CHAPTER 4

10:30 – 11:45am
Retirement Accounts

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Electronic format only:
1. Retirement Accounts

Electronic versions of these documents are available on the KCBA website:
PERSONAL ESTATE PLANNING FOR THE 99%
RETIREMENT ACCOUNTS

May 2013

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INTRODUCTION: INCOME TAXES AND THE 10%/50% PENALTY TAXES: HOW TO AVOID OR MINIMIZE THESE PROBLEMS EVEN IF ESTATE TAXES AREN’T A CONCERN

Qualified Plans and IRAs are often the largest asset owned by an individual. In a way, these assets grow in value for the same reason as a residence—clients place them “on hold” and in a special category of “non-spendable” items because they both need a place to live, and once they’ve budgeted for a 401(k) for example they don’t want to pay income tax so we leave it alone. The size of these assets alone make them worth studying. But in addition they are potentially subject to “double tax” (income and estate) or even “triple tax” (income, excise, and estate).

For a small or medium sized estate the most likely estate tax concern will be Washington State Estate Tax in view of the $5,250,000 federal estate tax exemption plus portability—compared to the $2,000,000 Washington State exemption without portability.

The purpose of this outline and presentation is not to provide an annotated and referenced restatement of the rules and guidelines that describe the taxation of these assets. Rather it is to state what those rules and guidelines are and then provide recommendations for doing things in a certain way, both at the documentation and transactional (distribution) stages of a participant’s or IRA owner’s life, and after death. In addition, “traps” will be described, which can trip people up.
I. TOO MUCH TOO SOON: THE AGE 59½ PENALTY

Section 72(t) of the Internal Revenue Code imposes a 10 percent penalty tax—an additional income tax on top of normal income tax. The tax is imposed on “early” retirement plan and IRA distributions. These are distributions before attaining age 59½.

Obviously, the 10 percent tax should be avoided. Sometimes it’s not possible. The tax is in addition to what’s taxable as income in the first place—after-tax contributions which are received without income tax are not subject to the 10 percent tax. The tax is meant to be a disincentive to take “early” distributions (prior to what is considered a “normal” retirement age—59½) but, it happens all the time.

Before getting into statutory exceptions to the tax, and the Series of Substantially Equal Period Payments (SOSEPP) exception, here are some “practice tips” dealing with traps, and opportunities:

➤ Practice Tip: There is a “hardship” exception from the 401(k) plan restrictions on distributions while still employed. This exception does not mean that a hardship distribution is excepted from the 10 percent early distribution tax, or the income tax itself—this is a common misconception.

➤ Practice Tip: In the case of distributions which are triggered by the death of a plan participant or IRA owner, there is a “death benefit” exception, but the death benefit exception from the 10 percent tax for the recipient only applies if the distributions are received from the plan or an IRA which is created in the name of the participant or IRA owner as an inherited IRA (still in the name of the decedent, for the benefit of the beneficiary). It is a common to make the mistake of not thinking about the surviving spouse’s need for distributions prior to age 59½ (the age of the decedent is irrelevant), and to do a spousal rollover to the spouse’s “own” IRA—perhaps in the interest of maximizing the “stretch” of minimum required distributions, which is correct, and which is another goal—it just needs to be coordinated with predicting how much the surviving spouse might need before reaching age 59½, and then leave this amount in the plan or add to an inherited IRA and then roll these benefits later, when 59½, while doing a spousal rollover of the rest to get the best deferral of required distributions (See “Too Little Too Late” Section of this outline).

➤ Practice Tip: The same analysis applies in the case of divorce—the “alternate payee” (the spouse of the plan participant—note this is a plan exception, not an IRA exception) qualifies for an exception from the 10 percent penalty for distributions governed by a Qualified Domestic Relations Order (QDRO), but only for distributions from the plan, not an IRA that the spouse rolls to under the QDRO. In a divorce proceeding someone needs to ask “How old is the spouse of the participant,” and “Might he or she want to take distributions under the QDRO before reaching age 59½?” Often the answers to these questions are something like “Age
52,” and “Yes,” but it’s too late because the plan benefits have already been transferred to the alternate payee’s IRA account.

This is understandable but unfortunate for the client: in the case of death and in the case of divorce, the beneficiary often wants to get as much distance as possible from the decedent’s or the participant’s plan or IRA—just be sure that you’ve covered this ground and asked these questions before moving ahead—it would be difficult to explain why you “Let me ‘create’ a 10 percent tax that I know nothing about.”

✏️ Practice Tip: Don’t forget about the “age 55” exception—the “early retirement” exception, which applies to a plan participant who terminates employment (retires) after age 55—Note: like the divorce QDRO this is a plan exception, not an IRA exception; a person cannot “retire from an IRA,” only from a plan. This exception is often missed by everyone, even though it’s described in the safe harbor IRS-approved memorandum of tax consequences given to a terminating plan participant. The participant will roll the benefits to an IRA and lose out on the exception. There is no equal-payment requirement and the retired participant can request whatever he or she needs between the ages of 55 and 59½—but the distributions must come from the PLAN, not from an IRA. And the participant needs to be age 55 when they terminate employment—they can’t leave the benefits in the plan after terminating at, say, age 53, and then hope to qualify when they later turn age 55 and take plan distributions.

With these practice tips in mind, what are the exceptions to the “too much, too soon” 10 percent penalty tax?

The 10 percent penalty imposed by Code Section 72(t) is bothersome. QDRO distributions, death benefit payments, and “early” retirement benefits frequently occur, and in each situation this penalty tax needs to be considered. It is one thing to make a “wrong judgment call” regarding timing of income taxable payments, or deferral, but quite another to incur a “penalty,” or “excise” tax!

At which year, month, or day does one attain age 59½? There is no equivalent “April 1” counterpart to the Code Section 401(a)(9), age 70½ “late” distribution rule, in Code Section 72(t) dealing with “early” distributions. Therefore, one should assume that the actual 6-month date following attainment of age 59 will apply, not the earlier January 1 (or any other earlier date) of that calendar year.

A. The “Special Case” Exceptions.

There are 11 (actually 13 or even 14, depending on the facts) “special case” exceptions from the 10 percent early distribution tax. These exceptions do not allow for much “planning,” since they are so client- and fact-specific.
Following is a summary and analysis:

1. **Death Benefits.** Code Section 72(t)(2)(A)(ii) excepts distributions from all plans and IRAs if “made to a beneficiary (or to the estate of the employee) on or after the death of the employee.” Does it matter if neither the participant nor the beneficiary were age 59½? No, this is a blanket exception.

But, the exception only applies to the death benefit “distributions,” to which term one should add “from a plan or IRA in which” the participant ceased participation due to death: a spousal rollover to another IRA, even though still “after” death, will lose the protection of Code Section 72(t)(2)(A)(iii).

What if the deceased spouse were over age 59½ before the spousal rollover? Here the “generous” rule of ignoring ages works the other way. A potential 10 percent tax is “created” by the spousal rollover; and “early” distributions (based on the IRA-rolling spouse’s age) will be subject to the tax.

2. **Disability Benefits.** Code Section 72(t)(2)(A)(iii) excepts payments “attributable” to disability from the tax. [See IRS Publication 590, requiring proof of disability from “any gainful activity” but, the IRS’s regulations refer to the same or similar job.] Clinically depressed participants have not fared well under this definition. *Dyer v. Commissioner*, 106 TC 337 (1996).

3. **Medical Expenses.** Under a circular calculation, it is possible for a distribution to be excepted if it does “not exceed the amount allowable as a deduction under Code Section 213 . . . for medical care.” Code Section 72(t)(2)(B).

*Note:* The “circular” calculation is required because although not subject to the 10 percent tax, the distribution increases taxable income; which in turn affects the “amount allowable” as a deduction, under the limitation:

4. **Age 55/Separation From Service.** Code Section 72(t)(2)(A)(v) excepts distributions from a plan (not an IRA—how do you “separate from service” with an IRA?) if the recipient was age 55 or more at the time of separation from service. *Note:* The key age/date is age 55 at separation, not just at the time of distribution after earlier separation (say, at age 53, or 54), although this is also required.

