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RETIREMENT PLANNING AND BENEFICIARY DESIGNATION ISSUES – INCLUDING CONDUIT TRUSTS AND PENSION PROTECTION ACT ISSUES OF INTEREST TO ESTATE PLANNERS

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BIOGRAPHY

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STEVE is recognized as one of the top 1% of lawyers in the U.S. by virtue of his inclusion in the "Best Lawyers of America." He has also been voted by his peers in Los Angeles County as a "Super Lawyer," and was further recognized as one of the top 100 vote recipients county-wide among all practice areas in 2004.

STEVE is a "Certified Specialist" in two areas: Taxation Law, and Estate Planning and Probate Law (certification by the Board of Legal Specialization of the State Bar of California).

STEVE is a Fellow of the American College of Trust and Estate Counsel ("ACTEC") and served as a Member of the ACTEC Employee Benefits Committee from 2000 to 2004.

STEVE served as Chair of the California State Bar Taxation Section Committee on Estate and Gift Taxation from 1996 to 1998. He is an active member of the American Bar Association, the State Bar of California, the Los Angeles County Bar Association, the American Institute of Certified Public Accountants, and the California Society of Certified Public Accountants.

STEVE attended the University of Illinois where he received his undergraduate, MBA, and JD degrees. He was admitted to the Illinois Bar in 1978 and to the California Bar in 1983. He became licensed as an Illinois CPA in 1979.

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TABLE OF CONTENTS

I. Case Studies - Methodology . . . 1
A. How "Success" Is Defined In Financial Model . . . 1
B. How The Numbers Were Run; What The Numbers Represent . . . 2
C. "Pile of Money" Defined . . . 2
D. Client's Investment Style . . . 2
E. How Basis "Step Up" Is Incorporated in the Financial Model . . . 3
F. Does Client Expect Beneficiaries To Continue Deferral . . . 4
II. Case Study: Jones & Son - Basic Stretch-Out . . . 5
A. Fact Pattern . . . 5
B. Planning Strategies Evaluated . . . 6
C. MRD Divisors - Final regulations . . . 6
D. Case Study Results . . . 8
E. Case Study Results - Including Roth IRA Conversion . . . 9
F. Case Study Results - Estate Tax Repealed . . . 10
III. Case Study: Mr. Gramps & Multi-Generational Planning . . . 11
A. Fact Pattern . . . 11
B. Planning Strategies Evaluated . . . 12
C. MRD Divisors - Grandchild . . . 13
D. MRD Divisors - Child . . . 14
E. Case Study Results . . . 15
IV. DB Designations & Post-Mortem Planning Under the New Rules . . . 16
A. The Pressure to Designate By RBD Is Off . . . 16

B. Post-Mortem Planning Period Under Final Regulations . . . 16
C. Beneficiary Drops Out Due to Qualified Disclaimer . . . 16
D. Death of Beneficiary . . . 17
E. Revocable Trust Designated . . . 17
F. Estate Designated . . . 18
G. Cash Out of Beneficiary . . . 18
H. Final Regulations Apply Regardless of Date of Death . . . 18
I. Beneficiary Designations Should Include the What-Ifs . . . 18
J. Dealing With Financial Institutions . . . 18
V. SAMPLE FORM: "Basic" DB Designation for Cindy Smith - Children as DBs . . . 20
A. Fact Pattern . . . 20
B. IRA Death Beneficiary Form . . . 20
VI. Trusts as Beneficiaries Under the MRD Rules . . . 24
A. Qualifying As a DB Trust . . . 24
1. Valid Under State Law . . . 24
2. Irrevocable . . . 24
3. Beneficiaries Are Identifiable . . . 24
4. Documentation Provided to Plan Administrator . . . 25
5. Drafting Suggestion - Documentation Requirement . . . 26
B. Identifying the Oldest DB Trust Beneficiary . . . 26
1. "Separate Share" Treatment for Multiple Subtrusts . . . 27
2. Beneficiaries Entitled to Plan Assets . . . 28
3. Beneficiaries Entitled to Current Distributions . . . 29
4. Permissible Beneficiaries . . . 29
5. Successor Beneficiaries . . . 29
6. Permissible Appointees Under Power of Appointment . . . 31
7. Conduit Trusts . . . 33
8. Treasury's Rationale On Trust Requirements . . . 33
C. Planning and Drafting Alternatives to Conduit Trust . . . 33
1. Outright Distribution . . . 34
2. "Last One Standing" Provision . . . 34
3. Variations on Conduit Provisions . . . 34
4. "Tweak" the Alternate Takers . . . 34
5. "Tweak" All Dispositive Provisions . . . 35
6. Continuing Grantor Trusts . . . 35
7. Dynasty Trusts . . . 37
D. Drafting Suggestion - Address Taxes and Expenses . . . 37
VII. DRAFTING STUDY: Jane Reynolds - Conduit Trusts as DBs . . . 39
A. Fact Pattern . . . 39
B. Drafting Considerations . . . 39
C. SAMPLE FORM: "Conduit" Subtrust . . . 41
D. SAMPLE FORM: IRA Death Beneficiary Form Designating Subtrusts . . . 43
VIII. Allocation Between Income and Principal - UPIA in California . . . 45
A. 1997 Uniform Principal and Income Act . . . 45
B. 1962 RUPIA Default Rules for Retirement Plans . . . 45

