficiary. Accordingly a pooled income fund is not an attractive choice as beneficiary of retirement benefits.

123. **WORST (usually): The estate.** It *should* be a good idea to leave benefits to the participant's estate, where the benefits could be used for necessary expenses then passed out to the estate's ultimate beneficiaries pursuant to a formula disposition in the participant's will. It SHOULD be a good idea, but it usually isn't, because of the RMD and income tax effects. For RMD purposes, an estate cannot be treated as a "designated beneficiary" (the IRS does not have a "see-through rule" for estates as it does for trusts; see "Group P" Ideas). There is no way to correct the situation after the participant's death (unless the "spousal rollover through estate" technique is possible—see Idea #193). Therefore, benefits payable to the estate will have to be distributed under the 5-year rule (if the participant died before his RBD) or over the participant's remaining single life expectancy (if he died on or after his RBD). Usually, longer deferral can be obtained by naming individual beneficiaries or a see-through trust. The income tax drawback of naming the estate is that an estate goes into the highest income tax bracket at just $12,500 of taxable income (2018 rates). Humans don't hit that bracket until they have much higher levels of income. This drawback can sometimes be overcome by

having the estate pass out, to its individual beneficiaries, the retirement plan distributions as they are received by the estate (Idea #165). § 1(c), (e).

Where to read more: See ¶ 1.5.03(E) and ¶ 1.5.04(E) of *Life and Death Planning for Retirement Benefits* regarding the RMD rules that apply when the estate is named as beneficiary.

124. **BEST: The estate (if benefits must be used for estate taxes or other immediate post-death requirements).** If the participant has a substantial portion of his wealth in retirement benefits, and it is expected that his estate will be subject to federal estate tax, and he does not want to cash out some of the benefits during life to cover that anticipated expense (Idea #110) (perhaps because he doesn't expect to die in the near future), consider naming the estate as beneficiary of a sufficient portion of the benefits (ideally, a separate IRA of the anticipated required amount) to enable the estate to pay the estate taxes (as well as the income taxes on the distribution that the estate takes to pay the estate taxes). The estate will receive a § 691(c) (IRD) deduction, which will reduce the income tax rate. Unlike individual beneficiaries, the estate's IRD deduction is not subject to the "reduction of itemized deductions" that applies to high-income individual beneficiaries under § 68(a) in years when that applies (it does not apply in 2018–2015, as a result of the TCJA). Thus, the estate may in some years have lower income taxes on the post-death distribution than would apply to individual family members.

While a long-term life expectancy payout is even more attractive in many cases, and that is available only to individual beneficiaries not to an estate, the usual rule of thumb ("don't name estate as beneficiary") does not apply to benefits that must be cashed out shortly after death, for example to pay estate taxes, as to which the option of a long-term life expectancy payout is irrelevant.

Where to read more: See ¶ 4.6.04–¶ 4.6.08 of *Life and Death Planning for Retirement Benefits* regarding the IRD deduction; see ¶ 4.4 regarding disclaimers of retirement benefits.

125. **WORST (but...): Name estate or trust to avoid reduction of itemized deductions on IRD passed out to individual beneficiaries.** As noted in the preceding Idea, an estate or trust, unlike an individual taxpayer, is not subject to § 68(a), which reduces itemized deductions of certain high-income taxpayers in certain years (2013–2017, and after 2025 and before 2010). § 68(e). If retirement benefits are paid to an estate or trust, can the estate or trust "capture" the applicable IRD deduction, then distribute the net amount remaining after taking that deduction to the individual beneficiaries, thus (1) eliminating any taxable income at the trust level through the combined IRD/DNI deductions, (2) evading the § 68(a) reduction applicable to individuals' itemized deductions and (3) still avoiding high trust income tax rates? No, according to *IRS Publication 559* ("Survivors, Executors, and Administrators") (2015), pp.12-13: If an estate or trust (other than a charitable remainder trust) passes out IRD to individual beneficiaries as part of DNI, it passes out the § 691(c) deduction to them also.

But note: If a see-through trust is named as beneficiary of a qualified plan, it has the option to do a post-death Roth conversion of that plan to an inherited Roth IRA. See Idea #96. The fact that the trust could obtain the IRD deduction, but may not subject to § 68 when individuals may be, makes it possibly more attractive than an individual beneficiary, for the purpose of carrying out a post-death Roth conversion. This would NOT apply to an estate; an estate is NOT eligible to do a post-death Roth conversion.

Where to read more: See ¶ 6.5 of *Life and Death Planning for Retirement Benefits* regarding all aspects of income tax treatment of retirement benefits payable to a trust, ¶ 6.5.04 regarding treatment of the IRD deduction on fiduciary returns.

126. **BEST way to maximize the long-term value of your Roth IRA.** To get the most value from a Roth IRA, the idea is to keep the tax-free accumulation going as long as possible; follow these three steps. Step #1: Do not withdraw anything from the account during the participant's life. Step #2: Name the participant's spouse as beneficiary; the surviving spouse rolls it over to her own Roth IRA and she does not withdraw anything from her rollover Roth IRA during her life. Step #3: Upon the death of the surviving spouse, make the Roth IRA payable directly to children, grandchildren, or other younger-generation beneficiary(ies) so it is paid out gradually over the (long) life expectancy of a young beneficiary.

Where to read more: For the minimum distribution rules applicable to Roth IRAs, see ¶ 5.2.02 of *Life and Death Planning for Retirement Benefits*.

127. **WORST: Don't name any beneficiary.** If the participant fails to name a beneficiary, the plan document will dictate who is entitled to the benefits. In the ultimate worst case scenario, a defined benefit QRP might provide that there is no death benefit *at all* if the participant failed to name a beneficiary. In most cases, the plan will say that the participant's estate is the beneficiary; this is usually a bad result (see Idea #123). In some cases the plan will designate the participant's spouse or issue or heirs-at-law as default beneficiary. The plan's choice of beneficiary might fortuitously be the same as what the participant would have chosen had he bothered to complete a beneficiary designation, but in some cases the plan's default choice of individual beneficiary will create other problems (*e.g.*, the plan designates the participant's spouse who is estranged, or designates the participant's children who are minors, necessitating the appointment of a legal guardian). The way to avoid all these mishaps is to complete and file a proper beneficiary designation form for every retirement plan, and keep the forms up to date.

128. **BEST for a community property IRA: NPS leaves his/her interest to the participant.** An IRA can be community property. If the nonparticipant spouse (NPS) predeceases the participant, leaving his/her interest in the IRA to someone other than the participant, the IRA (or at least the portion of it transferred to the NPS's beneficiary) will be disqualified, resulting in an immediate income tax to the participant, because the transfer to the beneficiary constitutes a deemed distribution to the participant. If the NPS does this

deliberately, then presumably he/she doesn't care about the adverse consequences to the participant, but it could happen inadvertently—*e.g.*, through a residuary clause in the NPS's will. Avoid this by having the NPS specifically leave his/her interest in the participant-spouse's IRAs to the participant. This is a problem only for IRAs, not with a qualified plan, as to which state law community property laws are pre-empted by federal laws on spousal rights in retirement benefits.

Where to read more: For full explanation of the problem and the solution, see Mike Jones's article "There's an IRA Trap in Community Property States," *Trusts & Estates*, Nov. 2007 issue, p. 32.

## M. PROBLEM: USING THE ESTATE TAX EXEMPTION

How do you fund the credit shelter trust if the only asset available is a retirement plan? *Should* you have a credit shelter trust in that case, or should you rely on "portability" to best use the estate tax exemption and go for income tax savings too?

Background: The Code allows each person a tax credit that may be applied to gift or estate taxes otherwise due on gratuitous transfers by that person. To the extent the credit is not used for lifetime transfers, it is available to shelter the person's estate from estate taxes. Because it may be applied to either gift or estate taxes, it is referred to as a "unified" credit. § 2010.

The maximum credit allowed for deaths in 2017 was equal to the estate tax on a taxable estate of $5.49 million. As of 2018, it is $11.18 million. Therefore, the effect of the credit is that each person can transfer up to $11.18 million free of estate taxes to his children, or any other beneficiary who is not the person's spouse or a charity. *Unlimited* amounts may be transferred tax-free to the spouse or charity, either by gift or at death.

Basic tax-oriented estate planning for a husband and wife, under the pre-2010 estate tax rules, involved making sure that each spouse took advantage of the federal estate tax exemption, most commonly by dividing assets equally between the spouses (or at least making sure that each spouse individually owned assets equal to the exemption amount) and having the first spouse to die leave assets equal to the exemption amount *either* directly to the couple's descendants *or* to a trust for such descendants' ultimate benefit. The surviving spouse could be a beneficiary of this trust, but would not have sufficient control over it to make it includible in his or her estate. Thus, this trust escapes estate tax at both deaths: It is not taxed in the first spouse's estate because it was sheltered by the decedent's unified credit; and it is not taxed in the surviving spouse's estate because he or she does not own it. Because such a trust is "sheltered" by the first spouse's unified credit, this type of trust is called a "credit shelter trust." It is also called a "bypass trust" because it "bypasses" the surviving spouse's taxable estate and goes (eventually) to a younger generation federal estate tax-free.

This credit shelter/bypass trust planning has much less importance now than it once did, as a result of "portability" of the federal estate tax exemption: If a federal estate tax return is filed for the estate of the first spouse to die and various other requirements are met, the estate tax exemption of the first spouse to die can be passed on to the surviving spouse, who will then have the benefit of both exemptions. Thus, even if the surviving spouse inherits the entire estate of the first spouse to die (no credit shelter trust), there may be no estate tax cost because he/she also has inherited the estate tax exemption ("deceased spouse unused exemption amount" or "DSUEA") of the first spouse to die. This is called "portability" of the estate tax exemption, and is available if the deceased spouse did not use up all of his/her exemption and an estate tax return is timely filed for the deceased spouse's estate leaving the DSUEA to the surviving spouse.

So is old-style bypass trust estate tax planning for couples completely dead? Not quite. There are still some strong reasons the credit shelter/bypass trust approach will still be used, such as:

1. State estate taxes. Many states still have the same old exemption approach in their estate tax regimes, with no portability. A client who lives in such a state may be forced to use a credit shelter approach to minimize state estate taxes.

2. Flubbing portability. "Porting" the estate tax exemption depends on timely filing a federal estate tax return for the first spouse to die. But families may not remember to do that or realize they have to do it, especially if the first spouse's estate is small. Also, if the surviving spouse remarries and survives his/her second spouse without having "used up" the first deceased spouse's exemption through gifts, the first spouse's estate tax exemption is effectively lost. Building in a credit shelter estate plan at the first death assures that estate taxes will be saved even if no estate tax return is filed for the first estate and even if the surviving spouse remarries.

3. Failure to update plan. Many people already have credit shelter-based estate plans. Many of these people may die without having updated their plans to reflect portability. Absent reformation, their survivors will be stuck setting up and administering a credit shelter trust even if it has no tax reason to exist.

4. Nontax reasons. Having the first spouse to die leave some assets to a life trust for the surviving spouse rather than outright to the him or her is popular for nontax reasons as it assures the children will get something even if the surviving spouse remarries.

Even though there are good reasons in some cases to keep using the supposedly "obsolete" credit shelter/bypass trust plan, those good reasons usually bow to the superiority of relying solely on portability when a married couple's assets exceed their combined estate tax exemption amount *but the credit shelter trust of one or both spouses cannot be fully funded without using retirement benefits*. The income tax cost of using the benefits to fund a credit shelter trust for the life benefit of the surviving spouse (see Idea #117) usually outweighs the advantages of the credit shelter trust plan now that portability provides a way to get the estate tax savings without using a credit shelter trust. Here is the new menu of options for federal estate tax planning for retirement benefits-heavy married couples:

129. **BEST: Leave benefits outright to spouse, rely on portability to minimize estate taxes.** With this plan, the first spouse to die leaves all of his/her retirement benefits outright to the surviving spouse, and the executor of the first spouse's estate elects (on a timely filed estate tax return) to allow the surviving spouse to use the deceased spouse's unused exemption

amount (DSUEA). The "portable" (between spouses) federal estate tax exemption [see introductory paragraphs of the "Group M" Ideas] allows the couple to get the benefits of both spouses' federal estate tax exemptions WITHOUT giving up the enormous income tax advantages of the spousal rollover. For this solution to work, "portability" has to still be applicable at the surviving spouse's death and the surviving spouse must not have risked forfeiting the ability to use the first spouse's exemption through remarriage. If "portability" is not available, this solution risks possibly increased estate taxes on the second death due to "wasting" the first spouse's estate tax exemption.

Though these risks are real, portability makes estate planning MUCH easier for married couples with substantial retirement benefits: The first spouse to die no longer has to choose between leaving retirement benefits to the surviving spouse (for the income tax benefits of the spousal rollover) or leaving them to a credit shelter trust (to save estate taxes); he/she could leave the benefits to the surviving spouse to achieve the income tax advantages of the spousal rollover AND still preserve estate tax savings by leaving his/her exemption to the surviving spouse. A couple where one spouse has all the assets, and all the assets are held in retirement plans, will not have to worry that the poorer spouse's exemption will be "wasted" if he/she predeceases the richer participant-spouse: The poorer spouse can simply leave his/her exemption to the other spouse, who will then have the combined exemption to shelter the large retirement plan.

This solution is appropriate if: The client cares more about the spouse's financial security than about saving estate taxes for future beneficiaries. Or, the client believes that (because of increasing exemptions, decreasing assets, and/or possible estate tax repeal) the couple will not have estate tax concerns, and therefore prefers reasonably definite income tax advantages over remote estate tax savings. Or, after running the numbers, the client and planner conclude that the net tax savings of a credit shelter trust (projected possible estate tax savings minus projected income tax loss) would be not worth the trouble. If using this solution, the option of funding a credit shelter trust can be kept alive by naming the credit shelter trust as contingent beneficiary to the extent the spouse disclaims the benefit (see next Idea). Also, the couple could divide their non-retirement assets equally between them, so that, regardless of which spouse dies first, *some* assets will go into the credit shelter trust of the first spouse to die.

130. **BEST/WORST: Name spouse as beneficiary, credit shelter trust as contingent beneficiary; spouse can disclaim benefits to fill up credit shelter trust.** If, after weighing the trade-offs involved, the client has determined that the surviving spouse is the best choice of primary beneficiary, the disclaimer-activated credit shelter trust may be another BEST idea. The credit shelter trust is named as contingent beneficiary; then when the first spouse dies, the surviving spouse gets a second look at the situation and a chance to revive the credit shelter estate plan by disclaiming the benefits so they pass to the credit shelter trust. The surviving spouse could activate this plan via disclaimer if, at the time of the first spouse's death, state estate taxes or some other concerns make the credit shelter trust desirable despite federal portability, etc.

Practitioners need to understand that this disclaimer estate plan does NOT eliminate the problem of funding a credit shelter trust with retirement benefits. Activating the credit shelter trust by having the spouse disclaim the retirement benefits will have EXACTLY the same drawbacks as naming the credit shelter trust as beneficiary in the first place (but with the added complications of a qualified disclaimer).

The disclaimer plan is a WORST idea when it becomes a substitute for choosing a death beneficiary: Some planners, for example, recommend "It's too hard to decide which beneficiary to name, so name spouse as primary and credit shelter trust as contingent and then we'll decide which is the better choice once the first spouse has died."

Where to read more: ¶ 4.4 of *Life and Death Planning for Retirement Benefits* explains qualified disclaimers and how they apply to retirement benefits.

131. **BEST, if spouse is wealthy: Leave benefits directly to younger generation.** This Idea uses the participant's estate tax exemption and does not overfund the surviving spouse's estate, since the benefits skip the spouse altogether. This solution also takes advantage of income tax deferral, since the distribution of the benefits can be spread out, after the participant's death, over the long life expectancy of younger generation beneficiaries (Idea #113). This solution is appropriate if providing for the spouse's financial security is not a goal, or if the spouse's financial security is well provided for without this retirement benefit. Another advantage of this solution is that it does not depend on the parties' correctly implementing "portability" of the estate tax exemption.

132. **BEST: Live in a community property state.** This is a good solution IF the couple have enough non-retirement assets to fund a credit shelter trust for one spouse, but not both, AND the retirement plan in question is an IRA. The goal in such a situation is to have the nonretirement assets wind up in the estate of the first spouse to die (where they can be used to fund decedent's credit shelter trust) and to have the retirement plan end up in the hands of the surviving spouse (who can roll it over—or keep it, if it already belongs to her—and get the advantages of longer income tax deferral).