Separation within the calendar year (or later) in which one attains 55 will be good enough, so long as the distribution itself is made after the actual date when one attains age 55 [at least this is what IRS Publication 575 says; Code Section 72(t) seems to require that separation also follow the actual date of attaining age 55].

5. **QDRO Payments to Alternate Payee.** Plan (not IRA) payments under a Qualified Domestic Relations Order (QDRO) are excepted under Code Section
72(t)(2)(C). Note: This applies no matter what the age(s) are of the participant or spouse.

Note: There are similar reasons for a divorced spouse not to roll benefits from a plan to an IRA, if that spouse wants or needs benefits prior to age 59½. In other words, do not “create” a 10 percent tax under an IRA rollover form of QDRO, if this does not fit the situation/needs of the participant and alternate payee.

Investment and continuing financial contacts between ex-spouses can make the “preservation” of this exception a difficult challenge.

6. ESOP Dividends. These qualifying amounts are excepted under Code Section 72(t)(2)(A)(vi).

7. Unemployed Individuals’ Health Insurance Premiums. Code Section 72(t)(2)(D) excepts IRA (not plan) distributions to a person who received unemployment compensation for 12 consecutive weeks, if the IRA payments were received during the year of unemployment benefits or the next year.

8. Higher Education. IRA (not plan) distributions not exceeding qualified higher education expenses under Code Section 529(c)(3) are excepted from the tax under Code Section 72(t)(2)(E).

9. First-Time Home Buyer. IRA (not plan) distributions up to $10,000 are excepted from the tax if used within 120 days to acquire a residence for a “first time” [not a homeowner within the prior two (2) years!] home buyer. The exception also applies to such expenses for the spouse, child, grandchild, or ancestor of the recipient or the recipient’s spouse.

10. Qualified Reservist Distributions. There is an exception for distributions for an IRA or from 401(k) elective deferrals, 403(b) plans and § 501(c)(18) trusts, to a person called to active duty for more than 120 days and made to such person during such time. Such person can “make up” the distribution within the two-year period after the active duty ends. I.R.C. § 72(t)(2)(G).


12. Return of Excess 401(k) Contributions. The actual excess 401(k) contributions returned to a participant are excepted under Code Section 401(k)(8)(D); 402(g)(2)(C), but not the earnings that are returned. IRS Publication 590, p. 22; Hall v. Carver, TC Memo 1998-336.
13. **“Added” Exception: After-Tax Situations.** Code Section 72(t)(1) only adds the 10 percent tax to otherwise income-taxable distributions. Therefore, return of previously-taxed voluntary plan contributions (or rollover) will not be subject to the tax.

14. **Another “Added” Exception: IRS “Waivers” of the 60-day Rule for Rollovers: “The Dog Ate My Homework.”** I.R.C. § 402(c)(3)(A) permits the IRS to “waive” the 60-day deadline for rollovers, if the income (and penalty tax) would be “against equity or good conscience, including casualty, disaster, or other events . . . .” So, if income tax is avoided on a “waived” failure to meet the 60 day rule, so is the 10 percent penalty tax.

The IRS has issued several waivers, and also published Rev. Proc. 2003-16, which gives guidance on how to obtain a waiver. Notably, there is an “automatic waiver” if the “sole reason” for failure to meet the deadline was an “error on the part of the financial institution,” and funds are actually placed in the eligible plan within “one year of the original distributions.”

B. **The “Universal” Periodic Payment Exception.**

Code Section 72(t)(2)(A)(iv) excepts from the tax any distribution which is part of a series of substantially equal, annual, periodic payments made for the life or life expectancy of the employee or the joint lives or joint life expectancies of the employee and his designated beneficiary.

As a practical matter, since there must be a separation from service for a plan exception, Code Section 72(t)(3)(B), this exception applies mainly to IRA distributions. However, in this arena, [keeping in mind the fact that Code Section 72(t)(4)(A) “recapture” of the tax plus interest can occur if the series is modified (up or down) before the later of age 59½ or five (5) years], the exception is a broad, flexible planning tool for the “semi-retired” IRA owner. This is because the amount needed for the five (5) years (or until age 59½) can be “backed into” by creating (by division of an IRA or IRAs) the “right size” IRA to create the “right amount” each year.

**Note:** This is truly a “stop gap” way to access IRA funds, for only a portion of the expected life of the IRA owner, and need not continue past the recapture period.

1. **“Back into” the “Right” Series of Payments.** Much of the need for a flexible method (annuity, actuarial, etc.) is alleviated by following these guidelines: (1) create an IRA and commence a series under the amortization method which is approximately what is needed; (2) do not alter this method; (3) err on the low side of what is needed since “too much” cannot be reduced mid-series; and (4) another IRA can be started with its own series of payments, if more is needed. PLR 9812038. Do not make any transfers between these (or other) IRA accounts.
2. **Exception from Recapture Upon Death or Disability.** Code Section 72(t)(4)(A) and IRS Publication 590 provide that there will be no recapture of the excepted 10 percent penalty (and interest) if the modification of the series occurs "by reason of death or disability." It is still not clear what "by reason" means – is the fact of death or disability enough?

3. **"Trap" Under 5-Year Rule.** Note the following time line:

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[Age 55]       [Age 60]       [Age 59½]          [Fifth Payment]           [First Payment]
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The 5-year rule starts with the first payment (October 2008) and ends five (5) years after that date. This is October 1 of 2013, not 2012, even though five (5) payments were made and the recipient was over age 59½ on October 1, 2012. This IRA should therefore make no further payment after October 2012, until another year has passed, since the 5-year rule still applies until October 2014. This can be a real trap.
II. TOO LITTLE, TOO LATE: THE AGE 70½ PENALTY

The legislative “purpose” for retirement plans and IRAs is to provide a source of retirement income, NOT wealth-building for the next generation. Section 401(a)(9) of the Internal Revenue Code requires that plans provide for “minimum” annual distributions, subject to a 50 percent penalty on what should have been distributed but was not, and spells out the guidelines and provides very cursory references and definitions for such terms as the “required beginning date” and “designated beneficiary.” This has been an evolving area of the law which continues to change. But we know more than we did, and many developments have been in favor of both living and deceased plan participants and IRA owners, and their beneficiaries.

As retirement planners and/or estate planners we first need to determine our clients’ goals. We often assume that clients want to delay plan or IRA distributions as long as possible, both for themselves and their heirs—this may not be the case. Unless a trust has been named as beneficiary, however, and even in that situation to a certain degree, there is no downside to building in the most flexibility and opportunity to delay or “stretch out” distributions into the documentation and inter-play between the estate plan (Will, Revocable Trust) and the retirement plan or IRA (beneficiary designation). This is because the typical plan participant or IRA owner, or their beneficiary, can normally request and receive an accelerated payment of benefits. The IRC Section 401(a)(9) rules are designed to require that certain minimum amounts be paid each year, based on the account balance as of the prior year—this account balance can always be reduced, or eliminated, for that matter, by an earlier or faster distribution scheme if the client or beneficiary wishes to do so.

A. Distributions During the Life of the Plan Participant or IRA Owner

The during-life minimum distribution rules are more logical, and less complex, than the post-death rules.

1. The Required Beginning Date. In summary, when a participant or IRA owner reaches his or her “required beginning date” (April 1 of the year following the year in which the individual attains age 70½), the first minimum required distribution (MRD) must have been paid, with certain exceptions for non-5 percent owners of a sponsoring employer who continue working until actual “retirement” at which time the first MRD must be paid.

☞ Practice Tip: Educators (professors) do not own any part of their tax-exempt, IRC Section 403(b) plan sponsor, and therefore could conceivably move prior-employer 403(b) benefits to their “final” university, to take advantage of the “actual retirement” exception.