C. A Lot Has Changed Since 1962 . . . 46
D. The 1997 UPIA Default Rule . . . 46
E. "Payment" Defined; Three Conditions Before Section 16361 Applies . . . 46
F. Default Rules for Allocating Payments to Income and Principal . . . 47
G. Special Rule for Marital Deduction Trusts . . . 48
H. New Legislation . . . 49
IX. SAMPLE FORM: Drafting Under the 1997 Principal and Income Act . . . 50
A. Avoid Reference to "Income" When Defining Economic Interests . . . 50
B. Leave Determination of Income and Principal to Trustee . . . 50
C. Provide a Specific Rule for the Trustee . . . 50
X. MRD Trade Off: Lost Deferral When Designating QTIP and Bypass Trusts . . . 52
XI. Case Study: Mr. and Mrs. Brady - MRD Trade-Off . . . 53
XII. Preserving Marital Deduction for Estate Tax When QTIP Trust is DB . . . 61
A. Rev. Rul. 2006-26: IRS Addresses UPIA . . . 61
B. Rev. Rul. 2000-2: IRS Relaxes Its Position . . . 61
C. What Does the New IRS Position Mean . . . 62
D. Watch Out for Additional Restrictions Unique to Plan . . . 63
E. Be Sure to Designate Subtrust . . . 63
F. Increased Importance of Allocation Between Income and Principal . . . 63
G. Tax Consequences of Income Withdrawal Power . . . 64
H. Ownership Under Grantor Trust Provisions . . . 65
I. Basis for Inclusion in Survivor's Estate . . . 66
J. "Reverse QTIP" Election . . . 66
K. Recovery Rights Under Sections 2207A and 2207B . . . 66
L. Planning Ideas for Second Marriage Estate Plans . . . 67
XIII. PPA of 2006 Allows IRA Rollovers by Non-Spouse Beneficiaries . . . 69
XIV. Summary of Other PPA of 2006 Provisions . . . 73
A. Roth IRA Conversions from Non-IRA Plans . . . 73
B. Roth IRA Conversion Eligibility Requirements . . . 74
1. AGI Requirement . . . 74
2. Filing Status Requirement . . . 75
C. Roth IRA Conversion Eligibility Requirements Repealed After 2009 . . . 75
D. EGGTRA Pension Provisions Made Permanent . . . 75
XV. PPA of 2006 Allows Direct Rollover to Charity . . . 76
XVI. Case Study: Ms. Wellington . . . 79
A. Fact Pattern . . . 79
B. Charitable Gift Strategies Considered . . . 79
C. Minimum Required Distribution Divisors If Charity Is Designated . . . 80
D. Minimum Required Distribution Divisors If Daughter Is Designated . . . 81
E. Case Study Results - Equal Benefits to Charity . . . 82
F. Case Study Results - What's Left for Daughter . . . 83
G. Analysis - What Is This Case Study Telling Us . . . 84
XVII. Completing the DB Designation for a Married Participant . . . 85
A. "Default" Approach: Retirement Plans . . . 85
B. Spousal Consents . . . 85

C. IRA Death Beneficiary Form - Children Designated as Individuals 85
D. IRA Death Beneficiary Form - Subtrusts Designated 87
E. Other Nonprobate Assets 88
F. Add Clarifying Language to Wills 89
XVIII. Planning to Avoid Waste of the Unified Credit 90
A. Redistribute Assets Among Spouses 90
B. Designation of Bypass Trust; Disclaimer 90
C. Life Insurance Not A Solution 90
D. Designate Revocable Trust 90
E. Aggregate Theory Agreement 91
XIX. How to Obtain A Spousal Rollover And Still Fund the Bypass Trust 92
XX. Aggregate Divisions Inside and Outside of Revocable Trust 94
A. Inside the Revocable Trust - Participant Dies First 94
B. Inside the Revocable Trust - Spouse Dies First 94
C. Inside and Outside the Revocable Trust 95
1. State Property Law Rights 95
2. Community Property States 95
3. Common Law States 95
4. Property Agreement May Be Required In Certain States 96
5. The Jones Example 96
XXI. Income Tax Risks of Aggregate Division 97
A. Not a Disposition Under I.R.C. Section 1001 97
1. Property Division By Spouses 97
2. Property Division By Co-Owners Not Related By Marriage 97
B. Assignment of Income Doctrine 98
C. Not a Plan Distribution Under I.R.C. Section 402 98
D. Not a Transfer Under I.R.C. Section 691(a)(2) 98
E. Two Favorable Private Rulings 98
F. The Dark Horse: The Roth IRA 99
XXII. Impact of ERISA on Aggregate Division 100
XXIII. Other Benefits of Aggregate Division 101
A. Second Marriages, Rollovers, and QTIPs 101
B. Special Basis "Step Up" for Marital Gifts After 2009 102
XXIV. Sample Forms 103
A. Aggregate Theory Agreement 103
B. Language To Be Included in Joint Revocable Trust 106
C. Language To Be Included in Wills 107
XXV. Additional Comments On Aggregate Theory Agreements in California 108
A. California Applies Item Theory At Death 108
B. California Allows Written Aggregate Theory Agreement 108
C. Non-Prorata Distribution Clause Distinguished 109

RETIREMENT PLANNING AND BENEFICIARY DESIGNATION ISSUES – INCLUDING CONDUIT TRUSTS AND PENSION PROTECTION ACT ISSUES OF INTEREST TO ESTATE PLANNERS

BY STEVEN E. TRYTTEN, ESQ., CPA, MBA

I. Case Studies - Methodology.

All case studies reflect the most recent MRD Rules. However, as of April 1, 2007, your author is still preparing case studies using:

> *(i) the dates of death in the case studies generally extend beyond the "sunset" date under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA-2001"); the general* ***estate, gift and generation-skipping tax*** *rates, etc., are calculated assuming that EGTRRA-2001 sunsets and that the pre-EGTRRA law continues. This is just as well, as the moving targets that arise under EGTRRA could produce misleading results; and*
>
> *(ii) general* ***income tax*** *rates, etc., as they exist under EGTRRA-2001. Your author regrets he has not yet incorporated the rate reductions enacted in 2003. Your author anticipates these will narrow the gap between "deferral" and "non-deferral" strategies ever so slightly.*

A. How "Success" Is Defined In Financial Model.

It is impossible to evaluate the results of a Case Study without a benchmark of comparison, *i.e.*, a definition of "success." It is too easy to define success as minimizing taxes (and, prior to the Tax Reform Act of 1997, minimizing the excise taxes, which carried the stigma of a penalty). What most clients really want is to maximize the net worth that remains after taxes have been paid ("After Tax Net Worth" or "ATNW"). If a client wants to preserve the maximum ATNW for future generations, the transfer taxes (gift, estate, and generation skipping taxes) must be included in the equation. On the other hand, if a client's primary concern is her own financial security during retirement, the best definition of success may be one that takes only lifetime income taxes into account. It is essential to discuss these issues with the client and reach a consensus in defining "success" for purposes of the client's distribution planning.