In some community property states, the participant and spouse can agree that all their assets (including the IRA) are "aggregate" community property, and assign all their assets to a joint trust. The joint trust is named as beneficiary of the IRA. Then, on the first death, regardless of which spouse dies first, the survivor gets to choose which assets he (or she) will take from the joint pot as his (or her) share of the community property, and can simply walk away with those assets, leaving the rest of the assets to constitute the deceased spouse's share of the community property (and to pass into the deceased spouse's credit shelter trust). So the survivor says "I'll take the IRA as my share" and keeps it (or, if it belonged to the deceased spouse, rolls it over to a new IRA in the survivor's name), and lets the nonIRA assets pass to the deceased spouse's credit shelter trust. Common law-state residents might be able to achieve the same advantages by transferring their property to an Alaska Community Property Trust.

Note that: This solution may not work even in community property states if the retirement plan is a QRP, because the Supreme Court has held that ERISA's spousal protection rules, which apply to QRPs, preempt community property law (though come practitioners in CP states argue that the SC opinion applies only to the benefits of the nonparticipant spouse if he/she predeceases the participant). Note also that this type of elaborate planning for community property is now (post-2010) less important because of the "portable" federal estate tax exemption (see Idea #129).

Where to read more: See "Practicalities of Post-Mortem Distribution Planning for Community Property Retirement Benefits and IRAs—Trusts as Beneficiaries, Separate Shares and Aggregate Theory Agreements," by Edward V. Brennan, Esq., *California Trusts and Estates Quarterly*, Vol. 5, No. 4 (Winter 1999), and "Alaska Enacts an Optional Community Property System Which Can Be Elected by Both Residents and Nonresidents," by David G. Shaftel and Stephen E. Greer, 25 *ACTEC Notes* 206 (1999).

133. **WORST: In a community property state, if nonparticipant-spouse (NPS) dies first, use a note (in lieu of NPS's interest in the IRA) to fund NPS's credit shelter trust.** A problem comes up in a community property state when *all* the family assets are in one spouse's (the participant's) IRA. The spouses agree the IRA is community property (CP) , but if the NPS dies first how does she get "her half" of that IRA into her credit shelter trust? The correct answer: if she dies first, she leaves her CP interest in the IRA to her trust, participant cashes out the NPS's half of the account, pays income taxes on that distribution, and transfers the net amount to the NPS's trust. The other answer (this is the planning idea): have the participant, at NPS's death, sign a note payable to the NPS's credit shelter trust in lieu of cashing out NPS's half of the IRA. That way, the theory goes, the participant can continue to enjoy the full tax deferral of his IRA, and the note "fills up" the NPS's credit shelter trust.

Sorry, I don't think this works. If the participant's promissory note is in exchange for valuable consideration, what is that consideration? It must be the NPS's interest in the IRA—that's what the participant is "buying" with his promissory note. But the sale of a decedent's interest in an IRA triggers immediate income tax, so the technique does not avoid current income taxes. § 691(a). On the other hand, if, trying to sidestep § 691(a), you claim the IRA was *not* the consideration for the note then there was NO consideration for the note, and you have an even worse problem: The promissory note will not be a deductible obligation of participant's estate. A note is deductible as a debt of the estate only if it was given for "adequate and full consideration in money or money's worth." § 2053(c)(1)(A). If the note is not deductible you have not reduced the estate taxes to the extent the note is outstanding at participant's death.

134. **BEST compromise, sometimes: Leave benefits to a Conduit Trust for spouse.** Some clients will use credit shelter trusts despite the availability of the "portable" federal estate tax exemption, for one of the reasons stated at the beginning of this Section M. The credit shelter trust is a "Conduit Trust" if it is required to pass out to the surviving spouse all retirement plan distributions as they are received by the credit shelter trust, regardless of whether these

distributions are defined as income or as principal for trust accounting purposes. The Conduit Trust approach avoids high trust income tax rates; plan distributions will be taxed to the spouse at her (usually lower) rate, rather than to the trust at its (high) rate. Under the minimum distribution regulations, the spouse would be treated as the "sole beneficiary" of this type of trust. Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2(i). The result of having the spouse treated as sole beneficiary under the minimum distribution rules is to allow somewhat more income tax deferral than if the spouse is merely one beneficiary of an accumulation see-through trust. This approach still does not produce as much potential income tax deferral as the spousal rollover, but it can be an attractive compromise if the client is not willing to name the spouse outright as beneficiary. A Conduit Trust for the sole benefit of the surviving spouse could:

A. Postpone the commencement of RMDs until the participant would have reached age 70½. This can provide substantial deferral *if* the participant died well before reaching age 70½.

B. Recalculate the spouse's life expectancy for purposes of determining RMDs to the trust (meaning that if the trustee takes only RMDs there is guaranteed to be something—not necessarily very much—left in the trust when the spouse later dies).

C. If the participant and spouse *both* die before the end of the year the participant would have reached age 70½ (not a very common scenario) the subsequent distributions to the younger generation remainder beneficiaries would be based on the remainder beneficiaries' life expectancy, not the spouse's. However, on this point, see PLR 2006-44022 (which was incorrectly decided in my opinion), in which the IRS ruled that the ADP in this situation would be the 5-year rule.

The main drawback of this approach is that the bulk of the retirement plan will be paid out over the surviving spouse's life expectancy. There will be probably be little left in that credit shelter trust when the surviving spouse later dies, assuming she lives for all or most of her IRS-defined life expectancy. Few estate tax dollars will have been saved, because the retirement plan has been added to the spouse's estate just as if you had named her directly as beneficiary—but without the advantages of the spousal rollover. If you want to avoid enlarging the estate of the surviving spouse, you must provide that the credit shelter trust does NOT distribute the original value of the participant's retirement plan to the spouse. Keeping this money IN the credit shelter trust (and out of the spouse's estate) is the whole point of having a credit shelter trust. Thus this approach makes sense only rarely; for example, if the spouse has a short life expectancy, but the participant does not want to cut her out entirely because she may need the money, and the participant understands that the credit shelter trust device will save significant estate taxes only if the spouse dies prematurely but the participant does not want to rely on portability.

It might also make sense if the participant dies young, and the trust can accumulate all income inside the IRA that is payable to the credit shelter trust until the year the deceased participant would have reached age 70½. The accumulation could be substantial, and if investment returns are good then the credit shelter trust might maintain substantial value well into the old age of the surviving spouse.

Where to read more: See Idea #162 or ¶ 6.3.05 of *Life and Death Planning for Retirement Benefits* for definition of Conduit Trust, ¶ 6.4.06(A) regarding use of a Conduit Trust to benefit the spouse.

135. **WORST, usually: Spray trust for the benefit of spouse and issue.** Giving the trustee discretion to distribute funds from the credit shelter trust to the surviving spouse or issue appears to reduce the drawbacks of naming a credit shelter trust as beneficiary, because it encourages the trustee to minimize income taxes by passing retirement plan distributions out to the spouse and/or the issue, depending on who is in the lowest income tax bracket. However, this approach does not eliminate the major drawback of leaving benefits to a credit shelter trust for spouse, namely, the loss of the spousal rollover. Furthermore, to the extent income taxes are reduced by distributing the income to the spouse, her estate taxes are correspondingly increased (because she ends up owning assets that were supposed to stay in the credit shelter trust); this defeats the purpose of the credit shelter trust. To the extent income taxes are reduced by passing the retirement plan distributions out to *issue*, the money is no longer available for the spouse's needs; and if she didn't need the money in this trust, why didn't you just make it payable to the issue in the first place and get the benefit of their long life expectancy (Idea #131)? Again, this seems likely to be a realistic solution in very few cases, though there seems to be no harm in giving the trustee discretion to distribute to issue in a nonconduit credit shelter trust established for the primary benefit of the spouse.

136. **WORST/BEST: Have participant buy life insurance to replace the credit shelter trust.** Buying an $11.18 million life insurance policy through an irrevocable trust, and paying the premiums with annual gifts, does not solve the credit shelter trust problem, because at the end of the day there is still nothing in the client's credit shelter trust. If the participant could figure out a way to fund his credit shelter trust, he could do both things—fund the credit shelter trust and *also* make lifetime gifts to an irrevocable insurance trust. However, a life insurance policy held in an irrevocable trust can be a good consolation prize for a person who has the problem we are discussing. It could, for example, be a good way to provide for the increased estate taxes potentially generated by leaving all the retirement benefits outright to the spouse (Idea #129) or to compensate for the "death of the stretch" (see Idea #113).

137. **WORST: Convert to Roth IRA, use Roth to fund the credit shelter trust.** By converting his IRA to a Roth IRA, the participant assures that a credit shelter-type trust for the surviving spouse can be funded with after-tax dollars, namely the Roth IRA. Unfortunately, the Roth IRA, if made payable to a "see-through" credit shelter trust of which the spouse is the oldest beneficiary, would have to be distributed over the spouse's single life expectancy. If the Roth were left to the spouse *outright*, she could roll it over to her own Roth IRA and then there would be no RMDs at all until the surviving spouse's death (see Idea #126). A trust that benefits the participant's surviving spouse for life can not use the life expectancy of the younger remainder beneficiaries to measure payouts even after the death of the surviving

spouse. So the participant would be paying the price of a Roth conversion (immediate loss of the money used to pay income tax on the conversion) without getting the benefit (long-term tax-free payout over younger beneficiary's life expectancy).

138. **BEST for the very rich: Cash out enough to give away exemption amount during life.** This Idea is for a participant who is extremely wealthy but has no other assets besides his retirement plans. The participant could withdraw enough money from the plan to leave him with $11.18 million after paying the income tax on the withdrawal. If he is over 59½, he could make this withdrawal in one lump sum without paying a penalty; if under 59½, he would have to incur a penalty or else qualify for an exception to the penalty (see Ideas #78 and #80). Then he could give the $11.18 million of cash to his younger-generation beneficiaries, and leave the remaining balance of the retirement plan to the surviving spouse, who could roll it over to her own plan. The major attraction of this option is that none of the participant's federal estate tax exemption would be "wasted" paying income taxes, and he would use his exemption as soon as possible (removing future growth on that money from his future taxable estate).

This idea does not maximize income tax deferral; rather it sacrifices income tax deferral in favor of estate tax savings. This option may be attractive: if the participant is approaching his RBD (so he will have to begin taking distributions soon anyway—by accelerating the distributions a few years, he would gain the peace of mind of having the exemption gift fully funded with nonretirement plan dollars); or if the participant is about to die (so he can be sure the benefits of the move—funding the exemption amount gift with after-tax dollars—would be realized soon); or if the family is way overweighted in retirement plan assets (for example if the spouse also has a multi-million dollar retirement plan; see Idea #23).

139. **WORST, usually: Put all nonretirement assets in name of spouse who will die first.** Some planners believe they can predict which spouse will die first. Such a planner simply causes all the nonretirement assets to be put in that spouse's name, so they can be used to fund the credit shelter trust when that spouse dies; the retirement plan can then be left to (or kept by) the surviving spouse. If the spouses die in the correct order, this plan solves the credit shelter trust-funding problem. However, this solution is possible only when there are enough nonretirement assets to fund the credit shelter trust of at least one spouse (though not both). Also, this plan can produce disastrous results if the wrong spouse dies first, especially if *all* the assets are in the other spouse's name. That said, this idea might be a BEST idea if one spouse is at death's door and the other spouse is alive and healthy and agrees to stay away from all banana peels and other hazards until after the plug is pulled. But portability of the federal estate tax exemption largely eliminates the need for this type of "planning idea"; even if the first spouse to die has no assets in his/her own name, his/her exemption can be left to the surviving spouse for her/his later use. See Idea #129.

140. **BEST, sometimes: Leave benefits to a traditional credit shelter trust.** If the best form of distribution of the benefits is a lump sum distribution, not rolled over (this could be the case

if for example the entire plan balance consists of low-basis employer stock; see Idea #4), it may not make much *income tax* difference whether the distribution is paid to the spouse or to a trust for his/her benefit. Similarly, if the alternative to leaving the benefits to a credit shelter trust is leaving them to a QTIP trust (*not* to the spouse outright) (this could be the case if, for example, the spouse is not able to manage money), there's little difference in terms of drawbacks between leaving the benefits to a QTIP trust or a credit shelter trust.

141. **WORST: Make the credit shelter trust a § 678(a)(1) grantor trust.** An approach that has been suggested by some practitioners is: Have the first spouse to die leave retirement benefits to a traditional credit shelter trust. Then use § 678(a)(1) to cause the spouse to be treated as the "owner" of the trust property for income tax purposes by making her the sole trustee with power to distribute principal to herself for her health, education, maintenance, and support ("HEMS" power). Since § 678(a)(1) says that a person who has power to pay funds to herself is treated as the "owner" of such funds for income tax purposes, and since § 678(a)(1) does not contain any apparent exceptions for a power limited by an ascertainable standard, the spouse would be treated as the owner of the trust principal by virtue of her power to pay such principal to herself (even though it is limited by an ascertainable standard). Yet this power is not broad enough to cause the trust principal to be included in the spouse's estate on her subsequent death because it meets the definition of a nongeneral (therefore nontaxable) power of appointment under § 2041(b)(1)(A). Thus, proponents say, income taxes on retirement benefits payable to the trust would be taxed at the spouse's personal (low) income tax rate rather than at (high) trust income tax rates.

This idea does not work. The problem is that, even though § 678 does not contain an *explicit* exception for powers limited by an ascertainable standard, the courts have found an implied one. When the IRS has sought to cause a surviving spouse to be taxable on trust income because of some right of withdrawal she holds, the courts have interpreted § 678 as applying only to an *unrestricted* right to withdraw from the trust. In other words, the courts have interpreted § 678 just the opposite of the way it is interpreted by practitioners encouraging this approach. Accordingly, if the spouse's power to withdraw principal is limited by a HEMS standard, she will *not* be taxable on the trust's income arising from retirement plan distributions merely by virtue of holding that power.

As with many of the other Ideas in this Group, portability of the federal estate tax exemption largely eliminates the need for this type of "planning idea." If portability exists, there is no need to do back flips to try to fund a credit shelter trust at the first death, if doing so would increase income taxes and/or involve questionable tax ideas.

<u>Where to read more</u>: Blattmachr, J.G., et al., *Income Taxation of Estates and Trusts*, 14th Ed. (2000), (Practicing Law Institute Press, 810 Seventh Ave., New York, NY 10019), § 3:4.5, n. 159, explains § 678 and the courts' interpretation of it.

142. **WORST: Rely on a § 2056(b)(7)(C) election to keep benefits out of spouse's estate.** This is another complicated tax theory that doesn't work. IRAs (and all retirement plans) are treated as "annuities" for purposes of the federal estate tax, regardless of whether paid as an

annuity. Reg. § 20.2039-1(b)(1). Thus, even though the typical IRA is an individual account plan, that the beneficiary can withdraw in a lump sum or in installments anytime he/she wishes, it is reported as an annuity on the federal estate tax return. See Instructions for IRS Form 706, Schedule I. If an annuity is payable to the surviving spouse, § 2056(b)(7)(C) provides that it qualifies for the marital deduction if the spouse is the only beneficiary during her life; and that the executor is deemed to have elected to treat the annuity as qualified terminable interest property (QTIP) unless the executor irrevocably elects OUT of QTIP treatment. The effect of this section, in the case of a true annuity (series of fixed payments for the spouse's life or a term of years), is (if the executor does not elect out of QTIP treatment) to cause (1) the value of the annuity to be deductible in the estate of the first spouse to die, and (2) any residual value in the annuity remaining at the spouse's death to be included in her estate.

Some practitioners argue as follows: An IRA payable to the spouse is subject to § 2056(b)(7)(C) because it is considered an annuity for federal estate tax purposes (true so far). Therefore, when the participant dies leaving his IRA to the spouse as named beneficiary, but failed to use his entire federal estate tax exemption, the executor should use § 2056(b)(7)(C)(ii) to elect NOT to take the QTIP marital deduction for the IRA; then, upon the spouse's later death, the IRA will NOT be included in her estate under § 2044. She can elect to treat the IRA as her own under Reg. § 1.408-8, A-5, thereby gaining the income tax advantages of a "rollover" without losing the alleged estate tax advantage of the § 2056(b)(7)(C) "election out."

The problem with this idea is that, even if the IRA is not included in the surviving spouse's estate *under § 2044*, it will be included in her estate under another Code provision, namely § 2041(a)(2), as "property with respect to which...the decedent has a general power of appointment," if she has the unlimited right to withdraw from it. (If she does not have the unlimited right to withdraw from it she cannot elect to treat the IRA as her own under Reg. § 1.408-8, A-5.) § 2044 is not the exclusive provision for taxing QTIP property in the surviving spouse's estate; property can be taxable under more than one Code section and a retirement plan benefit that the spouse can freely withdraw from would be taxed in her estate regardless of how it was treated for marital deduction purposes in the participant's estate.