☞ Practice Tip: The year in which a person attains age 70½ is still a “distribution year” with the prior year-end’s balance as the calculation starting point (described below) AND the year of April 1 following is another “distribution year” using the prior year’s balance, so there will be a “doubling” of distributions in the April 1
year—one distribution by April one, and one by December 31 of the same year. So delay may not be a good idea, and the individual may prefer to pay the first distribution year’s MRD by December 31 of the year in which the person attains age 70½.

2. Calculation of the RMD and Aggregation of Plans and IRAs. The account balance of a plan participant or IRA owner, at the end of the year prior to the year of the distribution, is the starting point, and the Uniform Lifetime Table factor based on the individual’s age is what needs to be applied to this amount to determine the MRD for the year, which must be paid (except for the April 1 initial year described above) by December 31 of the year of distribution. Reg. Section 1.401(a)(9)-5, A-4(a).

Each qualified plan (such as 401(k) or profit sharing plans) stands alone regarding both the calculation of the MRD, and the requirement that the distribution be made from the particular plan, not from another plan for which an individual is given credit. For IRAs and 403(b) plans each account balance is looked at separately in calculating that IRA or 403(b) MRD, but the total of IRA or 403(b) plan MRDs may be taken from any one or any combination of IRAs or 403(b) plans (Note: this does not mean that 403(b) minimums can be taken from IRAs, or the reverse—these groups of sources of benefits are separate from each other, as groups). Reg. Sections 1.401(a)(9)-8, A-1, 1.408-8, A-9, 1.403(b)-3, A-4.

Practice Tip: A Roth IRA has no required beginning date or MRD for the IRA owner—the income tax “freight” has been paid upon after-tax contribution or conversion from a traditional IRA. However, even if not taxable as income, MRDs must be calculated and paid to a death beneficiary of a Roth IRA. Congress wanted to ensure that Roth IRAs do not continue in existence from generation to generation in a nontaxable (not just tax deferred) status.

3. Waiver of Age 70½ Penalty for Reasonable Cause. During life, or even after death, the 50 percent penalty might be waived if it can be shown that the failure to receive the MRD(s) was due to reasonable cause. The IRS has been fairly understanding in granting waivers.

Note: The age 59½ penalty tax IS NOT also subject to a reasonable cause waiver, and the IRS imposes the 10 percent tax with enthusiasm.

IRS Form 5329 is filed to report the missed MRD(s) and request a waiver of the penalty. Payment of the penalty tax was required, for some time, and the request for waiver was a request for refund, but the instructions to Form 5329 now appear to no longer require this payment.

Practice Tip: The failure to pay the RMD(s) must also be “remedied” via actual distribution of the undistributed RMD and inclusion in income. It is not required that
an amendment to the income tax return be prepared and filed for the year that the
RMD was missed—the distribution is included in income in the (later) year in which
it is actually distributed.

B. Distributions After the Death of the IRA Owner or Plan Participant.

The “speed” or “timing and amounts” of the MRDs to a living IRA owner or plan participant
are actually fairly slow, and small in amounts, during the initial years of distribution
following the required beginning date. The Uniform Table is “back-loaded” in the sense that
the fraction which applies to the account balance is much smaller, being based on a longer
life expectancy at the time of initial distributions, than it is later on in the individual’s life.
So, even though the account balance may be large at this time compared to later years, when
the fraction is much larger, it may even increase over the initial years because the
contributions are less than the earnings or growth in the account balance—it may be that the
account balance will be the same at age 85 as it was at age 70½.

Death can certainly occur, therefore, when the account balance is substantial and the goal of
the MRD rules has not been met—the IRA owner or plan participant did not receive the
benefits during retirement, and the balance has in fact become a wealth or estate-building
asset, which is still going to be subject to both estate tax at the death of the individual, and
income tax when distributed.

There are two (2) questions which need to be asked upon the death of an IRA owner or plan
participant (actually, there are more than two (2) questions, but these are of primary
importance): (1) When do the RMDs have to commence, and (2) Over what time-frame, or
number of years (for calculation of the MRD fraction to be applied to the account balance)
do the RMDs have to be paid.

The general rule is that RMDs have to commence by December 31 of the calendar year
following the calendar year in which the individual died, and that so long as there is a
“designated beneficiary” (DB herein) the time-frame will be the life expectancy of the DB.

1. Importance of DB Status. You might logically assume that a DB is just what
it says—someone who is “designated” by the individual who fills out a beneficiary
form, or if this doesn’t occur there should be some “default” DB(s) spelled out in the
IRA or plan document. But unfortunately it’s not that simple. An estate planner
should use the following mental guide/question in testing a DB’s status: “Is the DB
an individual or a qualifying trust leading to an individual who has a heartbeat and
therefore a life expectancy which can lead to the time-frame calculation for the
MRDs, and does the DB have this status without any taint or complications caused
by companion or residuary beneficiaries that do not qualify as a DB or make it
questionable if this DB is the appropriate person (such as a charitable organization
or the estate of the decedent, or a permissible beneficiary who is older than the DB)”
Practice Tip: Don’t permit anyone’s estate to be beneficiary or included in a group of beneficiaries, such as “equally to my three children and my estate.” The result would be that none of the individuals’ life expectancies could be used to determine the time-frame for the MRDs.

This might be “fixable” via segregation of shares into separate accounts or pay-out to the estate, if done in time. But it is preferable to keep separate IRAs and plans either for individuals or qualifying trusts, or entities, but not for both. If a trust is named as beneficiary, with this mix-up of individuals and a charitable organization, the situation is even worse and possibly not fixable.

2. Consequence of Non–DB Status if Death Occurs Before the Required Beginning Date: For death both prior to and following the RBD of an individual, IF THERE IS A QUALIFYING DB, then the time-frame of the life expectancy of that DB individual or oldest trust beneficiary can be used by consulting single-life tables, and making sure that distributions commence by December 31 of the year following death (except for a surviving spouse DB—she or he can wait to commence distributions until December 31 of the year the decedent would have attained age 70½). Much more needs to be said about a trust qualifying as a DB—but for now we can note that DB status is the “goal” and that it provides for a long payout time-frame (the DB’s life expectancy), whether the death of the IRA owner or plan participant occurs before or after the age 70½ required beginning date.

Practice Tip: The surviving spouse of the IRA owner or plan participant is (in terms of maximum “stretch” and flexibility) the best of all individual (not trust) DBs because the surviving spouse can “start over” and get a “fresh start” by way of a spousal rollover to the spouse’s own IRA account, which will not need to commence MRDs until the spouse reaches his or her required beginning date, AND the beneficiaries named as designated beneficiaries of that IRA will determine the payout period when the surviving spouse dies. This avoidance of the one-year rule for commencement of benefits, and a “new” DB for a “new” IRA (not an “inherited IRA, which is not the same thing) is solely available to the surviving spouse of an individual.

Practice Tip: If the surviving spouse as DB has been the DB of his or her deceased spouse’s IRA (an “inherited IRA”) for many years, possibly waiting until the decedent would have attained age 70½, to commence distributions, the “fresh start” via naming new beneficiaries and using their life expectancies (children, grandchildren) IS NOT available in the spousal inherited IRA. The surviving spouse can name “successor beneficiaries” (children or grandchildren) but this only clears up where remaining IRA assets go upon the surviving spouse’s death—they will continue to be paid out over the surviving spouse’s life expectancy. In this situation—recommend/discuss a spousal rollover to a new IRA for which the surviving spouse will be the owner not just the beneficiary, to get a “fresh start” via new DBs in the
new IRA. There is no time limit to do this (60 days after death of deceased spouse, etc.)—and it is usually a good idea unless the surviving spouse is under age 59½ and avoiding the 10 percent penalty by not rolling to a new IRA, but rather taking advantage of the “death benefit” exception for payments from an inherited IRA of a decedent. This circumstance can be addressed by “blending” the rollover—rolling some to the new IRA and leaving some in the inherited IRA for pre-age 59½ distributions.

But what happens if, prior to attaining age 70½, a plan participant or IRA owner dies having named his or her estate as beneficiary (not a qualifying DB), or a trust that doesn’t qualify as a DB, and these non-DB situations cannot be remedied?