Either way, it is difficult to compare what is left for the client's family when different distribution strategies produce different amounts of retirement plan and "after-tax" assets. Other commentators have struggled with this issue and reached surprisingly different conclusions, depending on how they chose to compare the apples to the oranges.

There is a way to compare retirement plan assets to "after tax" assets on a true "apples to apples" basis, and this approach produces the most objective evaluation of

different distribution strategies. This method of comparison involves projecting the gradual payout of a retirement plan over the beneficiary's remaining deferral period until the beneficiary's entire estate consists of after tax assets. The beneficiary with the biggest pile of money at the end of the deferral period wins! (Note that the technical term "pile of money" has been substituted in place of "ATNW" throughout the balance of this discussion.)

This is the measure of success in the extensive Excel spreadsheets your author built to produce these Case Studies. This particular measure of success includes transfer taxes in the equation, which is appropriate if the client's primary goal is to maximize the size of the Beneficiary's pile of money. The point in time that is used for comparing piles of money in most of the Case Studies is the end of the youngest beneficiary's deferral period. The piles of money the beneficiaries have accumulated by then under each of the different distribution strategies can be compared on an "apples to apples" basis. Relative percentages are shown for convenience, with the "100%" being arbitrarily assigned to the distribution strategy involving full distribution of the plan in the earliest year.

B. How The Numbers Were Run; What The Numbers Represent.

The results of each Case Study were generated with a financial model that consists of an Excel file[1] that contains multiple spreadsheets corresponding to each planning scenario. In addition, an extra scenario runs in the background that measures how big the Beneficiary's pile of money would have been had there not been a retirement plan at all. From a statistical point of view, this scenario serves as the "control" and provides a basis of comparing the other scenarios.[2]

C. "Pile of Money" Defined.

The results shown for each scenario are isolated to show *only the portion of the Beneficiary's pile of money that corresponds to the retirement plan*. However, all of the calculations (such as tax brackets, *etc.*) reflect the full amount of assets and income corresponding to each scenario.

D. Client's Investment Style.

The distribution planner must understand the client's investment style. Higher yields magnify the differences between distribution strategies. The relative yields inside and outside the retirement plan also impact the financial analysis.

For example, a real estate developer may know how to earn 25% on his money, but the investments may not be permissible inside his retirement plan. In that situation, he may

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[1] ZCalc, an add-in accessory program for Excel, made this task much easier. For more information, visit www.zcalc.com.

[2] The backup calculations for each scenario fill ten pages using a 6 point font. The backup calculations for a seven scenario Case Study fills eighty pages (seven scenarios plus the "control" scenario). The backup calculations for a seven scenario Case Study run at three different dates of death fills 240 pages.

do better investing outside his plan than investing in his plan, and long deferral strategies may not be appropriate for him.

Even when the same investment choices are available inside or outside the plan, some individuals apply different investment styles to their inside and outside assets. If one group of assets is expected to earn a different yield than the other group, different distribution strategies will produce different overall investment yields, making it harder to distinguish between the effect of the changed yield and the effect of the various tax rules. Thus, for analytical purposes, all of the Case Studies assume the same investment performance inside and outside the retirement plan.

Investments with the same overall yield can produce different results in the outside portfolio, depending on the portions of yield that are recognized as ordinary income, short-term capital gains, and long-term capital gains. For this reason, financial models that only allow the input of a single "yield" number are of limited value. The financial model used in these Case Studies requires completion of several input fields to determine the ordinary income portion of yield, the portion of the portfolio that is susceptible to growth, and the portfolio turnover for purposes of determining what portion of growth is recognized each year as capital gains.

Portfolio turnover can affect the outcome. An astute investor may be able to arrange her overall portfolio in a way that allows higher turnover assets to remain inside the IRA and lower turnover assets to remain outside.

E. How Basis "Step Up" Is Incorporated in the Financial Model.

A great deal of thought went into applying the "step up" in cost basis that is allowed at death to outside investments.[3] The "step up" makes a big difference if the Beneficiary liquidates the entire portfolio. But if the Beneficiary will continue to invest using the same investment style, only a portion of the portfolio is liquidated in any given year depending on the portfolio turnover.

The financial model incorporates sophisticated portfolio modeling to calculate the unrealized appreciation in the outside investments, identify the taxable capital gain each year arising from portfolio turnover, and "step up" the cost basis at death. Then, the financial model applies the "step up" to reduce the capital gains recognized by the Beneficiary in the years following death assuming the Beneficiary continues to follow the Participant's investment style.

In order to accommodate the portfolio modeling, investment performance is entered using three variables: (i) percentage yield consisting of ordinary income (dividends and interest); (ii) percentage yield consisting of overall growth and appreciation (recognized or unrecognized capital gains); and (iii) portfolio turnover, entered as the percentage of the portfolio that "turns over" in any given year.

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[3] The "step up" is allowed under I.R.C. § 1014.

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F. Does Client Expect Beneficiaries To Continue Deferral.

It is essential for the planner and client to develop a clear expectation as to the likelihood of continuing deferral after death. The client knows his or her children best and can usually provide a reliable prediction.

Even if the children are not expected to continue deferral, a lifetime minimum distribution strategy will provide superior results if the Participant lives long enough due to the benefit of tax-deferred compounding over the Participant's remaining life.

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II. Case Study: Jones & Son - Basic Stretch-Out.