143. **WORST: Give your IRA or Roth IRA to a grantor trust for the sole benefit of another person.** Some estate planning experts have developed an idea called the "Supercharged Credit Shelter Trust," which involves a wealthy individual's creating a lifetime QTIP trust for the benefit of his/her spouse. There's no tax when the trust is set up (because of the gift tax marital deduction); or at the donee-spouse's later death (because the trust value is sheltered by the donee-spouse's estate tax exemption); or upon the later death of the original donor-spouse (even if he survived the donee-spouse and had life-income rights after the donee-spouse's death) because the donor-spouse's rights in the trust if any after the death of the donee-spouse are not sufficient to cause estate inclusion.

Suppose the wealthy individual wants to go ahead with this supercharged plan but his only asset is an IRA. Can he transfer his IRA to the inter vivos QTIP, if the QTIP trust is a 100 percent grantor trust as to the donor/IRA owner? After all, § 677(a) says the grantor shall be treated as the owner of a trust asset that can be distributed to the grantor's spouse in the discretion of a nonadverse party. And under Rev. Rul. 85-13, 1985-1 C.B. 184, a sale transaction between the grantor and his 100 percent grantor trust is ignored (not treated as a sale) because the asset is deemed to be owned by "the same person" both before and after the transaction, so there is no taxable transaction because you can't sell something to yourself. So isn't transferring an IRA to such a trust just the same as transferring it to yourself, i.e., it's not a transfer at all?

Well…maybe. The IRS has at least thrice blessed the transfer of an *inherited* IRA by the beneficiary to the beneficiary's own irrevocable 100-percent-grantor trust; see PLRs 2006-20025 2008-26008, and 2011-16005, and discussion at ¶ 4.6.03(C) of *Life and Death Planning for Retirement Benefits*. And it's true the IRS has repeatedly and adamantly affirmed the principle (invented by the IRS—it's not in the Code) that a grantor trust is an "ignored" entity for income tax purposes, as if the trust "doesn't exist" (see CCA 2013-43021 discussed below).

But then again, in PLR 2011-29045, in which "Taxpayer A" attempted to transfer her IRAs into "an IRA within a grantor trust benefitting Taxpayer A," the attempted transfer failed because (according to the IRS) the recipient financial institution "correctly determined that a grantor trust could not be the owner of an IRA."

So is there some difference between inherited and "regular" IRAs with regard to this question? Possibly. The income tax consequences of transferring an inherited IRA are governed by § 691 (income in respect of a decedent), which says certain transfers are taxable and others are not, but § 691 does not apply to lifetime transfers. Lifetime transfers do not have such specific statutory coverage; rather, regulations simply provide a flat-out prohibition on certain lifetime transfers (see cites below).

Here are two problems with the proposal to have the participant transfer his IRA to an irrevocable trust for the participant's spouse (even if it is a 100 percent grantor trust as to the participant).

*Compliance with minimum distribution rules*: The IRA must pay annual required minimum distributions to the participant once he reaches age 70½. To meet the marital deduction requirement that distributions cannot be made from a QTIP trust to anyone other than the donee-spouse during his/her lifetime, the IRA assigned to the QTIP will have to provide that required minimum distributions are paid *to the trust* rather than to the IRA participant, and in fact that IRA distributions during the spouse's life may not under any circumstances be paid to the participant himself. Who would like to be the first person to test the theory that, under the principle of Rev. Rul. 85-13, IRA distributions to the participant's 100 percent grantor trust for the sole exclusive life benefit of the participant's spouse will be deemed distributions "to" the participant and accordingly will satisfy § 401(a)(9)?

A variation of Idea #143 is to transfer a *Roth* IRA to an irrevocable grantor trust; see Horwitz, Stuart M., and Damicone, Jason S., "A Decent Proposal," *Trusts & Estates* (Nov. 2011), p. 46. This would eliminate the minimum distribution problem because a Roth IRA does not have to pay any minimum distributions until after the participant's death. But these ideas still have the following "other problem":

*Transfer disqualifies IRA*? The participant's transfer of an IRA to another individual by gift could trigger the immediate disqualification of the IRA. Reg. § 1.408-4(a)(2) provides that "an assignment of an individual's rights under an individual retirement account…shall…be deemed a distribution to such individual …of the amount assigned." Reg. § 1.408A-6, A-19, provides that "A Roth IRA owner's transfer of his or her Roth IRA to another individual by gift constitutes an assignment of the owner's rights under the Roth IRA. At the time of the gift, the assets of the Roth IRA are deemed to be distributed to the owner and, accordingly, are treated as no longer held in a Roth IRA."

Who would like to be the first person to test the theory that, because of Rev. Rul. 85-13, the transfer of an IRA to a 100 percent grantor trust for the sole exclusive life benefit of the participant's spouse will not be treated as an assignment of the participant's rights under the IRA? Or the theory that, because of Rev. Rul. 85-13, the sale of the participant's rights under a Roth IRA to a 100 percent grantor trust beneficially owned by individuals other than the participant will not be treated as a deemed-distribution-triggering transfer of the account?

*Conclusion:* I do not say these ideas cannot work. After all, the IRS seems "married" to Rev. Rul. 85-13; CCA 2013-43021 (for example) affirmed the IRS commitment to 85-13 without qualification. I'm just saying I wouldn't want to bet the ranch (or the IRA) on this one. If it's such a great idea, get a ruling okaying it.

Using an IRA or Roth IRA for estate tax-savings gift transfers as contemplated by these planning ideas defeats the purpose for which the Code provides tax breaks to IRAs, namely, to provide an asset for the participant to spend during his/her retirement. It makes no sense to suggest that the favorable income tax attributes of an IRA or Roth IRA, which are granted by the Code exclusively to the participant during his lifetime, will be preserved even after he has irrevocably transferred the asset to another individual, whether by gift or by sale. The fact that the grantor trust rules continue to treat the participant as "the owner" of the underlying assets even after the transfer is a pure tax fiction, designed to prevent shifting income to lower-bracket entities. Despite the IRS's apparently slavish devotion to Rev. Rul. 85-13, practitioners should not be complacent in believing that a grantor trust simply "doesn't exist" for income tax purposes. After all even Rev. Rul. 85-13 didn't say that, and the grantor trust rules in the Code certainly don't say anything like that. The IRS *could* say that, yes, the trust is still treated as owned by the grantor, but the IRA is disqualified, so what the grantor "owns" is a bunch of regular taxable assets. These planning ideas may finally pop the Rev. Rul. 85-13 bubble!

## N. PROBLEM: SECOND MARRIAGE/QTIP TRUST ISSUE

This problem typically arises in a second (or later) marriage: The participant has children from a prior marriage. He wants to benefit those children as well as his current spouse. Since his current spouse is not the parent of his children, the participant is concerned that the spouse does not share the participant's goal of benefitting such children.

In the case of nonretirement plan assets, this problem is easily solved by leaving benefits to a qualified terminable interest property (QTIP) trust. A QTIP trust pays income to the spouse for life, but on the spouse's death the trust property passes to beneficiaries chosen by the participant (i.e., his children), not to beneficiaries chosen by the spouse. If the trust meets the requirements of § 2056(b)(7)(B), and the surviving spouse is a U.S. citizen, it qualifies for the federal estate tax marital deduction, thus allowing estate taxes on the QTIP assets to be deferred until the spouse's later death. Unfortunately, leaving *retirement benefits* to a QTIP trust involves the same drawbacks as leaving benefits to a credit shelter trust (Idea #117).

Where to read more: The Natalie B. Choate *Special Report: Retirement Benefits and the Marital Deduction (Including Planning for the Noncitizen Spouse)*, downloadable at www.ataxplan.com, explains how the federal estate tax marital deduction and QTIP rules apply to retirement benefits.

144. **BEST: Leave some benefits to spouse and some to children.** With a QTIP trust, the spouse has a life interest and the children have a remainder interest. Instead of forcing his family members to share the retirement benefits via a QTIP trust, the participant could leave some of the benefits outright to the spouse and some either outright to the children or to a trust for their exclusive benefit. If the spouse takes advantage of the spousal rollover and the children (or the trust for the children) take advantage of the life expectancy payout option, both the spouse and the children should end up with substantially more dollars in their pockets than they would if they received theoretically the same relative shares of the benefits as life and remainder beneficiaries of a QTIP trust. Only the IRS loses.

145. **BEST compromise, rarely: Make QTIP trust a Conduit Trust for spouse.** This approach solves one of the drawbacks of leaving benefits to a trust for the life benefit of the spouse, namely, the high income tax rates that apply to trusts (as opposed to the lower income tax rates that would apply to a low-income individual). Because all plan distributions must be passed out immediately to the surviving spouse/life beneficiary, the benefits will be taxed to the spouse at her tax rate rather than to the trust. However, this solution is not appropriate for someone whose goal in establishing a QTIP trust was to preserve principal for the children, because (unless the spouse dies prematurely) the spouse ends up with the lion's share of the retirement plan—but without the income tax deferral advantages of the spousal rollover. This solution may be suitable if the participant wants to be sure his children receive something from the trust only if the spouse dies prematurely, and doesn't care whether they get anything if she lives to her full life expectancy.

Where to read more: See Idea #134. See Idea #162 and ¶ 6.3.05 of *Life and Death Planning for Retirement Benefits* for definition of Conduit Trust, ¶ 6.4.06(A) regarding use of a Conduit Trust to benefit the surviving spouse, and ¶ 6.5 regarding income tax treatment of benefits payable to or by a trust.

146. **BEST: Leave benefits to one, other assets (and life insurance?) to the other.** If the participant leaves the retirement benefits outright to the spouse and makes up the "asset loss" to the children via a life insurance policy (or leaves the benefits to the children and buys life insurance for the spouse), all the drawbacks of leaving the benefits to a QTIP trust are eliminated and each "side"of the family receives its proper share.

147. **WORST: Convert to a Roth IRA, use Roth to fund the QTIP trust.** The drawbacks of this solution are discussed at Idea #137.

148. **WORST: Name spouse as beneficiary, on condition that she will name participant's children as beneficiaries of her rollover IRA.** This frequently-advanced idea is usually not useful. For one thing, the children are not at all protected by the spouse's assurance that she will name them as beneficiary of her rollover IRA. Unless they force the spouse into some kind of court proceedings, how will they know if she has complied? Are they going to tail her with a lawyer to see where she opens the rollover IRA account? The IRA provider of her rollover account will not disclose anything to anyone besides the surviving spouse-IRA owner herself. But even if she complies, and names the children as beneficiaries of the rollover IRA, she has agreed to nothing, since she can withdraw all funds from that rollover IRA without anyone's consent. Once the funds have been withdrawn from the IRA she can spend them, or she can leave them to anyone she chooses, and the children will get nothing.

If the participant leaves benefits to the spouse on the condition (enforced by a separate agreement, since no plan administrator would accommodate such a condition) that she *not* spend them, and that she will leave either the benefits themselves or the proceeds thereof to the participant's children, then he has created a "terminable interest" that will not qualify for the marital deduction. Also, if the spouse's right to withdraw from the account is restricted, the benefits will not be eligible for the spousal rollover. Reg. § 1.408-8, A-5(a).

Where to read more: See ¶ 3.2.03 of *Life and Death Planning for Retirement Benefits* regarding requirements for spousal rollover of IRA. See the Natalie B. Choate *Special Report: Retirement Benefits and the Marital Deduction (Including Planning for the Noncitizen Spouse)*, downloadable at www.ataxplan.com, for explanation of the "terminable interest rule."

## O. DRAFTING THE BENEFICIARY DESIGNATION FORM

Here are some ideas to keep in mind when you sit down to draft the beneficiary designation form for a client.

149. **BEST: Estate planning lawyer drafts the beneficiary designation form.** The estate planner's responsibility should include drafting the beneficiary designation form for any significant (in terms of dollar value or percentage of the client's assets) retirement plan or IRA. Do not leave this vital step up to the client; or at the very least follow up with the client to make sure it is executed properly. Clients may fail to carry out instructions due to procrastination, lack of understanding, or many other possible causes. Clients do not have the training to draft legal documents, and this is a legal document. If necessary increase your fees to cover this vital service. Do not experience the horror that occurs when a client dies and it is discovered, too late, that "clear instructions" given to the client about how to complete his/her beneficiary forms were not carried out.

150. **BEST: Name a contingent beneficiary.** Here are two vital tips on how to name a contingent beneficiary.

**A. If there is one primary beneficiary:** If the surviving spouse (or any other individual) is named as primary beneficiary, the participant should also name a contingent beneficiary to receive the benefits if the spouse (or other primary beneficiary) predeceases (or dies simultaneously with) the participant. Unfortunately, many participants think "If my spouse predeceases me, then I'll fill out a new beneficiary form...I don't have to decide now." Then, the spouse predeceases the participant by only a short time, or dies simultaneously with him, and there is not sufficient time to fill out a new beneficiary designation form so the participant dies without having named a beneficiary. For what happens when there is no named beneficiary, see Ideas #127 and #190.

**B. If there are multiple primary beneficiaries.** If the primary beneficiary is a class (such as "my children equally") rather than a single individual, the participant needs to specify what happens to the share of a class member who predeceases the participant. State laws often solve this problem in the case of a *will*, by specifying that a gift to a blood relative automatically passes to the relative's surviving issue if the relative predeceases the testator and the testator did not specify otherwise. That type of "anti-lapse statute" may or may not apply to an IRA beneficiary designation form under the applicable state law. Also, some IRA agreements specify that, if there are multiple primary beneficiaries, the account will be paid equally to the class members who survive the participant. IRA providers prefer to avoid having a share pass to the "issue" of a deceased beneficiary, presumably because they are worried about being able to determine who the beneficiary's issue are. The practitioner can avoid getting trapped by either state law or the provisions of the IRA agreement by specifying in the beneficiary designation form what the participant wants to have happen to the share of a primary beneficiary who predeceases him—typically, in the case of a gift "equally to my children," to have the share of a deceased child pass to the deceased child's issue. This is sometimes referred to as the "*per capita versus per stirpes*" question, but it is not necessary to speak Latin to solve the problem; just specify, in English, what is to happen to the share of a beneficiary who predeceases the participant.

151. **BEST: Specify that contingent beneficiary takes in case of disclaimer, not just death.** Qualified retirement plans (QRPs) are subject to ERISA, a federal law that preempts state laws dealing with the same subject matter. To the surprise of the estate planning bar, the Supreme Court has interpreted ERISA's preemption clause as applying to state probate laws to the extent they purport to apply to retirement benefits under qualified plans. See, *e.g.*, *Egelhoff v. Egelhoff*, 121 S. Ct. 1322, 532 U.S. 141 (2001), upholding a QRP's refusal to follow a state statute that would have voided a beneficiary designation in favor of an ex-spouse. The Court cited the need for uniform national rules for plan administration.

Although the IRS has ruled that qualified disclaimers do *not* violate ERISA (GCM 39858), and has blessed disclaimers of QRP benefits in letter rulings (*e.g.*, 9016026, 9247026, 2001-05058), it is possible that the plan administrators will conclude that the Supreme Court has authorized them to ignore disclaimers under *Egelhoff* and similar decisions, on the rationale that the plan requires the benefits to be paid to the primary beneficiary if he/she survives the participant, and the plan cannot look to the state law of disclaimers to overrule the terms of the plan documents.

However, if the beneficiary designation form specifies that the benefits pass to a certain contingent beneficiary if the primary beneficiary fails to survive *or disclaims the benefits*, then the "plan terms" require payment to the contingent beneficiary in case of disclaimer by the primary beneficiary, because the beneficiary designation is part of the plan documents. This should allow an end run around the ERISA argument, or at least flush out (at the planning stage) the plan's opposition to disclaimers (if the plan refuses to accept the designation form with that language).

152. **BEST: Require plan to provide info to participant's executor.** As long as we are talking about problems created by obstructionist plan administrators, here's a doozy: The plan administrator refuses to provide information to the participant's executor, claiming that it can deal only with the new owner of the account (the beneficiary) and that the executor is a "stranger to the account." Beat this one at the planning stage, by specifying in the beneficiary designation form that the plan administrator must provide the participant's executor with all information the executor reasonably requests, and/or needs for performance of his duties, and/or that the participant could have demanded if living; and specify that any person named as beneficiary is deemed to have consented to the release of this information as a condition of receiving benefits under the plan (to avoid claims that providing information to the executor violates the beneficiary's privacy rights). If it's too late for that idea (because the participant is already deceased), remind the plan administrator that, if the plan administrator fails to supply the necessary information to the executor, the Code will require the plan administrator to file the estate tax return for this asset. § 6018(a).

Where to read more: See Form 5.5 in Appendix B of *Life and Death Planning for Retirement Benefits*, suggested letter to plan administrator who refuses to provide information to the executor.