The answer is unfortunate—there is a five-year distribution requirement in this situation whether the decedent was an IRA owner or a plan participant. See, Reg. Sections 1.401(a)(9)(B)(ii), 1.401(a)(9)-3, A-4, and A-2. Obviously, this is going to create a mandatory “spike” in income taxation to the non-DB regarding, for example, a $470,000 benefit even if in a small/medium sized estate of $1,300,000. The five-year distribution period is not a required equal-payment, per year, MRD method—distributions could be delayed until the end of the period but this is little comfort.

So, this is a cautionary tale, because a longer “default” payout is permitted when death occurs after attaining age 70½ (see below section of this outline) than death before age 70½, it is particularly important to be sure about qualifying DB status for a younger plan participant or IRA owner.

There is a “trap” awaiting a spouse of a younger plan participant (not IRA owner): A plan can require that a beneficiary elect between the life expectancy payout or the five-year rule and if no election is made within a certain time the five-year method will be the pay-out period. The “trap” is for the surviving spouse who could normally do a spousal rollover at any time, see above regarding spousal inherited IRA—but the trick is that once the benefits become MRDs (meaning they have to be paid under the five-year default method as MRDs), they can no longer be rolled over, even to a spousal IRA, because MRDs are not eligible for any type of rollover, they must be paid on time under the method that applies—in this case five years. Reg. Section 1.401(a)(9)-3, A-4(c).

Another “trap” awaits if an IRA owner fails to designate a beneficiary at all, or the form can’t be located at the decedent’s death. The “default” beneficiary would be described in the IRA document, and it’s often the decedent’s estate which doesn’t qualify as a DB, so the five-year rule would apply.

Note: Roth IRAs don’t have a required beginning date for the IRA owner so it’s presumed under the MRD guidelines that the five-year rule applies in all cases (unless of course there is a DB).
The moral of the story for younger plan participants and IRA owners is to: (1) be sure that the participant or IRA owner has a valid DB, and (2) after the death of the individual, especially if the DB is the surviving spouse of a plan participant, look into the situation right away (within a few months of the date of death) to preserve possible rollover treatment for the spouse (and other "fixes" such as disclaimer (nine-month deadline) and/or creating separate accounts, distributing to non-DB beneficiaries (such as charitable organizations) [September 30 or December 31 deadline in the year following the year of death]).

3. Consequence of Non-DB Status if Death Occurs After the Required Beginning Date. The five-year rule only applies if death occurs prior to the required beginning date. After that time, the IRA owner or plan participant's single life expectancy will apply as the non-DB default payout period.

This is typically better (longer) than the five-year rule: for example, the payout period for an aged 70½ decedent would be a fraction with a 15.3 year divisor.

Qualified plans are administered for employees to provide retirement income, usually via a requested lump-sum payment and IRA rollover when the plan participant retires and terminates employment. Plan administrators and trustees don't want to retain plan benefits and deal with death beneficiaries, trusts, etc. and pay out benefits over some long-term life expectancy for a DB (could be a trust for a three-year-old grandchild!). Even the life expectancy of the plan participant in a non-DB situation would be an administrative headache. Plans are not required to retain and pay out benefits to death beneficiaries this way, if they don't want to. Like IRA accounts, plans are required to pay out the MRDs to plan participants starting at age 70½ but this is a minimum and it relates to the participant/employee, not a death beneficiary. Qualified plans are not in the estate planning business.

In fact, a plan can provide that the only form of death benefit is a lump-sum payment. Reg. Section 1.401(a)(9)-3, A-4(b).

This is a qualified plan problem, not an IRA problem. The decedent could name a child, grandchild, or trust for either as beneficiary of an IRA, and that IRA could commence to make distributions over the life expectancy of the child or grandchild. This is called an "Inherited IRA," and brokerage firms and other IRA custodians are amenable to setting up the new IRA, as follows: "X, deceased, fbo Y, beneficiary," and paying out long-term payments. In this sense, the original IRA owner, though deceased, is still the IRA owner, but there is a "new" IRA that acknowledges the death of the IRA owner, and the measuring life (the designated beneficiary, either the person named, or the person (oldest person) beneficiary from a trust that is named). So, the problem is not with IRAs, it is with retirement plans.
Retirement plans are not this flexible. For a participant/employee who dies, a lump-sum payment may be the only option, which causes a real “spike” in income:

Example: A $400,000 401(k) benefit of a plan participant at Boeing, payable to child, fully taxable in one year as income, upon receipt! The plan sponsor (Employer) is under no obligation to “hold onto” the benefits and offer a “stretch out” form of payment of death benefits, and the child cannot “roll” or somehow transfer the plan benefits to an IRA, to stretch out the $400,000 benefit—only a “spouse” can do that.

Effective for distributions after December 31, 2006, Section 402 of the IRC was amended by the 2006 Pension Protection Act (PPA) to permit such beneficiary (or trust for such beneficiary) to do a “direct transfer” from the Plan to an IRA, which is an “inherited IRA,” which can make distributions over the life expectancy of the beneficiary.

This is a very positive development for all parties: the decedent, who can permit a trust to “safeguard” assets for a beneficiary, without immediate income tax; the individual or trust beneficiary, who can avoid one-year compression of income; and the Plan sponsor, who can still “get rid of” the plan benefits, because the sponsor did not want to hold on to the benefits over the lifetime of the beneficiary of a deceased employee, which was why they had a “lump sum” as the only death benefit option. The “direct transfer to IRA” alternative meets these needs, but saves a lot of immediate income tax for the beneficiary.

When the PPA was enacted, many assumed that the non-spousal rollover would be required of qualified plans. After all, the plans would be able to “get rid” of the deceased participant’s benefits, just by way of a distribution to an IRA, instead of a distribution to an individual. However, that was not the case until 2010 under the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA).

4. Who Gets Remaining Benefits and Over What Time-Frame When the DB or Non-DB Dies? Whether the payout period is based on a DB’s life expectancy, or the deceased participant or IRA owners life expectancy, what happens to unpaid benefits when the beneficiary later dies?

Clients and IRA custodians often look to the “contingent” or “alternate” beneficiary that may be named in the beneficiary form or the IRA document for the answer, but this is incorrect, the contingent, alternate, or “second” beneficiary would receive benefits only if the first-named beneficiary did not survive the participant or IRA owner and that is not the case. The correct term to use here is “successor” beneficiary to the original DB or non-DB, after this original beneficiary dies. It is the
original beneficiary who needs to actually “name” his or her successor for remaining benefits on his or her death. IRA custodians should permit this, using standard forms but filled out by the first beneficiary rather than the IRA owner.

What about the time-frame for these “successor” beneficiary payments? The time-frame doesn’t change—it’s still whatever was in effect on the death of the first beneficiary. There is no “fresh start” with a new life expectancy. What if no successor beneficiary is named—the typical IRA document will state that remaining benefits be payable to the estate of the first beneficiary in this way incorporating the first beneficiary’s selections of individuals. The estate as beneficiary in this situation does not mean that the benefits have to be accelerated in the pay-out schedule, or paid out of the IRA before the probate estate is closed. Rather, the “right to receive” the benefits, under the remaining time-frame, is distributed out of the estate to the appropriate heirs, and they can continue to receive benefits under the same schedule. Remember that this is still an inherited IRA which is in the name of “X, deceased, fbo _______.” So the “fbo” portion is what is changed, from the first beneficiary, to the estate, to the heir(s).
III. ERISA PREEMPTION: WHAT ABOUT COMMUNITY PROPERTY?

In a community property state, like Washington, spouses often want to: (1) possibly use plan or IRA benefits to “fund” the bypass/exemption trust in their Wills, because there are little or no other assets, and/or (2) protect these same assets against remarriage (or other diversion).

A. What if the Participant Spouse “Leaves” Benefits in a Qualified Plan and the Non-Participant Spouse Dies First?

Practice Tip: Clients are often surprised to discover that the community property interest of the non-participant spouse does not exist for estate-planning purposes. (See Boggs v. Boggs, 520 US 833 (1997).