For more details on the philosophy and methodology of the case studies in this outline, please refer to Section I.

A. Fact Pattern.

Mr. Jones visits his planner in the year 2003. He was born March 1, 1938, and is widowed with one child, age 30. Mr. Jones wants to leave his entire estate to his child. Mr. Jones is worried there won't be much left for his child after estate and income taxes, and wants to know how his child fares under various distribution strategies. Mr. Jones's estate consists of:

IRA	$ 1,000,000
Liquid Investments	$ 600,000
Residence	$ 400,000

- All investments earn 10% annual return, consisting of 1.5% ordinary income and 8.5% growth. Portfolio turnover is 20% per year.
- Mr. Jones receives a $48,000 pension each year, $10,000 of social security (indexed for inflation), and has cash outflow of $36,000 per year (indexed for inflation).
- Annual inflation will be 1.5% throughout the projection period.
- Mr. Jones has not made any prior taxable gifts.
- The projections assume that Mr. Jones will die at age 82.
- Mr. Jones's child earns $40,000 per year (indexed) and has cash outflow of $30,000 per year (indexed). When the child reaches age 65 he will receive social security benefits of $8,000 per year (in 2003 dollars, indexed for inflation).
- Current income and transfer tax rules will remain in effect, *e.g.*, alternative minimum tax, taxation of a portion of social security, "I.R.D." deduction, 3% phase-out ("haircut") of itemized deductions, limitations on charitable deductions, compressed rate brackets for trusts, *etc.* The I.R.D. deduction will be utilized on the earliest dollars distributed, as discussed earlier.
- Retirement Plan distributions to trusts are taxed at the trust's level (and I.R.D. deductions deducted at the trust's level) until the I.R.D. deduction is fully utilized. Note that it may be necessary for the trust to accumulate (*i.e.*, not make any distributions) to accomplish this.

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B. Planning Strategies Evaluated.

Strategy	Explanation
(1) Distribute in 2003	Mr. Jones takes full distribution of his Plan balance during the current year of 2003, which is included solely for the purpose of providing a basis of comparison for the other strategies.
(2) Distribute on Death Bed	Mr. Jones takes minimum distributions until the year of his death, and takes full distribution of his Plan immediately prior to his death.
(3) Distribute Just After Death	Mr. Jones takes minimum distributions during his life. Immediately after his death, his child takes full distribution of the Plan.
(4) Stretch Out; Plan Bears Death Tax	Same as before, except the child continues minimum distributions during his life. However, a Plan withdrawal is made to pay the Plan's prorata share of death taxes. The beneficiary pays the income tax on the Plan withdrawal from non-Plan assets, if possible.
(5) Stretch Out; Plan Bears No Death Tax	Same as before, except death taxes are apportioned to the Plan only to the extent that other assets are insufficient to pay them.
(6) DB Trust; No Death Tax	Same as before, except that the I.R.D. is accumulated and taxed inside a "complex" trust for the child's benefit. The trust is recognized as having the child's life expectancy.

C. MRD Divisors - Final regulations.

[See next page.]

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Jones & Son				
Calendar Year	*Distribution Year*	*Participant's Age*	*Beneficiary's Age*	*Divisor*
2008	1	70	35	27.4
2009	2	71	36	26.5
2010	3	72	37	25.6
2011	4	73	38	24.7
2012	5	74	39	23.8
2013	6	75	40	22.9
2014	7	76	41	22.0
2015	8	77	42	21.2
2016	9	78	43	20.3
2017	10	79	44	19.5
2018	11	80	45	18.7
2019	12	81	46	17.9
2020	13	82	47	17.1
2021	14		48	36.0
2022	15		49	35.0
2023	16		50	34.0
2024	17		51	33.0
2025	18		52	32.0
2026	19		53	31.0
2027	20		54	30.0
2028	21		55	29.0
2029	22		56	28.0
2030	23		57	27.0
2031	24		58	26.0
2032	25		59	25.0
2033	26		60	24.0
2034	27		61	23.0
2035	28		62	22.0
2036	29		63	21.0
2037	30		64	20.0
2038	31		65	19.0
2039	32		66	18.0
2040	33		67	17.0
2041	34		68	16.0
2042	35		69	15.0
2043	36		70	14.0
2044	37		71	13.0
2045	38		72	12.0
2046	39		73	11.0
2047	40		74	10.0
2048	41		75	9.0
2049	42		76	8.0
2050	43		77	7.0
2051	44		78	6.0
2052	45		79	5.0
2053	46		80	4.0
2054	47		81	3.0
2055	48		82	2.0
2056	49		83	1.0

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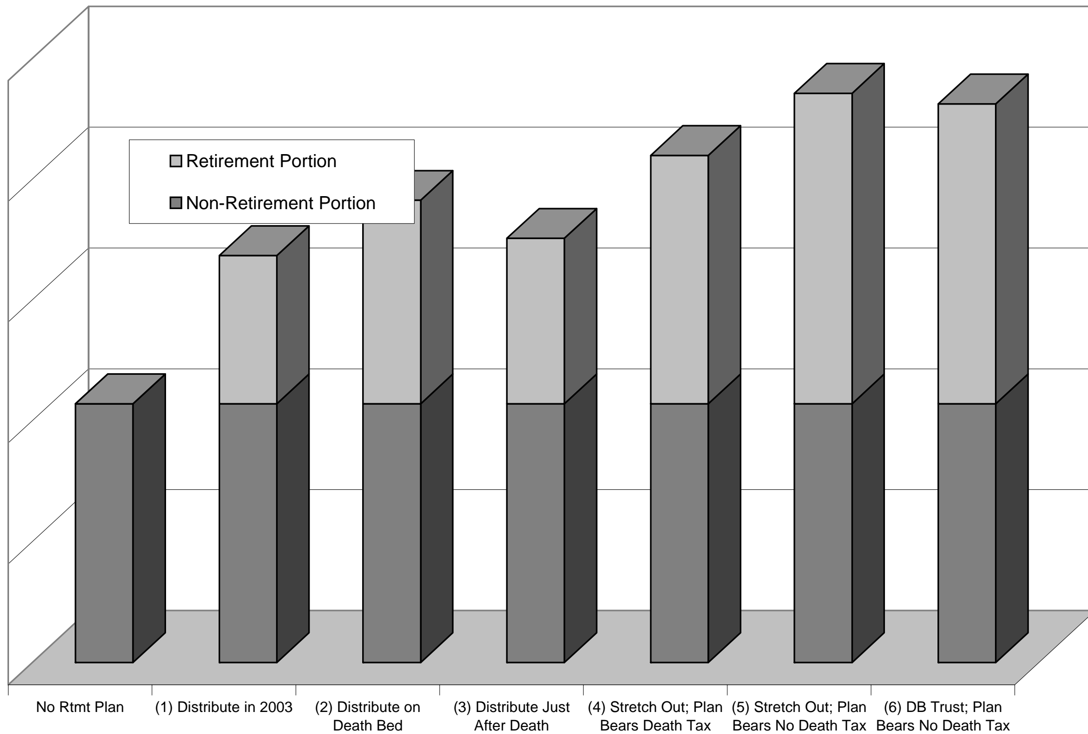
D. Case Study Results.