153. **BEST, for multiple beneficiaries: Change fixed-dollar gifts to fractional gifts.** When a retirement plan death benefit is left to multiple beneficiaries, no beneficiary may use the life expectancy payout method unless all the beneficiaries are individuals (or see-through trusts). Reg. § 1.401(a)(9)-4, A-3. If all beneficiaries are individuals or see-through trusts, the ADP for all such beneficiaries is the oldest beneficiary's life expectancy. Reg. § 1.401(a)(9)-5, A-7(a)(1). There is an exception to these unfavorable multiple beneficiary rules: If the benefit is divided into "separate accounts" for the different beneficiaries, each individual beneficiary's own life expectancy is the ADP for his or her separate account, provided the separate accounts are "established" by 12/31 of the year after the year of the participant's death. Reg. § 1.401(a)(9)-8, A-2(a)(2). The catch is that only fractional or percentage gifts can be treated as separate accounts; fixed-dollar (pecuniary) gifts generally don't qualify (unless the fixed-dollar gift is to share proportionately in gains and losses that occur after the

participant's death). Therefore, if separate accounts treatment is important, but the client wants to leave a fixed-dollar amount to one or more beneficiaries (*e.g.*, a specific dollar amount to charity, or his GST exemption amount to his grandchildren), consider rewriting the bequest as a fractional amount.

Where to read more: In *Life and Death Planning for Retirement Benefits*, ¶ 1.8.01 explains the separate accounts rule and Form 3.8 in Appendix B illustrates expressing a pecuniary gift as a fractional amount.

154. **BEST: If separate accounts treatment is desired, specify beneficiaries and shares in the beneficiary designation form, rather than in the trust.** In PLRs 2003-17041, 2003-17043, and 2003-17044, an IRA was payable to a trust that was required to terminate upon the participant's death. The assets of the terminating trust passed outright to the participant's three children; there was no trustee discretion involved in either the fact of the termination or the size of each beneficiary's share, and the trust qualified as a see-through trust. Each of the children sought a ruling.

In these 2003 rulings the IRS reached exactly the opposite result of PLR 2002-34074, which had similar facts, issued less than a year before. The 2003 rulings provided that *each child would have to use the oldest child's life expectancy to measure his/her RMDs*, because the IRA had been payable to the trust as named beneficiary and separate accounts could not be established (for ADP purposes) for the beneficiaries of a trust (citing a new sentence in the final regulations, Reg. § 1.401(a)(9)-4, A-5(c)). Accordingly, if it is desired to have the interests of multiple trust beneficiaries constitute separate accounts (see Idea #153), it is necessary to establish *separate trusts* for them (this was always true) and (the new part) put the division of the IRA into *the beneficiary designation form* rather than only in *the trust*.

For example, consider the typical case of a participant who wants to leave his IRA in trust for his spouse for life with remainder to his issue living on the death of the spouse. The normal (but not-recommended) way to accomplish this is to name the trust as beneficiary of the retirement plan, and leave it up to the trustee to either hold the benefits in trust for the spouse or to distribute them outright to the issue if the spouse does not survive the participant. Under the final regulations, this normal approach does not work ideally. Accordingly, if the participant wants the shares passing to his issue to qualify as separate accounts, he should name them *directly* as contingent beneficiaries of his IRA rather than simply leaving the benefits to the trust in all events. For example:

**Instead of this:** "I name the Natalie B. Choate Trust as beneficiary of my IRA."

**Use this:** "If my spouse survives me, I name the Natalie B. Choate Trust as beneficiary of my IRA. If my spouse does not survive me, I name as beneficiary of my IRA my issue surviving me, by right of representation."

If the trust that the participant would like to name as beneficiary is to terminate upon the participant's death and be divided up into specified shares allocated to newly-established separate trusts, the participant should *name the separate trusts directly* as beneficiaries of the IRA rather than naming the single, funding, trust as beneficiary.

Where to read more: See ¶ 6.3.02 of *Life and Death Planning for Retirement Benefits*. These rulings were discussed in the article "RMD Rule Reversal" by Natalie B. Choate, *Trusts & Estates*, Vol. 142, No. 7 (July 2003), p. 36.

155. **WORST: Use a formula that requires external facts to apply.** *E.g.*, "I name Child as my beneficiary up to the amount of the federal estate tax exemption available to me at my death and I name my spouse as beneficiary of the balance of the account." Since the plan administrator has no idea how much estate tax exemption the participant has left at his death, the plan administrator will probably reject this type of beneficiary designation. Some IRA providers will accept a formula requiring external facts *if* the beneficiary designation form specifies a fiduciary (such as the participant's executor, or the trustee of a trust) who is required to certify the necessary facts to the IRA provider, and the form specifies that the IRA provider can rely absolutely on the certifications provided by that fiduciary; if using this approach, be sure the documents appointing that fiduciary (such as the participant's will or trust) make clear the fiduciary must fulfill this duty.

Where to read more: See the "Trust as Beneficiary Checklist" at ¶ 6.1.01 of *Life and Death Planning for Retirement Benefits*. See the articles "Dear IRA Provider" by Natalie B. Choate and "Dear Estate Planner" by Andrea L. Wasserman, Esq., *Trusts & Estates*, Vol. 141, No. 9 (Sept. 2002), at page 29, for a practitioner's wish list of policies IRA providers should adopt, and an IRA provider's (Vanguard's) wish list of policies estate planners should adopt, in connection with the disposition of IRAs at the owner's death.

156. **BEST: Have administrator acknowledge receipt of beneficiary designation.** After all your hard work preparing a beneficiary designation form, don't leave it up to the plan administrator to lose the form. Get written acknowledgment of receipt, preferably in the form of a photocopy of the signed and dated beneficiary designation form stamped "Receipt acknowledged this ___day of__________, 20__, Signed: [signature of plan administrator]." Whenever you review a client's estate plan, insist on evidence that the beneficiary designation the client THINKS is on file with the plan really is there.

## P. LEAVING BENEFITS TO A SEE-THROUGH TRUST

Leaving retirement benefits to a trust presents several issues. One is whether the trust meets the requirements of the IRS's "minimum distribution trust rules." The minimum distribution rules of § 401(a)(9) permit death benefits to be paid out over the life expectancy of a human beneficiary. Regulations allow a trust that is named as beneficiary of retirement benefits to use this "life expectancy payout method" if various requirements are met. Reg. § 1.401(a)(9)-4, A-5; see ¶ 6.2.01 of *Life and Death Planning for Retirement Benefits*.

If the trust meets these requirements, the IRS calls it a "see-through trust." The Applicable Distribution Period (ADP) for benefits payable to a see-through trust is generally the life expectancy of the oldest trust beneficiary (see ¶ 1.5 of *Life and Death Planning for Retirement Benefits* for details and exceptions). The Ideas in this section tell you ways to comply with the trust rules, IF compliance is important.

157. **BEST: First determine whether you care about see-through trust status.** The first step is to determine whether qualifying as a see-through trust even matters. Sometimes it makes no difference whether the trust complies with the trust rules. If compliance doesn't matter, don't bother to jump through the hoops of qualifying as a see-through trust. For example:

A. If the participant is past his required beginning date (RBD), and the oldest beneficiary of the proposed trust is the same age as (or older than) the participant, then the ADP will be no longer if the trust passes the rules (the longer of the life expectancy of the participant or the life expectancy of the oldest trust beneficiary) than if the trust flunks the rules (the life expectancy of the participant). Thus, "passing" the trust rules will not result in a longer ADP. Note, however: If the participant's benefits are in a plan that pays death benefits only in the form of a lump sum distribution, and the trust does NOT qualify as a see-through trust, the trust will not be able to use the post-death rollover procedure (see Idea #179) to transfer the plan benefits to an "inherited IRA" to take advantage of the payout over the participant's life expectancy; this procedure is available only for a "designated beneficiary."

B. If the trust that is to be named as beneficiary is a charitable remainder trust that meets the requirements of § 664 then the trust is income tax-exempt. See Idea #119. An income tax-exempt entity does not need to take advantage of the income tax deferral potentially available under the life expectancy payout method, so passing the trust rules is irrelevant.

C. If the benefits will have to be cashed out shortly after the participant's death in any case (to pay estate taxes or debts; or because the beneficiaries will need the money), long-term life expectancy payout is not a goal.

D. Finally, in some cases complying with the trust rules involves significant compromise with the client's other estate planning goals. It may be appropriate to sacrifice the income tax deferral possibilities of the life expectancy payout method in order to realize the client's other goals.

Where to read more: See *Life and Death Planning for Retirement Benefits* regarding the different minimum distribution rules that apply in case of the participant's death before (¶ 1.5.03) or after (¶ 1.5.04) the RBD; see ¶ 1.4 regarding how to determine the RBD.

If you have figured out that you DO care about passing the trust rules, here are several Ideas about how to do this:

158. **BEST: Forbid use of benefits to pay debts, expenses (either completely or after BFD).** Some IRS PLRs imply that even indirectly allowing benefits to pass to the participant's estate (as through a trust provision that allows or directs the use of trust property to pay the participant's debts or probate expenses) may be treated the same as naming the estate as a beneficiary and may result in having "no designated beneficiary." See, *e.g.*, PLR 9809059. Draft the trust so it either prohibits this use of the retirement benefits altogether, or prohibits such use after September 30 of the year after the year of the participant's death (the "Beneficiary Finalization Date" or BFD; see Idea #194). If there are no other assets available to pay debts, expenses and taxes, consider specifying that only certain retirement plans may be used for this purpose, so that only the retirement plans authorized to be used to pay the debts and expenses will be "tainted," and the other(s) can be exempted from this problem. See also Idea #124.

However, **do NOT use this "boilerplate" clause if the trust has charitable beneficiaries** unless you are SURE that the life expectancy payout for the trust's human beneficiaries is a higher priority than using the benefits to fund the gifts to the tax-exempt charities! See Idea #169.

Where to read more: ¶ 6.2.10 of *Life and Death Planning for Retirement Benefits* discusses in detail the effect of a provision regarding payments to the estate on see-through trust status.

159. **BEST: Include "This trust shall be irrevocable upon my death."** The second IRS minimum distribution trust rule is: "The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee." Reg. § 1.401(a)(9)-4, A-5(b)(2). Generally, any testamentary trust or living trust automatically becomes irrevocable upon the testator's or donor's death, and therefore passes this test, so including in the trust the statement "This trust shall be irrevocable upon my death" is not necessary. On the other hand it does no harm to include this sentence, and inclusion may avoid an argument with possible future plan administrators and auditing IRS agents who may not be familiar with estate planning.

160. **BEST: Exclude adult adoptees from definition of "issue."** The third IRS minimum distribution trust rule is that all beneficiaries of the trust must be "identifiable," meaning that it must be possible to identify the oldest person who could ever be a beneficiary of the trust. If the trust beneficiaries are "all my issue living from time to time," the members of that class of potential beneficiaries should be considered "identifiable," even though the class is not closed as of the applicable date, because no person with a shorter life expectancy can be added later. The oldest member of the class can be determined with certainty (because the participant's issue who are born after his death are by definition younger than the oldest issue of the participant who is living at the participant's death). Reg. § 1.401(a)(9)-4, A-1.

However, there *is* theoretically a problem even with this common provision. If people who are issue by virtue of legal adoption are to be included on the same basis as "natural" issue, there is a potential for violating the rule. After the participant's death, one of his issue could adopt someone who was born earlier than the person who was the oldest beneficiary of the trust when the participant died. It is not known whether the IRS would ever raise this "issue," but to avoid the problem, include language in the trust providing that older individuals cannot be later added to the class of trust beneficiaries by legal adoption.

161. **BEST: Include trust documentation requirement on your administration checklist.** The fourth IRS minimum distribution trust rule is that the trustee of the trust that is named as beneficiary must supply certain documentation to the plan administrator. Reg. § 1.401(a)(9)-4, A-5(b)(4). In the case of an IRA, the IRA trustee, custodian, or issuer is the party to whom the documentation must be delivered (IRAs don't have "plan administrators"). Reg. § 1.408-8, A-1(b). The deadline for supplying this documentation is October 31 of the year after the year of the participant's death. Reg. § 1.401(a)(9)-4, A-6(b). The documentation to be supplied to the plan administrator is *either* a copy of the trust agreement or a certification of certain information spelled out in the regulation.

Where to read more: See ¶ 6.2.08 of *Life and Death Planning for Retirement Benefits*.

162. **BEST: Use a Conduit Trust when appropriate.** Conduit Trust is not an official term, but is a nickname for a trust that serves as a conduit for distributions from the retirement plan to the individual beneficiary of the trust. The trustee is required to withdraw the minimum distributions from the retirement plan over the life expectancy of the individual trust beneficiary (or of the oldest member of a group of individual trust beneficiaries); and the trustee is also required to distribute out to the individual beneficiary (or the members of the group) *all* distributions the trustee receives from the retirement plan, as they are received. The trustee does not have the power to hold ("accumulate," in IRS terminology) in the trust *any* plan distributions made during the lifetime of the beneficiary.

Under the regulations, with a Conduit Trust, the retirement benefits are deemed paid "to" the individual Conduit Trust-beneficiary for purposes of the minimum distribution rules, and the "all beneficiaries must be individuals" test is met. Remainder beneficiaries can be disregarded for all RMD purposes because they are "mere potential successors" to the conduit beneficiary's interest in the benefits. Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2. *This is a guaranteed safe harbor.* The Conduit Trust could be useful in some situations, such as when a grandparent wants to leave an IRA to young grandchildren and wants to be sure they take advantage of the life expectancy payout method (whether they want to or not); however, also see also Idea #172 in these circumstances.

When drafting a Conduit Trust, be sure to read also Idea #166.

163. **WORST: Always use a Conduit Trust for retirement benefits.** The Conduit Trust (see Idea #162) is not appropriate for all situations, even when compliance with the RMD rules is an important goal. For example, if the proposed beneficiary is a spendthrift, or is subject

to major creditors' claims, or is a drug addict, it may be advisable to give the trustee the power to withhold distributions from that beneficiary for distribution at a later time. Similarly, if the trust is a "pot" trust for several minor children, giving the trustee the power to hold back distributions to accommodate the beneficiaries' later varying needs is an important goal. In such cases, it may be preferable to comply with the "all trust beneficiaries must be individuals" rule by another method; see the following Idea.

164. **BEST and WORST ways to draft a nonconduit see-through trust.** Any trust that is not a "Conduit Trust" (see Idea #162) is nicknamed an "accumulation trust" because the trustee has the power to "accumulate" plan distributions received during the life beneficiary's lifetime. Drafting an accumulation trust that would "pass" the IRS's minimum distribution trust rules, and qualify as a see-through trust for RMD purposes, has long been a difficult task due to the IRS's insistence that "all trust beneficiaries must be ascertainable individuals" and "the oldest individual trust beneficiary's life expectancy is the Applicable Distribution Period" for the trust. The difficulty has been the IRS's vague and ambiguous rules about which trust beneficiaries may be disregarded in applying these tests.

However, since PLR 2004-38044 (and PLRs 2005-22012 and 2006-10026 to the same effect) things have become easier. These PLRs resolved an ambiguity in the regulations. Now it is clear that, in testing a trust, once you reach a beneficiary who will receive the trust assets OUTRIGHT, IMMEDIATELY upon the death of a prior beneficiary, you can "stop looking"; any beneficiary who comes "after" that outright beneficiary is considered a "mere potential successor" and is disregarded. Thus, if a trust says "Pay income to my spouse for life, and on my spouse's death pay the principal outright to my children, or if all my children are then deceased, to my favorite charity," the beneficiaries of the trust (for RMD purposes) are the spouse and the children (assuming the spouse and at least one child survive the participant). The charity is disregarded, because it is a mere potential successor to the children. Thus, estate planners are advised to use such an "Outright to now living persons" trust (or Conduit Trust, Idea #162) whenever it is possible to do so consistent with the client's goals, if see-through trust qualification is important (Idea #157). Practitioners have used different approaches to drafting these trusts.

**A. BEST: Name as immediate outright remainder beneficiary an individual who is living at the participant's death.** For example, "income to my spouse for life, remainder to our children living at her death." As long as the remainder interest is payable to the children immediately outright upon the spouse's death, and when the participant dies there is at least one such child living, you have closed your class of "countable" beneficiaries for minimum distribution purposes (spouse and child(ren)), and all are identifiable individuals, so the trust "passes." Any contingent successor who would take if the child(ren) happen to predecease the spouse are disregarded as "mere potential successors."

**B. Not so BEST: Have an automatic age-related holdback.** If in the preceding example the trust provided that the children would not get their shares until reaching a certain age, and the children were under that age at the time of the participant's death, the IRS (apparently—at least in some PLRS it has done this) would test the trust by counting, as a beneficiary, the person or entity who would take the benefits if the child(ren) do not survive to that age. This will often create very undesirable results for minimum distribution purposes.