Example: A retiring employee plans to “leave” a $400,000 401(k) plan benefit in his plan--his wife is in poor health. This is a second marriage couple and there are no children of this marriage, but children of prior marriages who are residuary beneficiaries of their trusts (in Wills) for the surviving spouse. The $200,000 community property interest of the non-participant spouse cannot be “accessed” via the Will of the non-participant, and she and her family are essentially disinherited regarding this significant asset, a situation which could be simply remedied by getting the plan benefits into an IRA in the name of the participant spouse.

The situation is different for an IRA. If an IRA-owning (named owner) spouse dies first, he or she can name the other spouse with regard to such spouse’s community property 50 percent interest, and this surviving spouse can roll that 50 percent interest into their own IRA account, with the deceased spouse’s 50 percent would be going to a trust (bypass/exemption or QTIP). This would be accomplished via the IRA-owning spouse’s beneficiary designation.

The non-IRA-owning spouse dies first? Can their community property interest be given to a trust under their Will (bypass/exemption or QTIP). The answer is yes: See RCW 6.15.020.

What if a retiree has a rollover IRA of $3,500,000, and other assets (home, etc.) are also $3,500,000. The retiree and his spouse therefore have $7,000,000 community property, and they want either spouse to be able to “fully fund” the $3,500,000 exemption trust, when either spouse dies.
B. **What if the Participant in a Qualified Plan Dies First, And There Was a Prenuptial Agreement Stating That the Qualified Plan Belongs to the Participant, But There Was no Valid, Written “Waiver” under ERISA by the Non-Participant Spouse?**

Under ERISA and Sections 401(a) (9) and 417 of the Internal Revenue Code the surviving spouse of a plan participant (not an IRA owner) must be entitled to receive a qualified pre-retirement survivor annuity (normally, a 50 percent benefit) in the case of a pension plan and certain other plans, or all of a certain other defined contribution plans [such as an electing 401(k) plan], unless the non-participant spouse has **signed a written waiver of such benefits which is Notarized or witnessed by a plan representative—a prenuptial agreement by definition would not qualify as a waiver because at the time of signature the person waiving the benefit was not a “spouse” under IRC Section 417.**

**Practice Tip:** This can be a trap, as follows: Your client was married, went through a divorce, and had a portion of his Boeing plan benefit divided and distributed to his ex-spouse in a QDRO. His portion that was remaining was subject to a new, post-divorce beneficiary designation naming his children of that marriage. If he remarries, and leaves this beneficiary designation the way it is, his new spouse could be entitled to 100 percent of these benefits even if they entered into a pre-nuptial agreement stating that these benefits would be his separate property. The children would be cut out—unless he obtains a qualifying IRC Section 417 written waiver from his new spouse.
IV. ROLLOVERS AND DIRECT TRANSFERS TO IRAS: DURING LIFE AND AFTER DEATH

With the exception noted at the beginning of this outline, regarding the possible “creation” of a 10 percent early distribution tax via rollover to an IRA account by an alternate payee in divorce, or spouse of a decedent, it is usually a good idea from an estate planning perspective to get retirement benefits out of a qualified plan, and into an IRA. The plan will no longer limit the form of death benefit to a lump sum, or prohibit the naming of a trust as beneficiary. More importantly, the community property interest of the non-participant becomes real, and accessible, to such spouse.

Most of us are familiar with the concept of a rollover to an IRA from a 401(k) plan when changing jobs or otherwise getting plan benefits into an IRA during life. However, the risk is that an individual will surmise from this that he or she can do the same thing regarding a plan or IRA benefit from a deceased individual—this is not the case; the only person who can do an actual rollover with death benefits, creating a new IRA in his or her name, is the surviving spouse, and the most that others can do will be to move one inherited IRA to another, still in the name of the decedent, or create an inherited IRA under the non-spousal IRA guidelines of the 2006 Pension Protection Act. PLR 2005-28031.

With this as background, what are some of the important requirements and pitfalls relating to IRA rollovers?

A. Minimum Required Distributions, Payments in a Series of Ten Years or More, Hardship Distributions, a Second IRA Rollover in the Same Year, and Participant Loans, Cannot be Rolled Over.

The above prohibitions should be noted, and won’t be covered in detail in this outline, except to say that the prohibition on rollover of plan loans can cause the whole IRA to which it is rolled to be treated as distributed because the plan loan going into the IRA is treated as a prohibited transaction under IRC Section 408(e). In other words, an unpaid loan of say $30,000 could cause a $400,000 otherwise nontaxable rollover to be treated as distributed to the plan participant!

B. Direct Transfers are Preferable to 60-Day Rollovers.

The plan participant has to come up with the 20 percent withholding that’s taken from a distribution to be 100 percent rolled over within sixty (60) days. IRC Section 402(c)(3)(A). It is easier to avoid the 60-day rule itself, and the withholding, via a direct transfer from the plan to the IRA, or from IRA to IRA.

If the 60-day deadline is missed because of “hardship” or other reasons deemed worthy by the IRS, a waiver and an IRS-blessed rollover under Rev. Proc. 2006-8 may be available depending on the facts. The IRS is becoming more stringent in its requirements, and there is a $3,000 user fee for rollovers of $100,000 or more.
Practice Tip: It’s only failure to meet the 60-day rule that is the subject of a waiver. Receiving a distribution that isn’t rollable in the first place isn’t going to be waivable. This is a common misconception.

C. Rollover Should be Avoided for an “Early Retirement” Situation at Age 55.

As discussed in Section I., there is an exception from the 10 percent early distribution penalty for payments from a plan to a participant who terminates employment at age 55. This exception would be forfeited if the plan benefits are transferred to an IRA account.

On the other hand, if there is no such exception available because the participant is younger than age 55, but the participant can receive and in-service distribution from the plan, he or she could get the benefits to an IRA and do a SOSEPP series of payments to both get access to the funds and avoid the 10 percent penalty.

D. Post-Death Rollovers are Normally the Best Option for a 59½ Aged Spouse, and the Non-Spousal Rollover (Creation of Inherited IRA) Permits Income Tax Deferral for a Non-Spouse Plan Beneficiary.

As noted in prior sections of this outline, community property access, broadened permitted beneficiaries, and more investment control are all available once a plan benefit is moved to an IRA account.
V. USING A TRUST FOR THOSE YOU DON'T

Aside from the estate tax savings available via a funded Bypass Trust or Exemption Trust, many medium and small-estate clients prefer knowing that their community and separate property will not be at risk via a subsequent marriage of the surviving spouse, decisions to give too much (in the client’s view) to charity, etc. This is the “hidden curriculum” of estate planning 101. Accordingly, instead of outright distribution of the residence, investment accounts, and the like, these assets are often held in trust for the surviving spouse in a combination of the Bypass Trust and a Marital Trust (often, a QTIP trust)—or in the small/medium sized estate plan, in a Washington State Bypass Trust (only) because the first spouse’s property is under the $2,000,000 estate tax exemption in Washington.

There is no reason that a client might feel differently about his or her IRA or retirement plan account—he or she may want this payable to a trust or trusts for he survivor, “taking care” of him or her, but not distributed outright. As noted, a retirement plan may not permit this type of “stretch” in payments, or even a trust as a beneficiary in the first place. IRA account documents are more flexible and permissive in these areas.

As described in the following sections a trust can be named as an IRA death beneficiary, but the attorney needs to be careful in drafting both the beneficiary designation (and attachments) [“outgoing”] and the trust in the Will or Revocable Trust [“incoming”].

A sample Will/Trust provision is attached to this outline (Exhibit A). The following are the points that need to be considered and then addressed in accomplishing this “coordination” between the IRA (retirement plan) and the Will/Trust (estate plan).