Jones & Son						
Retirement Plan in Yr 2003:	$ 1,000,000					
Deferral Period Ends:	2056					
Distribution Strategy:	(1) Distribute in 2003	(2) Distribute on Death Bed	(3) Distribute Just After Death	(4) Stretch Out; Plan Bears Death Tax	(5) Stretch Out; Plan Bears No Death Tax	(6) DB Trust; Plan Bears No Death Tax
Value of Retirement Plan Assets At End of Deferral Period:	13,494,097	18,531,558	15,074,342	22,616,115	28,278,020	27,308,669
Value of Retirement Plan Assets At End of Deferral Period (In Today's Dollars):	6,129,762	8,418,054	6,847,596	10,273,484	12,845,433	12,405,101
% Comparison:	100%	137%	112%	168%	210%	202%



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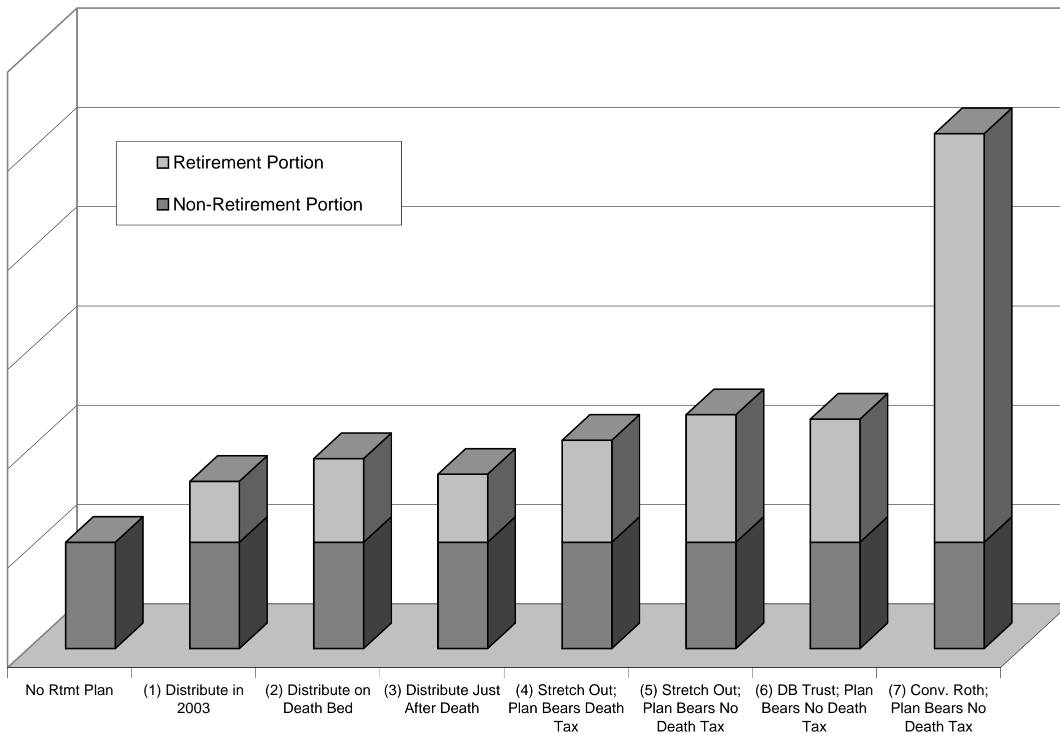
E. Case Study Results - Including Roth IRA Conversion.

Jones & Son							
Retirement Plan in Yr 2003:	$ 1,000,000						
Deferral Period Ends:	2056						
Distribution Strategy:	(1) Distribute in 2003	(2) Distribute on Death Bed	(3) Distribute Just After Death	(4) Stretch Out; Plan Bears Death Tax	(5) Stretch Out; Plan Bears No Death Tax	(6) DB Trust; Plan Bears No Death Tax	(7) Conv. Roth; Plan Bears No Death Tax
Value of Retirement Plan Assets At End of Deferral Period:	13,494,097	18,531,558	15,074,342	22,616,115	28,278,020	27,308,669	90,608,899
Value of Retirement Plan Assets At End of Deferral Period (In Today's Dollars):	6,129,762	8,418,054	6,847,596	10,273,484	12,845,433	12,405,101	41,159,550
% Comparison:	100%	137%	112%	168%	210%	202%	671%