**C.** **Not so BEST: Name the participant's "heirs at law who are younger than [beneficiary X]."** Touted as a panacea, this clause is a questionable solution. The IRS would (apparently) test the trust by determining, as of the date of the participant's death, who would take under this clause if all of the "real" beneficiaries died right after the participant. So you cannot just throw this clause into the trust—you need to test who would actually receive the benefits if this clause became applicable. This could be a lot of work: Which state law applies? Who would be the heirs under that state law if the participant and all his named beneficiary-family members died right now? The end result could be finding that there are no such "young" heirs at law! It is better to name a known younger individual.

**D.** **WORST: Rely on IRS shortsightedness.** IRS people reviewing trusts to determine "see-through" status are typically not going to be T&E experts, used to navigating the language of a trust instrument and applying statutory and common law trust rules. In PLR 2013-20021, a trust provided life income to the participant's "children," with remainder to their children. At the time of the participant's death she had only one child (not "children") and her child had no offspring. The trust instrument apparently did not state what would become of the trust property on the death of the participant's only child if he died without issue. T&E practitioners know that state law would step in under those circumstances and determine where that money would go—typically either to the estate of the last surviving beneficiary or back to the estate of the trust grantor, neither of which is an "individual." But the writer of the ruling did not look beyond the language of the trust instrument, and concluded that the trust qualified as a see-through because it did not name any beneficiary other than the participant's child, therefore he was the sole trust beneficiary! Similarly, in PLR 2016-33025, the IRS ignored "wipe-out" beneficiaries who would inherit the trust if the primary and contingent beneficiaries died before reaching ages 50 and 21 respectively. Some commentators want to treat these rulings as model trust precedents, but I don't recommend it. These represent outlier rulings that *may* represent a change of IRS policy—or may be just IRS mistakes! If the participant has already died, leaving retirement benefits to a trust like the ones in these PLRs, then I would use the PLRs as the basis for seeking and expecting a favorable PLR on see-through status. But I do not recommend relying on them in pre-death drafting mode.

Where to read more: ¶ 6.3 of *Life and Death Planning for Retirement Benefits* explains which beneficiaries "count" for purposes of the IRS trust rules. ¶ 6.4 discusses when to use a Conduit Trust and when to use an O/R-2-NLP trust for minors, disabled beneficiaries, or the spouse.

## Q. LEAVING BENEFITS TO A TRUST: OTHER IDEAS

Regardless of whether the trust qualifies as a see-through, consider these important issues that arise when retirement benefits are left to a trust:

165. **BEST: Permit or require pass-through of plan distributions to reduce income taxes.** Distributions to a trust after the client's death from the client's nonRoth retirement plans will generally be included in the trust's gross income as "income in respect of a decedent." § 691. With the exception of "grantor trusts" (§ 671–§ 678), trusts generally are taxed as separate entities, subject to a separate rate schedule that applies only to trusts and estates. A trust goes into the highest tax bracket (37%) for taxable income in excess of $12,500 (2018 rates). For an individual, the top income tax bracket applies only to taxable income above $500,000 ($600,000 if married filing jointly). Thus, in all but the wealthiest families, income taxed to a trust will be taxed at a higher rate than would apply to the individual family members.

One way to avoid the high trust rates is for the trust to pass out the retirement plan distributions, in the same year the trust receives them, to the individual beneficiaries of the trust. This way, the trust has gross income from the plan distribution, but gets an offsetting deduction for its distribution of "distributable net income" (DNI) to the trust beneficiaries, who then report that income on their personal returns and pay the tax at their (hopefully) lower rate. For that approach to be used, the trust instrument must either *require* or *permit* the trustee to pass those retirement plan distributions out to the individual beneficiaries, regardless of whether such plan distributions are considered "income" or "principal" for trust accounting purposes.

Of course, passing those amounts out to family members may defeat the purpose of the trust; usually, assets are left to a trust to *prevent* the individual beneficiary from owning those assets outright, for tax or other reasons. The client will have to decide which is more important: preserving the funds in the trust to achieve the trust's purposes (even if it means income taxes are higher) or minimizing income taxes (even if that means distributing more to the individual beneficiaries than the client would like).

Where to read more: See ¶ 6.5 of *Life and Death Planning for Retirement Benefits* for income tax treatment of retirement plans benefits paid to a trust, or through a trust.

166. **BEST: Define "retirement benefits."** If special provisions are to be included that deal with retirement plan benefits (such as leaving retirement benefits to one beneficiary, other assets to other beneficiaries; see Idea #169), you need to define "retirement benefits." There is no one definition that will work for all clients. Use a definition that will best carry out the client's intent regarding the particular plans and goals he or she has. That might mean all taxable and nontaxable deferred compensation; or only taxable deferred compensation and benefits; or only benefits for which the life expectancy payout is available.

If using a Conduit Trust (Idea #162), it is especially important to specify that the conduit provisions only apply to retirement benefits that can qualify for a "life expectancy of the beneficiary" payout under the minimum distribution rules. There is no point is requiring the trustee to distribute to the trust beneficiary, upon receipt, distributions that can not qualify for this "stretch" payout—for example, if the life expectancy payout method has been replaced (at the time the client dies) by a maximum five-year payout period for all plan death benefits, as has been proposed in Washington (see Idea #113).

167. **BEST: Include provisions needed to qualify benefits for marital deduction.** Many practitioners assume that, once the standard marital trust is drafted, and the trust is named as beneficiary of the participant's retirement benefits, qualification of those benefits for the estate tax marital deduction is assured. The IRS has a different view. The IRS's position is that, when a retirement plan benefit is payable to a marital trust, both the retirement plan benefit *and* the trust must meet the marital deduction requirements. In IRS's view, the retirement plan itself is an item of "terminable interest property" separate from the marital trust. Rev. Rul. 2000-2, 2000-3 I.R.B. 305.

Does this mean that all the marital deduction language must be recited in the beneficiary designation form as well as in the trust instrument? No. Although that would be one way to comply with the IRS's directive, Rev. Rul. 2000-2 says the requirements are satisfied with respect to a retirement benefit payable to a marital trust if (1) the marital trust document contains the required language (*e.g.*, giving the spouse the right to all income of the retirement benefits annually) and (2) the retirement plan document does not contain any provision that would prevent the trustee of the marital trust from complying with the trust's provisions. The easiest way to comply with this is to specify in the trust instrument that all income of the trust *and of the benefits* must be distributed to the spouse annually; see Idea #168.

Where to read more: See Choate, Natalie B., "Leaving Retirement Benefits to a QTIP Trust," 34 *Estate Planning* 12 (Dec. 2007), p. 14. For explanation of the federal estate tax marital deduction issues regarding retirement benefits, including other ways to comply with the "entitled to all income" requirement of the estate tax marital deduction, see the Natalie B. Choate *Special Report: Retirement Benefits and the Marital Deduction (Including Planning for the Noncitizen Spouse)*, downloadable at www.ataxplan.com,

168. **BEST: Define "income" and "principal" rules for retirement benefits.** If the trust requires the trustee to pay all "income"of the trust to A for life and distribute the "principal" of the trust to B at A's death, and the trust's only asset is a retirement plan, what is the "income" that A receives? "Income" as that term is generally used in a trust instrument means "trust accounting income," not income in the federal income tax sense. An asset can be "principal" for trust accounting purposes and yet be "income" for purposes of the federal income tax law. A second source of confusion is the difference between "trust accounting income" and "RMDs." The two are totally different concepts, though it is possible to have a definition of "income" that takes into account the minimum distribution concept.

Finally, the definition of what "trust accounting income" means as applied to a retirement plan benefit payable to a trust, under the most widely-adopted state law standard (the Uniform Principal and Income Act of 1997; "UPIA 1997") does not fairly allocate investment return between the income and remainder beneficiaries and is not acceptable to the IRS for marital deduction purposes. UPIA 1997 generally allocates 10 percent of any required distribution from a retirement plan to income. All other distributions (i.e., 90% of required distributions, and 100% of nonrequired distributions) are generally allocated to principal. UPIA 1997, § 409. The IRS has ruled that trustees may NOT use this so-called "10 percent rule" to determine income in a marital deduction trust. Alternative IRS-acceptable definitions of "income" with respect to a retirement plan include the internal accounting of the retirement plan account itself (*e.g.*, the interest and dividends earned inside an IRA; the "trust-within-a-trust" approach), or an acceptable "unitrust" percentage (i.e., 3%–5%) of the account's value annually (if the applicable state law and trust document permit unitrust accounting). Rev. Rul. 2006-26, 2006-22 I.R.B. 939.

If you are drafting a trust under which important substantive rights of the beneficiaries, and/or important tax distinctions (such as qualification for the marital deduction), depend on the distinction between "income" and "principal," and the trust may receive retirement benefits upon the client's death, it is advisable to include a provision explaining how retirement benefits are to be accounted for, and use an IRS-acceptable definition.

<u>Where to read more</u>: See ¶ 6.1.02–¶ 6.1.04 of *Life and Death Planning for Retirement Benefits* for trust accounting for retirement benefits, ¶ 3.3 for IRS rules for income accounting for a marital trust.

169. **BEST: If the trust has multiple shares or beneficiaries, decide which share should receive the benefits then allocate the benefits to that beneficiary or share in the instrument.** If a trust is to be divided into multiple shares for different beneficiaries, the benefits can be allocated, by the governing instrument, to one or more particular beneficiaries, and that allocation is respected for tax purposes. See Reg. § 1.663(c)-2(b)(3). Here are examples of when you might want to specify such allocation in the instrument:

   A. **Allocate benefits to marital share, not credit shelter share.** When traditional retirement benefits are left to the credit shelter trust, the income tax that must (sooner or later) be paid on the benefits reduces the value of the credit shelter trust, thereby wasting some of the decedent's estate tax exemption. Essentially, part of the decedent's estate tax exemption is wasted paying income taxes. A credit shelter trust funded with a $5.49 million traditional IRA might end up with less than $3 million after paying income taxes on those benefits; the rest went to the IRS. While this may be acceptable if there is no other asset available to fund the credit shelter trust, if there's a choice, it's better tax-wise to leave the retirement benefits to the surviving spouse and nonIRD assets to the credit shelter trust. That way, the credit shelter trust gets the full exemption amount undiluted by income taxes. Or leave nothing to the credit shelter trust and rely on "portability" to minimize estate taxes; see Idea #129. A Roth IRA can be left to the credit shelter trust without incurring this particular disadvantage (but see Idea #117). The spouse will have to pay income taxes on traditional benefits left to her, to the extent she cashes them in prior to her death. However, the income taxes she pays will reduce her future estate taxes, so the family at least gets some benefit out of paying those income taxes.

B. **Allocate benefits to charities, not individuals.** If the trust is passing, say, half to charity and half to the participant's children, consider specifying that the retirement benefits be allocated, first, to fund the charities' shares of the trust. See Idea #118.

170. **BEST: Don't allow retirement benefits to be subject to a pecuniary funding formula.** If the trust's assets are to be divided into shares or subtrusts upon the client's death, and retirement benefits that are payable to the trust will have to be allocated in that division, use a fractional rather than a pecuniary formula for the division. The IRS asserts that funding a pecuniary gift by transfer of a retirement plan constitutes an assignment of the right-to-receive-IRD that triggers realization of income under § 691(a)(2). CCM 2006-44020. Though I continue to believe that this should be true, if ever, *only* if there are other assets that could have been used, in place of the retirement benefits, to fund the pecuniary gift, and *not* true if the retirement benefit was the only asset available to fund the gift, it is preferable to avoid getting into a controversy on the subject. One way to avoid the controversy is to use only fractional formulas. All commentators (and the IRS) agree that dividing retirement benefit assets pursuant to a fractional formula does not create a § 691(a)(2) problem. Another way to avoid the issue is to specify, in the trust or the beneficiary designation form or both, that the retirement benefits must be allocated to one particular share or trust (see Ideas #154 and #169), so that the benefits do not become subject to the formula at all.

Where to read more: See ¶ 6.5.08 of *Life and Death Planning for Retirement Benefits* re funding pecuniary bequests with retirement benefits.

171. **BEST: Leave benefits outright rather than in trust.** In preparing the estate plan, it may at first appear easier to have all the client's assets (including retirement benefits) "pour" into one trust, such as the client's living trust, so that a single fiduciary has control of all the assets and can then divide them up and distribute them according to a master formula and provisions contained in the trust. In view of the substantial complications and other disadvantages (see preceding several Ideas) involved in making *retirement benefits* payable to a trust, this rule of thumb does not apply to retirement benefits. With retirement benefits, the bias is in favor of leaving the benefits outright to the intended beneficiaries unless there is a compelling reason to leave them in trust.

172. **BEST: Avoid need to draft a trust by using IRT rather than IRA.** What is popularly called an "IRA" (individual retirement account) can be created in either of two legal forms that are treated exactly the same for income tax purposes: a trust (IRT, for "individual retirement trust"; also called a "trusteed IRA"; § 408(a)) or the more common custodial account (§ 408(h)). An IRT *can* offer certain advantages that are rare or impossible with an IRA. One feature that is extremely rare in an IRA but common in an IRT is the option for the

participant to restrict the beneficiary's access to the account after the participant's death (so long as the beneficiary receives the RMD). For example, with an IRT, the participant could specify that the beneficiary receives *only* the RMD, or only the RMD plus amounts needed for health and support, or only the RMD until he/she reaches a certain age at which time he/she gains complete control. Similarly an IRT could permit the participant to name a successor beneficiary to receive what is left in the account after the first beneficiary's death, something rarely allowed in IRAs. (Whether a *particular* sponsor's IRT will include any of these features is a different matter. Strangely, there are some IRTs out there that offer no options not offered in the typical custodial IRA, so having an IRT does not automatically mean you will benefit from all its potential.)

Some sponsors' IRTs allow the participant to "check a box" to select various popular options (such as those described above, or (for a marital deduction IRA) "surviving spouse receives greater of the income or the RMD"), similar to an employer making choices in an "adoption agreement" for a prototype pension plan. Some sponsors offer no check-the-box options, but will allow customization of the post-death distribution provisions as long as the minimum distribution rules are complied with. Since the IRT is essentially a pre-approved "prototype" conduit trust (Idea #162), you avoid the complexities and risks involved in drafting a "see-through trust" by using an IRT.

The drawbacks of the IRT are that all RMDs must be distributed outright to the beneficiary (RMDs cannot be accumulated for later distribution to the beneficiary, as could be done with a see-through trust; see Idea #164); the possibly higher fee the IRT provider will charge (since it is typically performing more services); and (in many cases) the inability of the beneficiaries to transfer the account to another IRA provider after the owner's death.

Where to read more: See ¶ 6.1.07 of *Life and Death Planning for Retirement Benefits*.

173. **WORST: Leave benefits to a "toggle" trust without getting a PLR.** The idea is that an IRA would be left to a "conduit trust" (Idea #162) for the benefit of an individual beneficiary, who would have a testamentary general power of appointment over the trust, but under which a "trust protector" would be given the power to switch the trust to an accumulation trust no later than September 30 of the year after the year of the participant's death (the "Beneficiary Finalization Date"; see Idea #194). Under the accumulation trust, the same individual would still be the sole life beneficiary, but would not have the automatic right to receive all plan distributions; instead he would receive distributions only in the trustee's discretion. Furthermore, the beneficiary would *not* have a general power of appointment at death over the accumulation trust; rather, he would have a power to appoint only to individual beneficiaries younger than himself.

Does the toggle trust qualify as a see-through trust for minimum distribution purposes? Yes, *if* you agree with the following reasoning: The regulations say that the participant's beneficiaries, for minimum distribution purposes, are the beneficiaries as of the date of death, minus any beneficiary who is "removed" by September 30 of the year after the participant's death. Who are the beneficiaries of the toggle trust? Under the conduit trust, there are potentially nonindividual and older remainder beneficiaries under the general power of appointment, *but*, under a conduit trust, all remainder beneficiaries are disregarded. So if the trustee doesn't "pull" the toggle switch, there is a conduit trust and the remainder beneficiaries don't count. If the toggle is activated, the trust would not be a conduit trust, *but* the potential nonindividual and older beneficiaries would have been "removed" before the Beneficiary Finalization Date, because the power of appointment is now limited to younger individual beneficiaries. So the argument that the trust qualifies as a see-through is that on either side of that toggle there is a qualifying see-through trust: *Either* the trust is a conduit trust (so remainder beneficiaries don't count) *or* the "offensive" remainder beneficiaries are removed by the Beneficiary Finalization Date.