Note: These materials and the Exhibit A are not only for the “wealthy” client with a large IRA account—if the client wants to “protect” the IRA along with other “trust” assets (residence, etc.), the trust named as beneficiary of his or her community property 1/2 of the IRA (by beneficiary designation if he or she is the IRA owner, by his or her Will if the spouse of the IRA owner) will probably be a “discretionary” trust as is typically the case in estate plans (perhaps all income distributed to the spouse, both for marital deduction purposes and to minimize the very high income tax rate costs of accumulated income taxable to the trust, but principal under a Maintenance Support and Health standard).

A. A Decision Needs to be Made Between a Conduit Trust and a See-Through Trust.

The IRS is concerned (overly so in the opinion of many) that the oldest trust beneficiary in a qualifying DB trust might die or otherwise lose beneficiary status, and some older beneficiary will take his or her place and be able to use the slower pay-out period of the first beneficiary. Estate planners are not trying to play this game, but nevertheless the DB status of a trust is a challenging goal.
1. **How Does a Trust “Qualify” as a “Designated Beneficiary”?** Note: It is very important that a trust which is named as a beneficiary of a plan or IRA also qualify as a “Designated Beneficiary” under the age 70½ minimum distribution rules. Otherwise, all of the plan benefits would have to be paid to the trust either: (1) within five (5) years after death of the participant or IRA owner if death is before the required beginning date; or (2) over the remaining life expectancy of the decedent if death occurs after the required beginning date. This is not a good situation from an income tax standpoint, since the income tax would have to be paid by the trust over a short period of time, which would reduce benefits otherwise available by “stretched out” distributions to the trust over the (younger, usually) trust’s beneficiary’s lifetime.

In order to be a “Designated Beneficiary,” a trust must meet the following requirements:

1. The trust must be valid under state law;
2. The beneficiaries of the trust must be “identifiable” in the trust document;
3. The trust is irrevocable or becomes irrevocable on the death of the participant or IRA owner;
4. The trust or other documentation must be given to the plan administrator or IRA custodian.

2. **What are the Problems with Naming a Trust a Beneficiary; For Example. Can a Special Needs or Supplemental Care Trust Qualify as a “Designated Beneficiary” so that Plan or IRA Benefits Can be Stretched Out Over the Trust Beneficiary’s Lifetime?** Under IRS pronouncements, it is the second requirement, above, that is the most difficult to satisfy. In rulings, the IRS has stated that “possible” older or permissible beneficiaries (such as a residuary, out-of-sequence Uncle, estate, or charity) can result in the trust not being a “designated beneficiary,” with the resulting compression of income-taxable payments, over a shorter time frame.

As an example of these problems, and looking at the above requirements, will a typical “Special Needs Trust” qualify as a “Designated Beneficiary”?

(a) **Valid Under State Law.** This requirement will most likely be satisfied.

(b) **Beneficiaries are Identifiable.** This requirement would seem to be satisfied, because the person who is a lifetime beneficiary of the trust is clearly identified by name, but often this person has a general power to appoint another person (also could be older, with a shorter life expectancy) to receive the trust assets at his or her death. Accordingly, under the Regulations cited above, the trust would not be a Designated Beneficiary. There is a potentially older “Contingent Beneficiary” in the trust.
(c) The Trust is irrevocable or will be on the death of the IRA owner or plan participant: Yes, this requirement will be satisfied.

(d) The Trust document will be given to the plan trustee or IRA custodian: this will be satisfied.

Because of the problems with the number 2 requirement, above, the attorney preparing a Special Needs Trust which may (or will) be a beneficiary of a significant plan or IRA benefit is in the position of deciding between: (a) shorter IRA payout period and higher income tax to the trust, or (b) significant risk of disallowance of benefits intended to be protected by the trust due to the requirements that the trust be a “conduit trust” for the lifetime beneficiary (because paying out all income and required age 70½ distributions to the beneficiary would exceed the “special needs” limitations of the trust’s main operative provisions). If there are siblings who can be the successor beneficiaries, of about the same age as the special needs beneficiary, these should be the failsafe successors and the oldest of these beneficiaries will be the measuring life for the required distributions to trust, which can then be discretionary regarding actual distributions to the special needs beneficiary.

3. Other Trusts as Beneficiaries. Such as Discretionary Bypass Trusts to Preserve the Washington State Estate Tax Exemption

In many situations, the trust could qualify as a “pass through” or “conduit” trust. Particularly where a “dynastic” or “legacy” or other long-term trust is named, with the idea of controlling the “spreading” of payments to, e.g., grandchildren, the trustee must: (1) receive all minimum distributions based on the age of the oldest beneficiary, and (2) pay out all such distributions to all grandchildren. Reg. 1.401(a)(9)-5, A-7(c)(3).

If more flexibility than the “pass-through,” conduit trust is desired, in other words, a “see-through” trust, it will be necessary to have separate trusts, which cannot have older (even “possible”) beneficiaries, which is often the case for young beneficiaries (grandchildren) whose “heirs” may be their parents. [See: this unfortunate result in PLR200610027, brothers or sisters would be favorable residuary beneficiaries, if they are close in age to the lifetime beneficiary.]

Similar concerns exist for a typical Bypass or QTIP trust. A “conduit” approach guarantees DB status, but may result in little or no residuary benefits if the spouse lives to full-life expectancy. A “see-through” trust (accumulations permissible so long as MRDs are distributed to the trust and taxed as income) will be preferred. Unfortunately, this is no absolute assurance that contingent beneficiaries (such as charities) won’t stand in the way of DB status, unless, under Reg. Section 1.401(a)(9)-4, A-5(c), and PLR 2004-38044, at the death of the first spouse, if the
surviving spouse were to die, the residuary beneficiaries (children) were all old enough to be outright (not trust) beneficiaries. This may be the case, or it may not. An ability for a Trustee to name residuary takers who must be the same age or younger than the Trust’s oldest (measuring life) beneficiary would provide assurance of DB status. PLR 2002-35038.

There are several drafting methods of obtaining DB status for a discretionary (non-conduit) trust: (1) The trust could provide that living residuary individual beneficiaries (grandchildren) will receive trust benefits upon the death of lifetime beneficiaries (or to a UTMA account for such residuary beneficiaries); (2) The trust could provide that only individual (not entity) beneficiaries born after (not before) a certain date will receive residuary trust benefits; (3) The trust could provide that benefits will not be distributed to any non-individual beneficiary, or to any beneficiary who is older than the oldest lifetime beneficiary. See Exhibit A.

4. What About a “Trusteed IRA” or “Individual Retirement Trust (IRT)?”

Instead of having a “standard” custodial IRA which names a trust as beneficiary, a combined IRA and trust can be used—these are called “Trusteed IRAs” or “Individual Retirement Trusts (IRTs).” A trust company or IRA custodian with a trust department provides a document which includes IRA provisions and which also is completed with trust provisions similar to those discussed in a situation in which a trust is named as beneficiary. IRTs are available in “prototype” form from IRA providers, or can be custom-drafted based on IRS Form 5305.

Upon the death of the IRA owner the trustee of the IRT continues to hold the IRA benefits in accordance with the terms of the trust, such as for the spouse, and then children.

The IRT can provide benefits for a disabled IRA owner during his or her lifetime, instead of having to rely on a power of attorney with a traditional IRA.

There are at least two (2) downsides to IRTs: there are significantly higher fees than are charged for a standard custodial IRA, and the IRT has to be a “conduit trust,” which means that the trust can’t accumulate RMDs, post-tax, under discretionary maintenance and health standards so that there will be (or may be) fewer benefits in the trust for a future, residuary beneficiary.

B. An “Erroneous” Beneficiary Designation May Be “Corrected” if Timely Actions Are Taken.

Here’s an example of an “erroneous” IRA beneficiary designation, which could be an income–tax problem of a 5-year mandatory payout if the IRA owner dies before reaching age 70½:
"Equally to my three (3) children from my former marriage, and to my estate."

This is not a “trust” beneficiary with the complexity described above in which a “contingent” future beneficiary such as the University of Washington could jeopardize qualifying “designated beneficiary” status permitting the use of life expectancies of individual beneficiaries. It is a “class” of beneficiaries, only one of which cannot be a qualifying designated beneficiary (the estate), but if not corrected the entire class will forfeit designated beneficiary status. Reg. 1.401(a)(9)-4, A-3.