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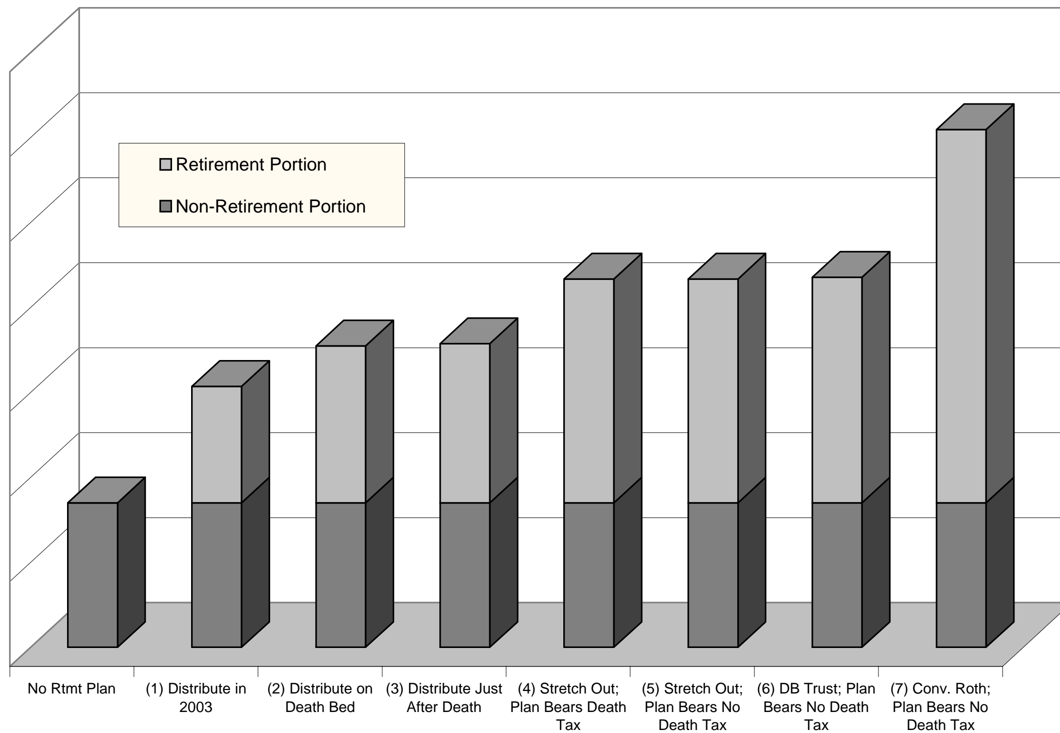
F. Case Study Results - Estate Tax Repealed.

Jones & Son							
Retirement Plan in Yr 2003:	$ 1,000,000						
Deferral Period Ends:	2056						
Distribution Strategy:	(1) Distribute in 2003	(2) Distribute on Death Bed	(3) Distribute Just After Death	(4) Stretch Out; Plan Bears Death Tax	(5) Stretch Out; Plan Bears No Death Tax	(6) DB Trust; Plan Bears No Death Tax	(7) Conv. Roth; Plan Bears No Death Tax
Value of Retirement Plan Assets At End of Deferral Period:	30,212,986	40,661,355	41,262,111	57,985,481	57,985,481	58,472,359	96,709,337
Value of Retirement Plan Assets At End of Deferral Period (In Today's Dollars):	13,724,401	18,470,626	18,743,522	26,340,198	26,340,198	26,561,364	43,930,704
% Comparison:	100%	135%	137%	192%	192%	194%	320%



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III. Case Study: Mr. Gramps & Multi-Generational Planning.

A. Fact Pattern.

Mr. Gramp's situation is the same as Mr. Jones (discussed earlier), except Mr. Gramps has one child, age 30, and one grandchild, age 4. Mr. Gramps wants to see the impact of various planning approaches that utilizes his generation skipping tax exemption. His estate is as follows:

IRA	$ 500,000
Liquid Investments	$ 1,000,000
Residence	$ 500,000

The assumptions are generally the same as the Mr. Jones Case Studies, with the following additional or changed facts:

- Mr. Gramps has not made any prior taxable gifts or GST exemption allocations. Mr. Gramps is assumed to die at age 82, and his child is also assumed to die at age 82.
- The GST exemption amount in the year of Mr. Gramps' death will be $1,360,000, roughly what indexing would provide under pre-2001 law.
- Mr. Gramps's child earns $40,000 per year (indexed) and has cash outflow of $30,000 per year (indexed). When the child reaches age 65 he will receive social security benefits of $8,000 per year (in 2003 dollars, indexed for inflation).
- Beginning at age 21, Mr. Gramps's grandchild will earn $40,000 per year (indexed) and will have cash outflow of $30,000 per year (indexed). When the grandchild reaches age 65 he will receive social security benefits of $8,000 per year (in 2003 dollars, indexed for inflation).
- Current income tax rules will remain in effect (indexed for inflation), *e.g.*, alternative minimum tax, taxation of a portion of social security, "I.R.D." deduction, 3% phase-out ("haircut") of itemized deductions, limitations on charitable deductions, compressed rate brackets for trusts, *etc.* The I.R.D. deduction will be utilized on the earliest dollars distributed, as discussed earlier.

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B. Planning Strategies Evaluated.

Strategy	Explanation
(1) Distribute in 2003	Mr. Gramps takes full distribution during the year 2003.
(2) Distribute on Death Bed	Mr. Gramps takes minimum distributions until death and takes full distribution just prior to death.
(3) Stretch Out to Child	Mr. Gramps designates his child who takes minimum distributions. Death taxes are apportioned to other assets.
(4) Stretch Out; $1.36M Investments to GC	Same, except Gramps directs investment assets to grandchild in amount of then-indexed GST exemption ($1,360,000).
(5) Stretch Out; $1.36 M IRA to GC	Same, except Gramps designates portion of IRA to grandchild equal to the then-indexed GST exemption; other assets pass to child. Child and GC take MRDs.
(6) Stretch Out; Entire IRA to GC (incurs GST tax)	Same, except Gramps designates the entire IRA to grandchild, and pays GST tax at death; other assets pass to child.
(7) Stretch Out; $1.36M Roth IRA to GC	Same as scenario (5) except that Gramps completes a conversion of his entire retirement Plan to a Roth IRA in the year 2003 (paying income tax from non-IRA assets).
(8) Stretch Out; Entire Roth IRA to GC (Incurs GST tax)	Same as scenario (6) except that Gramps completes a conversion of his entire retirement Plan to a Roth IRA in the year 2003 (paying income tax from non-IRA assets).