However, there is no guarantee that the above interpretation is correct. If the toggle is not exercised (i.e., if the trust stays as a "conduit" trust with the beneficiary holding a general testamentary power of appointment) the IRS *could* reason as follows to *disqualify* the trust: 1. The trust, as of the date of death, was not a conduit trust, because the trustee had the power (through the toggle) to accumulate distributions. 2. The trust had older and/or nonindividual beneficiaries as of the date of death, because of the beneficiary's general power of appointment. 3. The older and/or nonindividual beneficiaries were not removed as of the Beneficiary Finalization Date because the toggle was not exercised. Therefore: 4. The trust does not qualify as a see-through.

Because the toggle trust does not necessarily satisfy the RMD trust rules, I would not recommend using a toggle trust, unless you either: (A) obtain your own PLR blessing the trust, or (B) limit the power of appointment under the conduit trust to younger individual beneficiaries (though if you do that there may be no point in having a conduit trust, since you don't need the conduit provision to qualify if all the remainder beneficiaries are younger individuals).

PLR 2005-37044 (in which the IRS "blessed" a toggle trust as a see-through, following extensive reformation of the trust after the participant's death) introduced this innovative planning idea. However, in my opinion PLR 2005-37044 itself is NOT a good source for how to carry out the toggle plan. Based on the trust provisions as quoted in the PLR, the IRS made a mistake and should not have allowed the ruling, though (according to correspondence I subsequently received from an attorney involved in obtaining the ruling), the IRS did not correctly state these trust provisions in the PLR. Also, according to this attorney, there were numerous other factors involved that make the PLR itself an unreliable guide to even what happened in that particular case. Finally, subsequent PLRs suggest that the result obtained in PLR 2005-37044 could not be duplicated today because the IRS has tightened its standards regarding post-death reformations (see Idea #191).

Before risking all these complications, one must ask, what is the advantage of setting up a trust like this? Apparently, the advantage is that the participant wants his beneficiary to receive all the RMDs, so he basically wants the beneficiary to have a conduit trust with total control (via a general power of appointment) at death. However, the participant is concerned that, when the participant dies, the beneficiary might be subject to creditors' claims, a messy divorce, or other problems that make it unwise to give the beneficiary so much control, so the participant allows the trustee to throw the switch to create a more protective trust.

Does this trust accomplish that objective? Yes, *if* the beneficiary's problems happen to arise around the time the participant dies and no later than the Beneficiary Finalization Date. If the beneficiary's problems were visible well *before* the participant's death, the participant could leave the benefits to an accumulation trust in the first place, without bothering with the toggle mechanism.

If the beneficiary's problems don't arise until after the Beneficiary Finalization Date, then this toggle trust won't help because it's too late to pull the toggle switch. So my personal opinion of the toggle trust is: It's a lot of trouble and risk for a marginal benefit.

174. **BEST, sometimes: Leave benefits to a trust that contains *only* benefits.** If a client is leaving retirement benefits and other assets in trust, should he leave all assets to one single trust, with special provisions in the agreement that apply only to the benefits? Or should he leave retirement benefits to one trust specially created for them, and other assets to a different trust? My shocking answer: Sometimes it is appropriate to create a separate trust just for the benefits…and sometimes it isn't!

To hear some practitioners talk, the world is divided into two groups of people, separate-trusters and single-trusters, and never the twain shall meet. Ed Morrow makes the best case for the separate-trusters in his excellent article (see "where to read more," below). I definitely see his point: With all the special requirements that must be met to qualify a trust as a see-through, it is highly *unlikely* that the standard family trust will hit those requirements by accident, and highly *likely* in fact that the standard family trust will contain provisions that violate the see-through trust rules. For greater safety at the initial drafting stage and in later years as the estate plan changes and matures, argues Ed, a separate trust is the way to go; read his article for more.

At the same time, some experienced estate planning lawyers scoff at the notion that they can't properly draft and administer a trust that contains both benefits and other assets while still complying with the see-through trust requirements. Many top estate planning lawyers routinely leave benefits to the same trust as other family assets; since all the assets are being held on essentially similar terms for the same beneficiaries, it is wasteful to create two separate trusts. And of course it's beyond wasteful to set up separate trusts where one (or both!) of the asset pools are not large enough to support the administration expenses involved in a separate trust.

One more consideration: The IRS does not have to recognize multiple trusts as separate trusts for income tax purposes. If the trusts have the same grantor and beneficiary(ies) and are created at the same time and have substantially similar substantive terms, the IRS is authorized to issue regulations treating the multiple trusts as a single trust—however to date it has not done so.

So when does it make sense to leave retirement benefits to their own separate trust? When the benefits (and the other assets) are of substantial enough size to warrant incurring the extra administrative expenses, and the substantive terms are sufficiently different (*e.g.*, the benefits are going to a conduit trust for grandchildren while other assets are in a family pot trust for all generations), and/or the attorney, as a matter of good practice, has a different forms that are specially designed to be suitable for each type of asset and is convinced that future amendments and trust administration will have fewer problems if the assets are kept separate.

Where to read more: See Morrow, Edwin P., III, "Contrasting Conduit Trusts, Accumulation Trusts and Trusteed IRAs," CCH *Journal of Retirement Planning*, May–June 2007, p. 31.

## R. ADVISING NONSPOUSE BENEFICIARIES

Here are Ideas to consider when advising a client who has inherited a retirement plan from someone other than his or her spouse. See also Group A and Group B Ideas, and Idea #96.

175. **BEST: Don't take any distribution before evaluating LSD.** The Code allows special favorable tax treatments for certain lump sum distributions (LSDs); see Ideas #4 and #5. These deals are available to beneficiaries as well as to the participant himself, BUT ONLY for a qualifying LSD, which is a distribution of the participant's entire plan balance within one taxable year of the recipient following the most recent triggering event. The participant's death is a triggering event. If the beneficiaries take a distribution in the year of the participant's death, they will NOT be able to qualify for the favorable LSD treatment unless they also take out the rest of the entire plan balance in that same year. Thus the beneficiaries shouldn't touch a QRP balance until the availability and desirability of the LSD option has been evaluated. However, this advice may be tough to follow if there is an RMD for the year of death; the plan must distribute it to the beneficiaries even if they don't want to get it.

Where to read more: For the requirements and benefits of LSDs, see ¶ 2.4–¶ 2.5 of *Life and Death Planning for Retirement Benefits*.

176. **BEST: Correctly title the inherited retirement plan.** Supervise the transition of the account from the decedent's ownership to the beneficiary's ownership with eagle eyes. The IRA provider's staff may not be aware of the critical issues involved in this step. If the IRA provider issues a check payable to the beneficiary, you are faced with a completed distribution (in which case see Idea #196). Make sure that the IRA provider keeps the IRA titled as an "inherited" IRA. There is no particular required wording for this; the only requirement is that the account documentation must make clear that (even though the beneficiary now owns the account) this is not the "beneficiary's" IRA. The beneficiary cannot make any contributions to this account for example (with a limited exception for certain plan-to-plan transfers from other plans inherited from the same participant). Acceptable methods of titling include "John Doe, deceased, for the benefit of Richard Roe, beneficiary," and "Richard Roe, as beneficiary of John Doe, deceased." The name of the deceased participant should appear somewhere, with indication that the beneficiary owns this account merely as beneficiary of the original participant. The Social Security number on the account should be the beneficiary's, despite some old PLRs saying that the decedent's number should be used; see IRS Instructions for Form 1099-R ("Beneficiaries" section).

177. **WORST: Roll the benefits to the nonspouse beneficiary's own IRA.** A beneficiary who is not the surviving spouse of the participant cannot roll or transfer the inherited benefits to the beneficiary's own IRA. Such rollovers are the privilege ONLY of the participant himself and his surviving spouse. § 402(c)(1), (9); § 408(d)(3)(A), (C). Unfortunately some IRA providers are unaware of this rule. When the beneficiary comes in to claim the inherited IRA, such unknowing providers will transfer the inherited funds into an IRA in the name of the

beneficiary, which causes the beneficiary to have a taxable distribution from the inherited plan and an excess contribution into his own IRA, resulting in a 6% excise tax. § 4973(a).

There is one "grandfather" exception to this rule: Any beneficiary, even a nonspouse, who inherited an IRA from a decedent *who died prior to 1984* COULD elect to treat that IRA as his or her own. § 408(d)(3)(C) (denying rollovers for inherited IRAs) was added in 1982, effective for deaths after 1983; see 1987 version of Prop. Reg. § 1.408-8, A-4(a). See also the next two Ideas for transfers permitted to an "inherited IRA."

178. **BEST: Do an IRA-to-IRA transfer to the beneficiary's preferred financial institution.** The beneficiary of an inherited IRA may want to transfer it to a different IRA provider. This can be done by means of a direct transfer of funds from one IRA custodian to another IRA custodian, from one "inherited IRA" (the IRA that was actually inherited) to another "inherited IRA" (that isn't really inherited, it is a new account in the name of the decedent).

The IRS has no problem with these transfers PROVIDED that: The transferee account is still titled as an inherited IRA, not the beneficiary's "own" IRA (see two preceding Ideas); and the assets go DIRECTLY from one IRA custodian (or trustee) to the other IRA custodian (or trustee). See IRS Publication 590-B (2015), p. 4. From IRS Publication 590-A (2015), p 21: "A transfer of funds in your traditional IRA from one trustee directly to another, either at your request or at the trustee's request, is not a rollover... Because *there is no distribution* to you, the transfer is tax free." (Emphasis added.) Not all IRA providers will accept (or release) funds in beneficiary-initiated plan-to-plan transfers, but they should do so. Rev. Rul. 78-406, 1978-2 C.B. 157, provides the required legal authority allowing plan-to-plan transfers to take place even where a rollover would not be permitted. See, *e.g.*, PLR 2000-28040.

179. **BEST: Transfer funds from lump-sum-only plan to "inherited IRA" by direct rollover.** The Code decrees that the slowest permitted rate of distributions of retirement plan death benefits is annual installments over the life expectancy of the designated beneficiary. § 401(a)(9)(B)(iii). The Code does not say the beneficiary has the *right* to take benefits out over his life expectancy; it merely says that benefits must not be distributed at a slower pace than that. If the plan wants to distribute the benefits *more rapidly* than that, the plan has the right to do so.

For reasons of administrative convenience, many employer plans *do not permit the life expectancy payout of death benefits*. Many QRPs permit payment of death benefits in one form only: a lump sum distribution (LSD). This is "no problem" if the designated beneficiary is the participant's surviving spouse (because she can roll over the lump sum to an IRA; see Ideas #116 and #186), or if the beneficiary is a charity or charitable remainder trust (which is income tax-exempt; see Ideas #118–#120). However, it IS a problem for a nonspouse beneficiary who is eligible for the life expectancy payout that the plan does not allow.

For distributions after 2006, there is a solution to this problem. The beneficiaries can transfer the inherited 401(k) plan (or other inherited QRP, 403(b), or 457 plan) to an "inherited IRA" by means of a plan-to-plan transfer (direct rollover). This MUST be done by direct rollover; it can NOT be done by "60-day rollover." Furthermore, a new separate inherited IRA must be opened to receive the distribution; it is opened in the name of the deceased participant, payable to the same beneficiaries (see Idea #176). Finally, the beneficiary must be a "designated beneficiary" as defined in § 401(a)(9) of the Code (or a trust for the benefit of designated beneficiaries, as determined by IRS rules; see "Group P" Ideas).

For use of the beneficiary rollover to effect a Roth IRA conversion, see Ideas #96 and #125.

Note the limitations: This type of rollover can NOT be used to change the beneficiaries of the plan. It can NOT be used by an estate, or a non-see-through trust, because such entities are not "designated beneficiaries." It can NOT be used to roll inherited benefits into the beneficiary's own IRA. According to IRS Notice 2007-7, it can NOT be used to "get out of" the five-year rule (if the benefits were subject to the five-year rule in the original plan), unless the rollover is completed by the end of the year after the year of the participant's death.

Where to read more: See IRC § 402(c)(11), IRS Notice 2007-7, 2007-5 I.R.B. 1, and ¶ 4.2.04 of *Life and Death Planning for Retirement Benefits*.

180. **BEST: Have plan purchase, and distribute, a nontransferable annuity contract.** This is another way to preserve a life expectancy payout for a beneficiary if the plan does not permit the life expectancy payout. If the annuity contract is nonassignable, and provides for distributions that meet the requirements of the RMD rules, the beneficiary pays income tax when he receives distributions under the contract, NOT when he receives the contract itself. Reg. § 1.402(a)-1(a)(2). However, this approach might require a plan amendment; that could make larger employers, and small employers who use prototype plans, unwilling to do it.

Where to read more: See PLR 2002-44023, and "Giving to the Grandchildren" [a misleading title inserted by the magazine's editor; the article has nothing to do with giving to grandchildren] by Steven B. Gorin, *Trusts & Estates*, Vol. 141, No. 9 (Sept. 2002), p. 43.

181. **WORST: Convert an inherited IRA to a Roth IRA.** I heard a planner recommend this. It cannot be done. A nonspouse beneficiary cannot convert an inherited IRA to a Roth IRA. § 408(d)(3)(C).

Where to read more: See ¶ 4.2.05 of *Life and Death Planning for Retirement Benefits*.

182. **BEST: Establish separate accounts for multiple beneficiaries.** If there are multiple beneficiaries of a single IRA, and their interests are fractional (*e.g.*, "Equally to my four children"), they may want to treat the inherited benefit as "separate accounts" for RMD purposes, so that each beneficiary can use his or her own life expectancy to compute RMDs. See Idea #153. They will need to "establish" the separate accounts after the participant's death; usually this is done by opening a new "inherited IRA" for each beneficiary and transferring the proper percentage share of the original inherited IRA directly into each beneficiary's separate inherited IRA account. See Idea #178. As long as each beneficiary's

separated inherited account is the right value (*e.g.*, all accounts should initially be of equal value if the IRA was left equally to several children), they can even pick and choose which investments would go into which beneficiary's separated account. The deadline for accomplishing the establishment of the separate accounts is 12/31 of the year *after* the year of the participant's death, in order for it to be effective for purposes of allowing each beneficiary to use his or her own life expectancy.

Where to read more: See ¶ 1.8.01 of *Life and Death Planning for Retirement Benefits* for full explanation of the separate accounts rule.

183. **BEST: Don't forget the IRD deduction.** If the participant's estate was subject to federal estate tax, a beneficiary who receives income-taxable distributions from the participant's retirement plan is entitled to an income tax deduction for the estate taxes paid on the inherited benefit. § 691(c). Calculation of this "IRD deduction" is complex and (in some cases) uncertain, but the main problem with the deduction is (apparently) beneficiaries don't know about it and so don't take it. This is a big waste of money. Surprisingly, the deduction goes to the person who receives distributions from the inherited retirement plan, regardless of whether he or she is the person who paid the estate tax. If the benefits are paid to an individual beneficiary, the IRD deduction's value may be reduced by § 68 (reduction of itemized deductions for high-income taxpayers) in years § 68 is in effect; however, § 68 does NOT apply in the years 2018–2025 as a result of TCJA. Also, § 68 has never applied to an estate or trust named as beneficiary. See also Ideas #123–#125.

Where to read more: ¶ 4.6.04–¶ 4.6.08 of *Life and Death Planning for Retirement Benefits* explain all aspects of the IRD deduction.

184. **BEST: Use IRD first.** In an estate that was subject to a substantial estate tax, the effect of the "IRD deduction" (see preceding Idea) is to lower the beneficiary's tax bracket on plan distributions. The beneficiary should take that into consideration when he needs spending cash. If the beneficiary's choice is to take money from an inherited IRA or from his own IRA, there are three advantages to using the inherited IRA before tapping his own IRA. First, the distribution from the inherited IRA may be subject to lower income taxes because of the IRD deduction. Second, a distribution from an inherited IRA is never subject to the 10 percent penalty even if the beneficiary is under age 59½. Third, RMDs from an individual's own IRA can be deferred longer (until he reaches age 70½), then taken out more slowly both during his life (using the Uniform Lifetime Table) and after his death (over the life expectancy of his beneficiary) than RMDs from the inherited IRA, from which he must take an RMD annually after the participant's death, over his single life expectancy, and for which there is no possibility of deferral beyond his life expectancy.

Where to read more: See two articles by Christopher R. Hoyt, Esq., of the University of Missouri-Kansas City Law School, "Inherited IRAs: When Deferring Distributions Doesn't Make Sense," *Trusts & Estates*, Vol. 137, No. 7 (June 1998), p. 52, and "Sometimes It's Better to Avoid Stretch

IRAs,"*Trusts & Estates*, Vol. 142, No. 3 (March 2003), p. 38. See ¶ 9.4.01 of *Life and Death Planning for Retirement Benefits* regarding the death benefits exception to the 10 percent penalty.