What steps can be taken to “fix” this unintended “acceleration” of income tax consequences?

1. **Establish Separate Accounts with the Plan Trustee or IRA Custodian by December 31 of the Year Following the Year of the IRA Owner’s Death**

   If separate accounts (including pro-rata sharing of gains or losses) are established for each member of the class by December 31 of the year following the IRA owner’s death, then each beneficiary will be able to use their own age for determining the required distributions over their lifetime, and the “taint” of the estate as a non-individual will be removed. Reg. 1.401(a)(9)-8, A-2(a)(2).

   What if (1) there is a “pecuniary” (e.g., $120,000) share for a beneficiary instead of percentage or fractional shares? or (2) the beneficiary designation was to a trust which named the class as beneficiaries of the trust? In these situations, the separate account rule won’t work, unless both the beneficiary form and the trust are set up for “separate account” treatment at the outset when the documents were prepared (see below).

   But it might still be possible to “fix” even these situations, if done in time.

2. **Pay Out the Benefit to the “Defective” Beneficiary Prior to September 30 of the Year Following the Year of the IRA Owner’s Death**

   September 30 of the year following the year of the death of an IRA owner or plan participant is the “beneficiary finalization date” for the minimum distribution rules. Reg.1.401(a)(9)-4, A-4(a). So, in the above example if the estate were named as a $100,000 beneficiary, or were a beneficiary along with other individuals of a trust which was named as a beneficiary—the estate could receive the benefit as soon as possible—no later than September 30 of the year following the year of death.

   This would take the estate off the table and the remaining beneficiaries could take the benefits based on the oldest trust beneficiary’s life expectancy (not separate shares—which aren’t possible under the circumstances of a trust as beneficiary), or if separately named as a class and after the estate has been paid off—based on their
separate life expectancies if separate shares are then created after the payment is made to the non-individual beneficiary and before December 31.

Note: “Separate share” treatment can be accomplished even with a trust as beneficiary, if both the designation of beneficiary and the trust are written so that the separate share requirement occurs at the “plan” IRA level not just the “trust” level. Instead of saying “... to the trust to be divided into shares ...,” the designation of beneficiary should say:

... this IRA shall be divided into equal shares and accounts that are separately designated to the separate subtrusts for each beneficiary named in the (bypass) trust arising at my death.
PLR 2005-37-044.

Note: The difference between the two “fix by” dates of December 31 and September 30 of the year following death. It would be a mistake to think that the deadline is December 31 for a trust with non-individual beneficiaries, because after September 30 this would not be a fixable situation: the date for pay-out, and removal, of the non-individual beneficiary would have passed.

3. Reformation (Correction) of Faulty Designation of Beneficiary (Example: Use of Washington Trust and Estate Dispute Resolution Act (TEDRA)).

What about re-doing the (faulty) beneficiary designation via an agreed reformation? For example, what if there is no “default” (alternate) beneficiary named, the first beneficiary (spouse) is deceased, and under the IRA document the estate of the IRA owner is “default” beneficiary? Or, what about agreed (via TEDRA) re-written provisions to qualify a bypass trust as a “see-through” beneficiary?

In early rulings the IRS permitted reformation (PLRs 2006-16-039, 040) when the defect was due to transfer between custodians and “new” forms were defective, and/or disclaimer or other actions were taken soon after death PLR 2006-16-041.

More recently, and in cases of reformation which dealt with the original IRA and/or individuals were being “added” rather than “removed” (which is counter to Reg. Section 1.401(a)(9)-4, Q&A 4 requiring that a DB was named as a DB at the date of death, until the September 30, next year, determination date), the IRS has prohibited reformation as a way of correcting a faulty original designation, or default designation. PLR 2007-42-026, PLR 2010-21-038.
ARTICLE ___
RETIREMENT BENEFITS

___.1 Retirement Benefits Defined. For the purposes of this Article ___, the term "Retirement Benefits" shall mean and refer to any plan or account which is subject to the minimum distribution rules of IRC Section 401(a)(9).

___.2 Non-Pro Rata Division/Division of Trust(s) for Beneficiaries. My Personal Representative and any Trustee under this Will shall have the full and complete power to agree with my spouse to an equal division, on a non-pro rata basis, of our former community property (both probate and non-probate). In this regard, it is my intent that, to the extent practicable and advisable under federal tax law, any Retirement Benefits be allocated to my spouse as my spouse’s share of our former community property.

My Personal Representative and my Trustee shall further have the power and authority to create a separate trust, trusts, or subtrust(s) for Retirement Benefits received, or to be received, on behalf of any beneficiary hereunder, and to divide Retirement Benefits into separate shares for any Retirement Benefits received or to be received by an individual, individuals, or group of individuals as beneficiary or beneficiaries hereunder.

___.3 Retirement Benefits Allocated to Trust for Spouse. To the extent Retirement Benefits remain payable to any trust for the benefit of my spouse after any non-pro rata division of our former community property, it is my intent that required minimum distributions ("RMD") be calculated with reference to the life expectancy of my spouse.

___.4 Retirement Benefits Payable to Trust for Descendant. To the extent any Retirement Benefits are payable to a trust for a descendant of mine, it is my intent that RMDs be calculated with reference to the life expectancy of such descendant, and my Personal Representative and Trustee are hereby authorized and directed to create a separate trust or trusts for such purposes, as described herein.

___.5 Retirement Benefits Payable to Trust for Spouse or Descendant. If a Retirement Benefit is payable to any Trust or Subtrust under this Will, it is my intent that said Trust be considered a “qualified trust” or “see-through trust” under Reg. 1.401(a)(9) with an individual trust beneficiary whose life expectancy is or will be used to determine the timing and amount of post-death distributions of such Retirement Benefits. Any provision of this Will which would result in said Trust failing to so comply, shall not apply and any provision needed for said qualification which has been omitted from this Will, shall be added under Washington State’s Trust and Estate Dispute Resolution Act. In any event, the following provisions and limitations shall apply to any such Trust or Subtrust:
ARTICLE ___
RETIREMENT BENEFITS

_1 Retirement Benefits Defined. For the purposes of this Article _, the term “Retirement Benefits” shall mean and refer to any plan or account which is subject to the minimum distribution rules of IRC Section 401(a)(9).

_2 Non-Pro Rata Division/Division of Trust(s) for Beneficiaries. My Personal Representative and any Trustee under this Will shall have the full and complete power to agree with my spouse to an equal division, on a non-pro rata basis, of our former community property (both probate and non-probate). In this regard, it is my intent that, to the extent practicable and advisable under federal tax law, any Retirement Benefits be allocated to my spouse as my spouse’s share of our former community property.

My Personal Representative and my Trustee shall further have the power and authority to create a separate trust, trusts, or subtrust(s) for Retirement Benefits received, or to be received, on behalf of any beneficiary hereunder, and to divide Retirement Benefits into separate shares for any Retirement Benefits received or to be received by an individual, individuals, or group of individuals as beneficiary or beneficiaries hereunder.

_3 Retirement Benefits Allocated to Trust for Spouse. To the extent Retirement Benefits remain payable to any trust for the benefit of my spouse after any non-pro rata division of our former community property, it is my intent that required minimum distributions (“RMD”) be calculated with reference to the life expectancy of my spouse.

_4 Retirement Benefits Payable to Trust for Descendant. To the extent any Retirement Benefits are payable to a trust for a descendant of mine, it is my intent that RMDs be calculated with reference to the life expectancy of such descendant, and my Personal Representative and Trustee are hereby authorized and directed to create a separate trust or trusts for such purposes, as described herein.