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C. MRD Divisors - Grandchild.

Calendar Year	*Distribution Year*	*Participant's Age*	*Beneficiary's Age*	*Divisor*
2008	1	70	9	27.4
2009	2	71	10	26.5
2010	3	72	11	25.6
2011	4	73	12	24.7
2012	5	74	13	23.8
2013	6	75	14	22.9
2014	7	76	15	22.0
2015	8	77	16	21.2
2016	9	78	17	20.3
2017	10	79	18	19.5
2018	11	80	19	18.7
2019	12	81	20	17.9
2020	13	82	21	17.1
2021	14		22	61.1
2022	15		23	60.1
2023	16		24	59.1
2024	17		25	58.1
2025	18		26	57.1
2026	19		27	56.1
2027	20		28	55.1
2028	21		29	54.1
2029	22		30	53.1
2030	23		31	52.1
2031	24		32	51.1
2032	25		33	50.1
2033	26		34	49.1
2034	27		35	48.1
2035	28		36	47.1
2036	29		37	46.1
2037	30		38	45.1
2038	31		39	44.1
2039	32		40	43.1
2040	33		41	42.1
2041	34		42	41.1
2042	35		43	40.1
2043	36		44	39.1
2044	37		45	38.1
2045	38		46	37.1
2046	39		47	36.1
2047	40		48	35.1
2048	41		49	34.1
2049	42		50	33.1
2050	43		51	32.1
2051	44		52	31.1
2052	45		53	30.1
2053	46		54	29.1
2054	47		55	28.1
2055	48		56	27.1
2056	49		57	26.1
2057	50		58	25.1
2058	51		59	24.1
2059	52		60	23.1
2060	53		61	22.1
2061	54		62	21.1
2062	55		63	20.1
2063	56		64	19.1
2064	57		65	18.1
2065	58		66	17.1
2066	59		67	16.1
2067	60		68	15.1
2068	61		69	14.1
2069	62		70	13.1
2070	63		71	12.1
2071	64		72	11.1
2072	65		73	10.1
2073	66		74	9.1
2074	67		75	8.1

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D. MRD Divisors - Child.

Calendar Year	*Distribution Year*	*Participant's Age*	*Beneficiary's Age*	*Divisor*
2008	1	70	35	27.4
2009	2	71	36	26.5
2010	3	72	37	25.6
2011	4	73	38	24.7
2012	5	74	39	23.8
2013	6	75	40	22.9
2014	7	76	41	22.0
2015	8	77	42	21.2
2016	9	78	43	20.3
2017	10	79	44	19.5
2018	11	80	45	18.7
2019	12	81	46	17.9
2020	13	82	47	17.1
2021	14		48	36.0
2022	15		49	35.0
2023	16		50	34.0
2024	17		51	33.0
2025	18		52	32.0
2026	19		53	31.0
2027	20		54	30.0
2028	21		55	29.0
2029	22		56	28.0
2030	23		57	27.0
2031	24		58	26.0
2032	25		59	25.0
2033	26		60	24.0
2034	27		61	23.0
2035	28		62	22.0
2036	29		63	21.0
2037	30		64	20.0
2038	31		65	19.0
2039	32		66	18.0
2040	33		67	17.0
2041	34		68	16.0
2042	35		69	15.0
2043	36		70	14.0
2044	37		71	13.0
2045	38		72	12.0
2046	39		73	11.0
2047	40		74	10.0
2048	41		75	9.0
2049	42		76	8.0
2050	43		77	7.0
2051	44		78	6.0
2052	45		79	5.0
2053	46		80	4.0
2054	47		81	3.0
2055	48		82	2.0
2056	49		83	1.0

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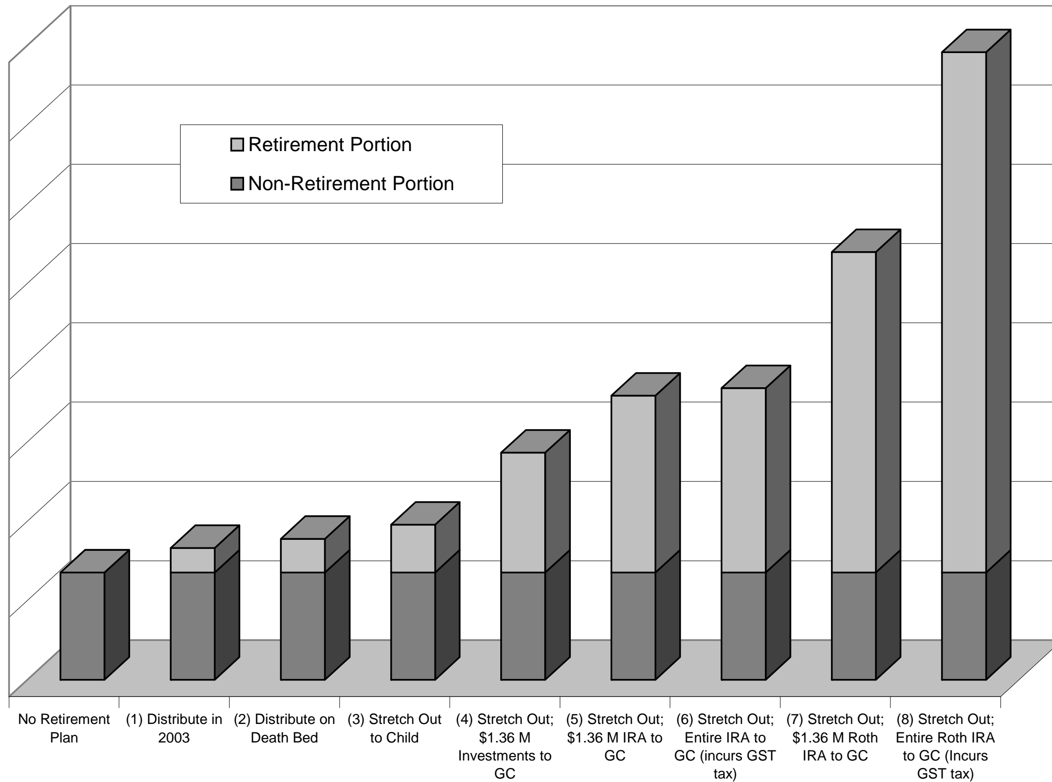
E. Case Study Results.