185. **BEST: Beneficiary should name a successor beneficiary.** Some plans and IRA providers allow the original beneficiary to name his or her own successor beneficiary. The successor beneficiary inherits whatever's left in the account when the original beneficiary (having inherited the account by surviving the participant) later dies. If the plan does not allow the beneficiary to name a successor beneficiary, or if the plan allows it but the beneficiary fails to do it, the account will typically become an asset of the original beneficiary's probate estate on his or her death—though some IRA providers' documents name individual default successor beneficiaries in this case, so always check the plan documents. Note that the beneficiary's choice of a successor beneficiary (or failure to name a successor beneficiary) has no effect on how RMDs are computed: whoever succeeds to ownership of the account on the original beneficiary's death (even if it's the beneficiary's estate) simply continues to compute RMDs using the remaining life expectancy of the original beneficiary. So naming a successor is just part of proper estate planning for the beneficiary who owns an inherited retirement plan, to make sure that asset is dealt with in the best way in the beneficiary's estate plan. [NOTE: We're talking about nonspouse beneficiaries in this paragraph. A different rule applies in some cases when the surviving spouse is sole beneficiary.]

Where to read more: See ¶ 1.5.12–¶ 1.5.13 of *Life and Death Planning for Retirement Benefits* regarding definition of "successor beneficiary," and what happens to an inherited retirement plan when the original beneficiary (having survived the participant) later dies without having withdrawn all of the benefits from the plan.

## S. ADVISING THE SURVIVING SPOUSE

186. **BEST: Roll over the benefits as soon as possible, unless...** The advantages of the spousal rollover were explained at Idea #116. When benefits are left to the surviving spouse, in most cases, distribution options after the spouse's death will be much better if she has rolled over, to her own plan, the benefits she inherited from the participant than if she dies while still holding the benefits as beneficiary of the participant. Therefore the moral of the story is: the spouse should roll over the benefits to her own IRA or other retirement plan as soon as possible after the participant's death. There are four circumstances that can create exceptions to this rule of thumb: if she is contemplating a disclaimer (Idea #187), or if she is under age 59½ (Idea #188), or if she is older than the predeceased participant (Idea #189), or if she is potentially subject to creditors' claims (Idea #36).

Where to read more: For explanation of the minimum distribution requirements that apply to benefits that are payable to the surviving spouse after the surviving spouse herself dies, see ¶ 1.6.05 of *Life and Death Planning for Retirement Benefits* (if both spouses died before December 31 of the year the participant would have attained age 70½) or ¶ 1.6.03(E) (in all other cases).

187. **BEST: Hold off investment changes, rollover, if disclaimer contemplated.** Some estate plans depend on the surviving spouse's disclaiming benefits left to her as primary beneficiary, allowing them to pass to a credit shelter trust or other contingent beneficiary (Idea #130). Her disclaimer will not be "qualified" if the spouse has previously "accepted" the benefits (§ 2518(b)(3)). Taking the required minimum distribution for the year of the participant's death is NOT considered "acceptance" of the account (see Rev. Rul. 2005-36), but exercising investment control over the account normally would be considered acceptance. Reg. § 25.2518-2(d)(1), (d)(4), Example 4. Similarly, rolling the benefits to her own account, or electing to treat an inherited IRA as her own IRA, would presumably be considered acceptance. Merely naming a successor beneficiary should not be "acceptance" if the spouse disclaims the benefits during her life; the power to name a successor beneficiary should be the same as a testamentary power of appointment, which is not "exercised" until the nomination of a successor beneficiary is "activated" by the spouse's death. See Reg. § 25.2518-2(d)(4), Example 7. However, presumably the spouse's naming a successor beneficiary would prevent her executor from disclaiming the benefits on her behalf.

<u>Where to read more</u>: See Rev. Rul. 2005-36, 2005-26 I.R.B. 1368, and ¶ 4.4.04 of *Life and Death Planning for Retirement Benefits*.

188. **BEST: Four ideas to help a surviving spouse who is under age 59½.** A surviving spouse who is under age 59½ faces a dilemma. If she leaves the inherited benefits in the name of the deceased participant, she can withdraw the benefits whenever she wishes penalty-free, because the 10 percent pre-age-59½-distributions penalty does not apply to death benefits. § 72(t)(2)(A)(ii). However, if she dies while the benefits are still in the deceased participant's account the distribution options after her death will *usually* be unfavorable. As an alternative, the spouse could take the benefits out of the deceased participant's account and roll them over to her own retirement plan, an action that will usually produce better distribution options for her beneficiaries upon her later death; but once the benefits are rolled to her own plan, they become "her" benefits, and the death benefit exception no longer applies. She will not be able to withdraw from the rollover account until she reaches age 59½ unless she pays the 10 percent penalty or qualifies for an exception. Here are four strategies to deal with this dilemma:

A. <u>Best for poor widow of young decedent</u>? Leave the benefits in the deceased participant's account until the spouse reaches age 59½, then roll them over. While under age 59½, the spouse can withdraw funds as needed penalty-free under the death benefits exception. If her death prior to completing the rollover would produce undesirable income tax results for her beneficiaries, she can buy term life insurance to protect against that risk. If the spouse will reach age 59½ before the end of the year in which the deceased participant would have reached age 70½, AND the decedent's plan allows the spouse to name her own successor beneficiaries, AND she does so, this option does not produce bad results EVEN IF the spouse dies before she reaches age 59½: her designated beneficiaries would be able to use their own life expectancies to compute RMDs from the account even though it was still in the participant's name. § 401(a)(9)(B)(iv)(II). But that's not a very common scenario.

B. Best for rich or very ill widow? Roll the money over immediately to the spouse's own IRA, to assure that the best possible distribution options will be available to her beneficiaries regardless of when she dies. If she later needs to withdraw funds from the rollover IRA while she is still under age 59½, she can use the SOSEPP exception (Idea #78) to avoid the 10 percent penalty.

C. Fine tuning? Estimate the spouse's needs prior to age 59½, leave that amount in the deceased participant's account, and roll over the rest to the spouse's own IRA. *E.g.*, if she will need $20,000 per year, and she is age 57½, leave $40,000 (plus maybe a little extra cushion) in the decedent's name (so she can withdraw it penalty-free over the next two years) and roll over the rest (so if she happens to die before reaching age 59½ her beneficiaries will get the fullest choice of distribution options).

D. Roll over to IRA in decedent's name. If the spouse wants to leave the benefits in the decedent's plan for a while, but the plan in question insists that the spouse must take a lump sum distribution of the benefits immediately, the spouse can roll over that distribution to an "inherited IRA" (i.e., an IRA in the name of the decedent, payable to her as beneficiary), in order to preserve its status as a penalty-free death benefit until such later time as she chooses to roll it to her own IRA. See PLR 2004-50057.

189. **BEST: Delay rollover if surviving spouse is older than decedent spouse.** Once the surviving spouse rolls over the inherited benefits to the surviving spouse's own IRA, she will have to start taking required minimum distributions (RMDs) once she reaches age 70½. If she leaves the benefits in the decedent's plan, and if she is the sole beneficiary of that plan, she does not have to take any RMDs as beneficiary until the year the deceased spouse would have reached age 70½. By leaving the benefits in the decedent's plan until the year he would have reached age 69½, then rolling them over to her own plan in that year, an older surviving spouse never has to take a distribution as beneficiary, and also delays the commencement of RMDs to herself as long as possible.

**Example:** Butch dies in Year 1 at age 65, leaving his IRA to his wife Zena, who turns age 71 in Year 1. Had Butch lived, he would have reached age 70½ in Year 6. If she rolls the benefits over to her own IRA in Year 1, Zena will have to start taking RMDs from the rollover IRA in Year 2 (using the Uniform Lifetime Table). If she leaves the benefits in Butch's IRA, she will not have to take any RMDs as his beneficiary until Year 6. By rolling over to her own IRA in Year 5, she will have to start taking RMDs from Butch's former IRA (as owner not as beneficiary) in Year 6.

## T. CLEANUP IDEAS, AFTER PARTICIPANT'S DEATH

You are administering an estate. The participant named no beneficiary for his retirement plan, or he named his estate as beneficiary with unfavorable results (Idea #123). Here are some Ideas that may help; most were first published in my article "Clean-up Strategies When Benefits Are Left to a Participant's Estate," *Trusts & Estates*, Vol. 141, No. 6 (June 2002), p. 16.

190. **BEST: Don't assume "no beneficiary" means "estate is beneficiary."** If the participant failed to name a beneficiary (or no named beneficiary survived the participant), the plan document or IRA agreement will indicate who is the default beneficiary. Don't assume the estate is the default beneficiary. In the case of a qualified retirement plan (QRP), the Code requires that all or part of the death benefits pass to the surviving spouse if the participant was married for more than a year at the time of his death. § 401(a)(11). Whether or not the Code requires the benefits to be paid to the surviving spouse, the QRP or IRA may provide for a human default beneficiary such as surviving spouse, children, issue, or next of kin. If the default beneficiary(ies) under the plan or IRA is (or are) individual(s), then the participant's estate is not the beneficiary.

Where to read more: ¶ 3.4 of *Life and Death Planning for Retirement Benefits* explains the spouse's rights in QRPs under REA.

191. **BEST: Reform the beneficiary designation.** Look into state court proceedings to reform a defective beneficiary designation, or perhaps even to create a proper one from scratch. In PLR 2006-16039, the family and financial institution (FI-2) cooperated in a local probate court proceeding to "reform" the decedent's beneficiary designation form. The decedent had moved his IRA from FI-1 to FI-2 and instructed FI-2 to prepare the beneficiary designation form just like it had been at FI- but they didn't do so, and the participant apparently didn't notice the difference when he signed it. After his death, based on this testimony, the court caused the beneficiary designation form to be reformed to say what it was supposed to have said. Although a new beneficiary added after the participant's death cannot be a "designated beneficiary" for minimum distribution purposes (Reg. § 1.401(a)(9)-4, A-4(a)), the IRS accepted the reformed form as effective to establish the beneficiary designation. A similar procedure could perhaps be used if the parties know what the beneficiary designation form said, but the FI lost the form.

Unfortunately for this Idea, the IRS has turned very negative on post-death reformations. In PLR 2007-42026, the parties did not have as strong a case as in PLR 2006-16039 for the proposition that the beneficiary designation form had been filled out improperly due to a financial institution error, but a state court nevertheless ordered the reformation to produce a more tax-saving beneficiary designation. The IRS not only refused to recognize the reformation in this case but added some strong language suggesting that post-death state-court reformations should NEVER be allowed to affect minimum distribution results! Nevertheless, I believe that the IRS will accept a reformation, even for minimum distribution purposes, if the reformation meets traditional legal requirements that compel a reformation of a document, such as a scrivener's error, undue influence, etc. What the IRS will not accept, I believe, is the post-death rewriting of a beneficiary form or a trust motivated purely by the desire to get a better tax result when there is no evidence of the existence of the traditional legal grounds for reformation. See PLR 2014-38014 confirming this belief.

Where to read more: See ¶ 4.5.05–4.5.06 of *Life and Death Planning for Retirement Benefits*.

192. **BEST: Look for a way to change the beneficiary after the participant's death.** Investigate whether an undesirable beneficiary designation could be invalidated. Perhaps the participant was incompetent, or did not comply with the formalities required by the plan to have a valid designation; this approach could be fruitful if invalidating the designation would reinstate a prior more favorable prior beneficiary designation, or a more favorable default beneficiary. *E.g.*, in one case the author heard of, the participant's financial advisor had filled in some blanks in a beneficiary designation form that the participant had previously signed; the plan administrator agreed that this form did not comply with the plan's requirements for a beneficiary designation *by the participant*. Also check whether state law gives the surviving spouse the right to claim a statutory share of a nonERISA plan. Some states give the spouse the right to claim a share of all marital assets (including IRAs) *and* the right to choose which assets will be used to fulfill her statutory share. A cooperative surviving spouse could exercise these rights by taking the retirement plan in fulfilment of her share, then roll it to her own plan. See PLR 2001-52040. This strategy is not helpful if the spouse is required to waive other benefits, or otherwise give up too much to exercise the right, or for a QRP (spousal rights under which cannot be governed by state law due to REA's preemption). A *bona fide* "will contest" (beneficiary designation contest?) may be another way to change the beneficiary designation *post mortem*; see PLRs 2001-27027, 2014-32029, 2014-37025, and 2014-37034 . But the contest must be a genuine dispute over who gets the money, not a collusive proceeding solely designed to get a better tax result.

193. **BEST: See if spousal rollover through estate or trust is possible.** According to a multi-decade string of numerous consistent PLRs, if benefits are payable to the participant's estate, and the surviving spouse is the sole beneficiary and executor of the estate, the spouse can distribute the retirement benefits out of the plan to herself (either directly or through the estate first) and roll them over tax-free to her own retirement plan, provided the rollover occurs within 60 days of the distribution. (See Idea #46 regarding whether the 60-day deadline can be extended.) The IRS has approved spousal rollovers through an estate or trust wherever the spouse has the right to the benefits, either because she is sole beneficiary of the estate or trust, or because she has the right to and does demand the benefits in fulfilment of her share. The key is that the spouse must have the right to distribute the benefits to herself or to demand distribution of them. If the spouse's receipt of the benefits depends on the discretion of a third party, the existing rulings suggest that this approach does not work.

Where to read more: ¶ 3.2.09 of *Life and Death Planning for Retirement Benefits* discusses spousal rollovers through an estate or trust and lists PLRs illustrating this IRS position. Unfortunately, this

IRS position is "established" *only* in PLRs, which cannot be relied on as precedent, though the Supreme Court has ruled that the IRS cannot, without notice, change its position as expressed in multiple consistent rulings.

194. **BEST: Pay off "undesirable" beneficiaries before the BFD.** If there are multiple beneficiaries, some of whom are "undesirable" for RMD purposes (*e.g.*, the estate, a charity, or an elderly individual) and some of whom are "desirable" for RMD purposes (younger individuals), you can eliminate the undesirables by paying out to them their full share of the benefits prior to September 30 of the year after the year of the participant's death (the Beneficiary Finalization Date or BFD). For example, if the beneficiary designation form says "Pay $10,000 to Charity X and pay the balance to my child," if Charity X's $10,000 share is distributed to Charity X prior to September 30 of the year after the year of the participant's death then Charity X is not considered a beneficiary of the account for purposes of determining required distributions. The child is thus considered the "sole" beneficiary and he can determine RMDs based on his life expectancy. If Charity X has not been paid out in full prior to September 30 of the year after the year of the participant's death, both Charity X and child are considered the participant's beneficiaries and child cannot use his life expectancy to determine RMDs because "all beneficiaries must be individuals." Reg. § 1.401(a)(9)-4, A-3.

<u>Where to read more</u>: See ¶ 1.8.03 of *Life and Death Planning for Retirement Benefits* for full explanation of the BFD.

195. **BEST: Use disclaimers to shift benefits to the right beneficiary.** Investigate disclaimers as a way of getting to a more favorable tax result. The IRS says the participant's own estate cannot disclaim the benefits (PLR 9437042), but disclaimers by the estate *beneficiaries* might be used to shift benefits to a surviving spouse for a rollover or to other estate beneficiaries who are in a lower bracket. If the beneficiary is not the estate, but is some other "undesirable" beneficiary, a disclaimer by the undesirable beneficiary (*e.g.*, a high-income or older individual) could be helpful if it would have the effect of shifting the benefits to a more desirable contingent beneficiary (*e.g.*, a low-bracket or younger individual).

<u>Where to read more</u>: See ¶ 4.4 of *Life and Death Planning for Retirement Benefits*.

196. **BEST: Undistribute the distribution (never give up?)**. Generally speaking, pretty much, once money is distributed out of a retirement plan, it's distributed. Unless the recipient is the participant or the surviving spouse of the participant, the recipient is not eligible to "roll" a distribution back into the plan it came out of or into any other plan. So once the distribution has occurred, it's taxable, right? Well maybe. If the distribution was made to the participant during his lifetime, and he died before he was able to complete the rollover into another plan, see ¶ 4.1.04 of *Life and Death Planning for Retirement Benefits* regarding post-death rollovers (by the participant's executor) of pre-death distributions. Also, anecdotally, I hear that sometimes IRA providers or plan administrators can be persuaded to take back a

distribution and erase it from their books, file a corrected 1099-R if one has already been filed, and "re-do" the distribution as a life expectancy payout or direct rollover. This might be the case if, for example, the provider/administrator realizes it made a mistake and didn't follow the correct instructions or procedures in making the distribution.

See also PLR 2011-39011 in which the IRS allowed a distribution to a minor beneficiary from the child's late father's retirement plan to be paid into an "inherited IRA" for the benefit of the minor—years after the distribution had occurred! The IRS allowed the minor to re-do her income tax return to un-report the distribution and get a refund. The statutory basis for this extraordinary remedy is not specified. The IRS treated the situation as if the money had been stolen from the plan and/or from the minor by her first (bad) guardian, who did not request a direct rollover to an inherited IRA (which would have been in the best interest of the minor) because the guardian wanted to (and did) use the minor's money for the guardian's own purposes.