_5 Retirement Benefits Payable to Trust for Spouse or Descendant. If a Retirement Benefit is payable to any Trust or Subtrust under this Will, it is my intent that said Trust be considered a “qualified trust” or “see-through trust” under Reg. 1.401(a)(9) with an individual trust beneficiary whose life expectancy is or will be used to determine the timing and amount of post-death distributions of such Retirement Benefits. Any provision of this Will which would result in said Trust failing to so comply, shall not apply and any provision needed for said qualification which has been omitted from this Will, shall be added under Washington State’s Trust and Estate Dispute Resolution Act. In any event, the following provisions and limitations shall apply to any such Trust or Subtrust:
A. **Individual Beneficiaries.** Unless otherwise provided in this Will or other instrument, it is my intent that all Retirement Benefits held by or payable to any Trust or Subtrust-trust under this Will shall be distributed to or held for individual beneficiaries within the meaning of the minimum distribution rules, and accordingly the trustee of any such Trust or Subtrust-trust shall not distribute any Retirement Benefits to or for the benefit of my estate, any charity, or other non-individual beneficiary. Further, unless otherwise provided by this Will or other instrument, on or after September 30 of the year following the calendar year of my death (or earlier determination date under the minimum distribution rules), the trustee of any such Trust or Subtrust shall not use Retirement Benefits for payment of any debts, taxes, expenses of administration or other claims against or relating to my estate.

B. **Adopted/Young Issue.** For purposes of any Retirement Benefits payable to any Trust or Subtrust, an individual’s child or issue shall not include an individual who is such individual’s child or issue by virtue of adoption if such individual is adopted after my death and is older than the oldest individual who was a beneficiary of any such Trust or Subtrust at my death. With respect to any individual beneficiary who has not yet attained twenty-one (21) years of age at the time he or she is to receive Retirement Benefits, whether as an individual beneficiary or as a beneficiary of a trust receiving Retirement Benefits, his or her Retirement Benefits shall be distributed to his or her parent or legal guardian as custodian under the Washington Uniform Transfers to Minors Act until such individual attains age twenty-one (21).

C. **Contingent Beneficiaries.** Unless otherwise provided in this Will or other instrument, it is my intent that any Retirement Benefits payable to any Trust or Subtrust under this Will shall be distributed using the Trust or Subtrust beneficiary or beneficiaries at the date of my death for purposes of life expectancy or expectancies under the minimum distribution rules, and accordingly any such Trust or Subtrust shall not make distributions to or for the benefit of any non-individual beneficiary, or any individual who is older than the oldest individual who was a beneficiary of any such Trust or Subtrust at the date of my death, unless under Reg. 1.401(a)(9) such beneficiary is a beneficiary of a conduit trust as described in Reg. 1.401(a)(9)-5, A-7(c)(3), is a mere potential successor as defined in Reg. 1.401(a)(9)-5, A-7(c)(1), or because of post-mortem planning the beneficiary is removed from consideration as a beneficiary under Reg. 1.401(a)(9)-4.

D. **Trust Terminations and Estate Transfers.** Upon termination of any Trust or Sub-trust to which Retirement Benefits are payable, the Trustee is authorized and directed to arrange for the transfer of such Retirement Benefits from the Trust or Sub-trust to the applicable beneficiary so that the beneficiary holds the powers over investment and withdrawals formerly held by the Trustee, without necessarily causing a distribution of Retirement Benefits to the beneficiary. My Personal Representative is similarly authorized and directed to arrange for such transfer in the event that my estate is the beneficiary of any Retirement Benefits.

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6 **Copy of Will to Custodian/Administrator.** My Personal Representative and/or Trustee shall provide a copy of this Will to the plan administrator or custodian of the Retirement Benefits payable to a Trust under this Will within the time period required under Reg.
1.401(a)(9) which, as of the time of this Will is no later than October 31 of the calendar year following the calendar year of my death.

_.7 Power to Deal with Plan Administrator/Custodian. My Personal Representative and Trustee shall each have full power and authority to request information from and provide information to the custodian or plan administrator of any Retirement Benefit.

_.8 RMD for Year of Death. If, as of my death, I have not taken the full RMD for the calendar year of my death, (i) said RMD shall be taken no later than the December 31st of the calendar year of my death, (ii) my Personal Representative shall have the power to cause such RMD, and (iii) said RMD shall be the property of the beneficiary of the Retirement Benefit.

_.9 2006 Pension Protection Act; Direct Transfers. Pursuant to the provisions of the Pension Protection Act of 2006, my Personal Representative and/or Trustee shall have full power and authority to instruct the Administrator or Custodian of any Retirement Benefit to make a direct transfer of such Benefits to an inherited IRA of any beneficiary or trust for a beneficiary under this will, or under the beneficiary designation applicable to such Retirement Benefit, if, in the opinion of my Personal Representative and/or Trustee, such direct transfer will be beneficial for tax purposes, and/or will permit a longer period of payments under the minimum distribution rules of IRC Section 401(a)(9).

_.10 General Principles. This Article shall govern the Trustee's accounting for Retirement Benefits. In general, a Retirement Benefit shall be deemed an asset of any Trust or Subtrust-trust named as a beneficiary of Retirement Benefits, increases or decreases in its value shall be allocated to income or principal of the Trust as provided herein, and distributions from the Retirement Benefit shall be accounted for as provided herein.

_.11 Certain Individual Account Plans. With respect to any Retirement Benefit which is an individual account plan, for which the Trustee receives such reporting of the investment activity in the account that the Trustee can readily determine the “income” and “principal” of the Trust’s interest in the plan in accordance with traditional principles of income and principal, the Trustee shall account for the Trust’s interest in the Retirement Benefit as if the applicable plan assets were owned by the Trust or Subtrust directly.

_.12 All Other Retirement Benefits. With respect to any other Retirement Benefit, the Trustee shall treat the inventory value of the trust’s interest in the Retirement Benefit as principal, and allocate any subsequent increases in value (or charge decreases in value) in such interest to income or principal in accordance with any reasonable method selected by the Trustee that is consistent with traditional principles of income and principal and is consistently applied to the Trust’s interest in such plan, including:

A. A method specified in any Uniform Principal and Income Act (UPIA) or other state law governing trust accounting for retirement benefits or deferred compensation, but only if such law provides for a reasonable apportionment, each year, between the income and
remainder beneficiaries of the total return of the trust for such year. The "10 percent rule" of
UPIA Section 409(c), or any other state law that determines income with respect to Retirement
Benefit by reference to the amount of the retirement plan’s required distributions rather than by
reference to the return on the applicable investments or other traditional principles of income and
principal, or that otherwise departs fundamentally from traditional principles of income and
principal, may not be used to determine "income" for any purpose of the Trust or Subtrust.

B. In the case of a plan similar to the type of plan specified in paragraph
___.11 above, the method specified in said paragraph ___.11 adapted as necessary.

C. Any method used in the Code or Treasury regulations to distinguish
between “ordinary income” and “return of principal” (or corpus) with respect to similar assets.

_.13 Treatment of Distributions. When a distribution is received from or under a
Retirement Benefit, and, at the time of such distribution, under the foregoing rules, the trust’s
interest in the Retirement Benefit is composed of both income and principal, such distributions
shall be deemed withdrawn first from the income portion.

_.14 Definition of Inventory Value. In the interpretation of this Article, the
“inventory value” of an interest in a Retirement Benefit shall mean:

A. In the case of an interest that becomes payable to (or is owned by) the
Trust as of the date of my death, its “fair market value” determined in accordance with the rules
applicable for valuing such interests for purposes of the federal estate tax (as in effect at my
death, or, if such tax does not then exist, as last in effect); or, 

B. In the case of an interest that becomes payable to the Trust as of the date
after the date of my death (for example, by transfer from another fiduciary), its “fair market
value” shall be its value as of my death determined as provided in the preceding subparagraph,
adjusted as necessary for distributions, expenditures, and receipts that occurred between the date
of my death and the date of transfer to the Trust; or, if the trustee cannot determine its value in
that manner, its “fair market value” shall be its value as of the date it becomes an asset of the
Trust, determined as provided in the preceding subparagraph, provided, in the case of an interest
transferred to the trust from another fiduciary (such as my Personal Representative) accrued
income so transferred shall be treated as income and shall not be included in “inventory value.”