If you face a situation where benefits were distributed to beneficiaries that should NOT have been distributed (*e.g.*, the beneficiary told the administrator not to distribute, or the beneficiary never requested the distribution, or the administrator erroneously advised the beneficiary that the money HAD to be distributed, or did not provide the beneficiary with legally required notices, etc.), you may be able to persuade the administrator to take the money back and "undistribute" the distribution. I've even heard that an IRS agent once recommended this course to a beneficiary! If you would like to speak with an experienced consultant about your situation, someone who can help you work with the plan administrator in the most persuasive and effective way to resolve this type of issue, I recommend Denise Appleby (www.deniseapplebyconsulting.com).

## U. IDEAS FOR FIDUCIARIES

These Ideas are for the trustee or executor administering a trust or estate that holds an IRA or other retirement benefit as beneficiary of a deceased participant. See also Idea #75.

**197. BEST (usually): Pay expenses from the trust, not the IRA itself.** An IRA owner has a choice regarding how to pay the management expenses of the IRA. See Idea #53. A fiduciary has an additional incentive to pay the expenses out of the trust's or estate's taxable account rather than out of the retirement plan itself: If there is any relationship (for example, a family relationship) between the fiduciary and the IRA beneficiary or participant, paying the fiduciary's fee out of the plan assets may raise a prohibited transaction question, whereas paying that fee out of the taxable account does not raise any such concern. So distribute funds from the retirement plan to the trust's taxable account, then pay the fee out of the taxable account.

Where to read more: See Dept. Of Labor Advisory Opinion 2009-02A, *In re IRA of Seymour Goldberg*.

**198. BEST: Get a legal opinion on RMD status.** If you believe that the trust you are administering is a qualified "see-through trust," you will be using the life expectancy of the oldest trust beneficiary as the Applicable Distribution Period. That may involve taking annual distributions over several decades. If you are ever called upon to support your method of calculating RMDs, what evidence will you produce? Would it not be desirable to have in the file a legal opinion spelling out the analysis as to why this trust does qualify as a see-through trust and what the ADP is? At the very least, the exercise of preparing such an opinion will satisfy the fiduciary and beneficiaries that due diligence has been applied to the issue.

## V. NONCITIZEN SPOUSE

If the participant's spouse is not a U.S. citizen, and does not become a U.S. citizen by the applicable deadline, then the usual marital deduction is not available for retirement benefits left to her (or to a marital trust for her benefit). Rather, a modified version of the marital deduction applies for assets (including retirement benefits) that are left to a "Qualified Domestic Trust" (QDOT). If benefits are left outright to a noncitizen spouse, they may still qualify for the modified marital deduction if the spouse transfers the assets to a QDOT within a certain time frame or (in the case of nontransferable assets) agrees in writing that she will transfer the assets to a QDOT, or pay an estate tax on them, as she receives them. § 2056(d), § 2056A.

Where to read more: Chapter 4 of the old 5th ed. (2003) of *Life and Death Planning for Retirement Benefits* (reproduced in a Special Report, "Retirement Benefits and the Marital Deduction, Including Noncitizen Spouse" available at www.ataxplan.com) explains the modified marital deduction that applies for a noncitizen spouse, the QDOT requirements, and the choices available when retirement benefits are to be left to a noncitizen spouse. The following Ideas are excerpted from that Chapter.

199. **BEST: Leave benefits to QDOT that is a grantor trust as to U.S. resident-spouse.** By leaving the benefits to a QDOT, the participant assures that the modified marital deduction will be available without the necessity of the spouse's taking any action after the participant's death. By giving the spouse the unlimited right to withdraw all assets from the QDOT after the participant's death, the participant assures that the trust assets will be treated as "owned" by the spouse for income tax purposes under § 678(a)(1)—*if* the spouse is a U.S. resident. (If the spouse is not a U.S. resident this Idea does not work; § 672(f)(1).) This would assure that plan distributions to the trust would be taxed at the spouse's bracket rather than the trust's bracket, which would be desirable if the spouse's bracket is likely to be lower. The drawback of this approach is that it makes the spousal rollover unavailable (unless the spouse actually withdraws the money from the trust, which would defeat the purpose). See Reg. § 1.408-8, A-5(a). That drawback could be overcome by naming the spouse, individually, as contingent beneficiary; then the QDOT could disclaim the benefits and allow them to pass to the spouse individually, so she can roll them over, if she is ready, willing and able to do so at the time, and she could assign the rollover IRA to a QDOT (if that works—see next Idea). Or, if the spouse appears unable to do the rollover (for example because she is disabled), the QDOT would not disclaim the benefits.

Where to read more: ¶ 1.6.07 of *Life and Death Planning for Retirement Benefits* explains which privileges and special rules available for a surviving spouse are (and which are not) available to a trust for the benefit of the surviving spouse.

200. **BEST: Leave benefits to U.S.-resident spouse; she rolls inherited benefit to her own IRA, which is a trusteed IRA that is also a QDOT.** If benefits are left outright to the surviving spouse, she can roll them over to her own IRA, thus getting maximum income tax deferral. If she rolls them into a custodial IRA, she can then assign the IRA to a QDOT. If the QDOT is fully revocable by her and she is the sole life beneficiary of it, it is a grantor trust and presumably that transfer does not disqualify the IRA; but see PLR 2011-29045 and issues discussed at Idea #143. A safer alternative is to roll the benefits into a trusteed IRA (see Idea #172) that is also a QDOT. The issues around assigning an IRA to a grantor trust are avoided, while the income tax benefits of the rollover are maintained. The difficulty is finding a U.S. bank willing to serve as trustee of this unusual type of trust.

201. **BEST: Leave benefits to spouse, who elects to treat them as nonassignable and agrees to transfer to QDOT (or pay deferred tax on) corpus distributions she receives from plan.** This approach is more cumbersome than the two preceding Ideas, but has the advantages of being usable even if the spouse is not a U.S. resident and also of being clearly authorized by the regulations; see Reg. § 20.2056A-4(c) for details. It was successfully used by taxpayers in PLRs 1999-04023, 9729040, and 9713018.

202. **BEST: Convert to Roth IRA, leave Roth to QDOT.** When the surviving spouse is not a U.S. citizen, and estate taxes are a concern, benefits that are to be left to the spouse must be held in a QDOT in order to qualify for the modified marital deduction. It is easier for the QDOT trustee to hold a Roth IRA (distributions from which are income tax-free) than a traditional retirement plan.

203. **BEST: Ideas for administering a QDOT.** If a QDOT is named as beneficiary of a retirement plan, the trustee should consider the following strategies for minimizing deferred estate taxes that will be payable on that trust:

    **A.** **Maximize use of hardship exception**. The deferred estate tax that usually applies to principal distributions to the surviving spouse from a QDOT does not apply to distributions "on account of hardship." § 2056A(b)(3)(B). Hardship distributions are generously defined, and permitted if the spouse has no other readily available liquid assets. Reg. § 20.2056A-5(c)(1). The trustee should work with the spouse to make sure that as many trust distributions as possible qualify as hardship distributions.

    **B.** **Distribute all income annually**. QDOT distributions of "income" to the spouse are not subject to the deferred estate tax. § 2056A(b)(3)(A). Every dollar (whether inside or outside the retirement plan) that can legally be considered "income" for purposes of § 2056A should be distributed to the surviving spouse in the year it is earned. Such income should not be accumulated inside the retirement plan or the QDOT, because indications are that the IRS will try to treat accumulated income as principal, distributions of which are subject to the deferred estate tax (unless the hardship exception applies). If using this Idea means that more than the RMD is withdrawn from the retirement plan and distributed to the spouse, and the income distributions to the spouse are mandatory under the trust instrument, the excess of the “income” over the “RMD” should be transferred by direct trustee-to-trustee transfer into another IRA belonging to the surviving spouse that is not subject to the QDOT restrictions and taxes. See Idea #193 and PLR 2005-43064.

# Appendix: Client Profiles

This Appendix describes various client profiles and suggests the Ideas that may be particularly useful to a person with those characteristics.

Everybody!

See Ideas # 75 and #76.

Everybody: estate planning essentials

To construct an estate plan for someone who owns retirement benefits, start with the "Group H," "Group J," and "Group L" Ideas. If the retirement plan offers only the lump sum distribution form of benefit, also read Ideas #28 and #179. If the client is married and concerned about estate taxes, read the "Group M" Ideas and Idea #37. If the client is reluctant to leave retirement benefits outright to his or her spouse, read the "Group N" Ideas. Then when you are finally ready to draft the documents, read the "Group O" Ideas (when drafting the beneficiary designation forms) and "Group Q" Ideas (when drafting a trust that is to be named as beneficiary of the retirement plan).

Client about to retire

This person is about to retire from his employment and is considering his options regarding the benefits he holds in his company's retirement plan. Ideas #4–#8, #11, and the "Group C" Ideas.

Client taking RMDs (or approaching the required beginning date)

Anyone who is approaching age 70½ or already into the system of taking RMDs should review the "Group A," Group B," and "Group C" Ideas.

Surviving spouse who has inherited a retirement plan

A surviving spouse should review the "Group S" Ideas (and, if not a U.S. citizen, also the "Group V" Ideas).

Nonspouse beneficiary who has inherited a retirement plan

The "Group R" Ideas are for the nonspouse beneficiary who has inherited a retirement plan. Also, many of the Ideas regarding how to take RMDs that apply to living participants over age 70½ also apply to beneficiaries who are taking RMDs: see Ideas #1, #4–#14, and #16–#20. If there are problems, see also the "Group T" Ideas.

Roth retirement plans (client has one or is considering one)

See the "Group G" Ideas.

Client looking for novel ideas and daring strategies

Ideas #3, #13, #40–#41, #48, #53, #56, #58–#64, #66–#67, the "Group E" Ideas, #85–#87, #92, #97–#101, #133, and #143.

Very wealthy individual

The very wealthy individual does not need all of his retirement benefits to live on. He either has lots of other assets to live on, or has way more in his retirement plans than he is likely ever to need. He should consider Ideas #1, #11, #13, #21, #23, #24, #82, #118–#119, #131, and #138.

Not so wealthy individual

See Ideas #26 and #69.

Parents and grandparents

See Ideas #44, #101, and #113.

Client with very short life expectancy

See "Group K" Ideas and Ideas #138, #139.

Client considering marriage or divorce

Idea #32 and "Group N" Ideas.

Client interested in giving to charity

Ideas #11, #13, #64, #74, and #118–#122.

Client has died, you are administering estate

Look at Ideas #4–#6, #46, #70, and #201, and the "Group T" Ideas.

Client younger than age 59½

Ideas #30–#31, #42–#43, #77–#81, and #188.

Client's spouse is not a U.S. citizen

See "Group V" Ideas.

# The "Uniform Lifetime Table"

...for determining lifetime required distributions for (almost) everyone

| Table for Determining Applicable Distribution Period (Divisor) | | | |
|---|---|---|---|
| **Age** | **Distribution period** | **Age** | **Distribution period** |
| 70 | 27.4 | 93 | 9.6 |
| 71 | 26.5 | 94 | 9.1 |
| 72 | 25.6 | 95 | 8.6 |
| 73 | 24.7 | 96 | 8.1 |
| 74 | 23.8 | 97 | 7.6 |
| 75 | 22.9 | 98 | 7.1 |
| 76 | 22.0 | 99 | 6.7 |
| 77 | 21.2 | 100 | 6.3 |
| 78 | 20.3 | 101 | 5.9 |
| 79 | 19.5 | 102 | 5.5 |
| 80 | 18.7 | 103 | 5.2 |
| 81 | 17.9 | 104 | 4.9 |
| 82 | 17.1 | 105 | 4.5 |
| 83 | 16.3 | 106 | 4.2 |
| 84 | 15.5 | 107 | 3.9 |
| 85 | 14.8 | 108 | 3.7 |
| 86 | 14.1 | 109 | 3.4 |
| 87 | 13.4 | 110 | 3.1 |
| 88 | 12.7 | 111 | 2.9 |
| 89 | 12.0 | 112 | 2.6 |
| 90 | 11.4 | 113 | 2.4 |
| 91 | 10.8 | 114 | 2.1 |
| 92 | 10.2 | 115 and older | 1.9 |

Under the final Minimum Distribution Regulations, the above "Uniform Lifetime Table" may be used by all taxpayers to compute their lifetime annual required minimum distributions for 2002, and must be used for 2003 and later years (for exceptions see below). For each "Distribution Year" (i.e., a year for which a distribution is required), determine: (A) the adjusted account balance as of the preceding calendar year end; (B) the participant's age on his/her birthday in the Distribution Year; and (C) the applicable divisor for that age from the above table. "A" divided by "C" equals the required minimum distribution for the Distribution Year. In the age-71½ Distribution Year, do NOT reduce the "A" number by the amount of any required distribution for the age-70½ year that had not been taken out by the end of that year. For adjustments required in determining the account balance, see ¶ 1.2.05 of *Life and Death Planning for Retirement Benefits*.

This table does not apply to beneficiaries of a deceased IRA owner; or if the sole beneficiary of the IRA is the participant's spouse who is more than 10 years younger than the participant. This table may not be used for distribution years prior to 2002.

No minimum distributions were required for the year 2009.

# Single Life Expectancy Table

For computing required minimum distributions after the participant's death.

## Ages 0 to 57

| Age | Life Expectancy | Age | Life Expectancy |
|---|---|---|---|
| 0 | 82.4 | 29 | 54.3 |
| 1 | 81.6 | 30 | 53.3 |
| 2 | 80.6 | 31 | 52.4 |
| 3 | 79.7 | 32 | 51.4 |
| 4 | 78.7 | 33 | 50.4 |
| 5 | 77.7 | 34 | 49.4 |
| 6 | 76.7 | 35 | 48.5 |
| 7 | 75.8 | 36 | 47.5 |
| 8 | 74.8 | 37 | 46.5 |
| 9 | 73.8 | 38 | 45.6 |
| 10 | 72.8 | 39 | 44.6 |
| 11 | 71.8 | 40 | 43.6 |
| 12 | 70.8 | 41 | 42.7 |
| 13 | 69.9 | 42 | 41.7 |
| 14 | 68.9 | 43 | 40.7 |
| 15 | 67.9 | 44 | 39.8 |
| 16 | 66.9 | 45 | 38.8 |
| 17 | 66.0 | 46 | 37.9 |
| 18 | 65.0 | 47 | 37.0 |
| 19 | 64.0 | 48 | 36.0 |
| 20 | 63.0 | 49 | 35.1 |
| 21 | 62.1 | 50 | 34.2 |
| 22 | 61.1 | 51 | 33.3 |
| 23 | 60.1 | 52 | 32.3 |
| 24 | 59.1 | 53 | 31.4 |
| 25 | 58.2 | 54 | 30.5 |
| 26 | 57.2 | 55 | 29.6 |
| 27 | 56.2 | 56 | 28.7 |
| 28 | 55.3 | 57 | 27.9 |

# Single Life Expectancy Table, cont.

## Ages 58 to 111+

| Age | Life Expectancy | Age | Life Expectancy |
|---|---|---|---|
| 58 | 27.0 | 87 | 6.7 |
| 59 | 26.1 | 88 | 6.3 |
| 60 | 25.2 | 89 | 5.9 |
| 61 | 24.4 | 90 | 5.5 |
| 62 | 23.5 | 91 | 5.2 |
| 63 | 22.7 | 92 | 4.9 |
| 64 | 21.8 | 93 | 4.6 |
| 65 | 21.0 | 94 | 4.3 |
| 66 | 20.2 | 95 | 4.1 |
| 67 | 19.4 | 96 | 3.8 |
| 68 | 18.6 | 97 | 3.6 |
| 69 | 17.8 | 98 | 3.4 |
| 70 | 17.0 | 99 | 3.1 |
| 71 | 16.3 | 100 | 2.9 |
| 72 | 15.5 | 101 | 2.7 |
| 73 | 14.8 | 102 | 2.5 |
| 74 | 14.1 | 103 | 2.3 |
| 75 | 13.4 | 104 | 2.1 |
| 76 | 12.7 | 105 | 1.9 |
| 77 | 12.1 | 106 | 1.7 |
| 78 | 11.4 | 107 | 1.5 |
| 79 | 10.8 | 108 | 1.4 |
| 80 | 10.2 | 109 | 1.2 |
| 81 | 9.7 | 110 | 1.1 |
| 82 | 9.1 | 111+ | 1.0 |
| 83 | 8.6 | | |
| 84 | 8.1 | | |
| 85 | 7.6 | | |
| 86 | 7.1 | | |