Mr. Gramps: Multi-Generational Planning								
Retirement Plan in Yr 2003:	$ 500,000							
Deferral Period Ends:	2094							
Distribution Strategy:	(1) Distribute in 2003	(2) Distribute on Death Bed	(3) Stretch Out to Child	(4) Stretch Out; $1.36 M Investments to GC	(5) Stretch Out; $1.36 M IRA to GC	(6) Stretch Out; Entire IRA to GC (incurs GST tax)	(7) Stretch Out; $1.36 M Roth IRA to GC	(8) Stretch Out; Entire Roth IRA to GC (Incurs GST tax)
Value of Retirement Plan Assets At End of Deferral Period:	19,470,850	26,764,536	37,993,987	95,203,189	140,374,752	146,422,442	254,392,161	412,864,322
Value of Retirement Plan Assets At End of Deferral Period (In Today's Dollars):	6,187,279	8,505,003	12,073,401	30,252,846	44,607,075	46,528,858	80,838,542	131,196,455
% Comparison:	100%	137%	195%	489%	721%	752%	1307%	2120%



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IV. DB Designations & Post-Mortem Planning Under the New Rules.

A. The Pressure to Designate By RBD Is Off.

Under the final regulations, the pressure is off as far as getting the beneficiary designation in place by the Participant's RBD.[4] Now the Participant can be asleep at the switch at RBD and can remain asleep long after RBD, as long as he or she wakes up in time to make the appropriate beneficiary designation before death. If the Participant dies without an appropriate death beneficiary designation in place, the heirs' options will still be quite limited, even under the final regulations.

B. Post-Mortem Planning Period Under Final Regulations.

The final regulations allow certain problems to be "fixed" during a post-mortem planning period that is open until ***September 30th*** of the calendar year following the year of death (the author calls this date the "Post-Mortem Date," and has heard others call it the "Applicable Date" or the "Designation Date").[5] This concept was first introduced with the 2001 proposed regulations, and is one of the most significant changes made to the regulations over the years. The final regulations moved the date up from December 31 to September 30 in response to concerns by financial institutions that the December 31 date would make it too difficult to comply with the new reporting requirements under the MRD regulations. A great deal of flexibility can be built into a death beneficiary designation if it is drafted carefully to make the most of the planning opportunities that are possible under this new post-mortem planning period.

C. Beneficiary Drops Out Due to Qualified Disclaimer.

One of the post-mortem planning maneuvers allowed under the final regulations is the "qualified disclaimer." (A qualified disclaimer occurs when a recipient declines to accept a gift or inheritance, and it passes to the next alternate recipient. A recipient may disclaim all or a portion of an inheritance. If done correctly, the recipient who declines is not treated as having made a gift for gift tax purposes.[6])

Clients considering the disclaimer approach should remember that a qualified disclaimer of an inheritance must be made within nine months of death.[7] This deadline will generally occur earlier than the "Post-Mortem Date."

Example 1: *Paul the participant dies on January 1, 2003. He designated his only child Donna Beth as primary beneficiary and Donna Beth's three children as next alternates in equal shares. Donna Beth*

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[4] The one situation where designating a beneficiary by RBD is still necessary is when the Participant seeks MRDs over the joint life expectancies of Participant and a Spouse who is more than ten years younger, but the consequences of missing this deadline are much less severe than under the 1987 proposed regulations.

[5] Reg. § 1.401(a)(9)-4, A 4.

[6] I.R.C. § 2518.

[7] I.R.C. § 2518.

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has until October 1, 2003 to disclaim. If she disclaims, her three children are recognized as the designated beneficiaries and will receive stretched-out distribution periods based on their three respective life expectancies (provided their separate shares are in place by December 31, 2004).

Does it matter whether Paul had actually mentioned Donna Beth's three children on his death beneficiary designation? Yes, it is essential that they be designated as alternates, and that the designation direct how their shares are determined (equal shares in this example). If Paul had only designated Donna Beth, the three children would still receive the plan but they would not be recognized as "designated beneficiaries" because they had not actually been designated, and they would not be allowed to use their life expectancies. The final regulations allow post-mortem planning that causes designated beneficiaries to "drop out" of the picture, but they do not allow post-mortem planning that introduces new beneficiaries that had not actually been designated.[8] Further, if Paul has not designated Donna Beth's children as alternates and Donna Beth disclaims, Donna Beth's children take minimum distributions using Paul's life expectancy and not Donna Beth's, because Donna Beth is no longer a designated beneficiary as of the Post-Mortem Date. Thus, it is essential to have all of the "what ifs" covered by including all of the alternate beneficiaries in the death beneficiary designation to preserve as many post-mortem disclaimer options as possible.

D. Death of Beneficiary.

The final regulations provide that if Donna Beth *dies* prior to the Post-Mortem Date she *will* continue to be recognized as the designated beneficiary regardless of whether alternate beneficiaries were designated.[9] Depending on applicable state law and the timing of Donna Beth's death, her executor might be able to accomplish a qualified disclaimer, which would make it possible for the alternate beneficiaries' life expectancies to govern MRDs.

E. Revocable Trust Designated.

What if Paul designated a revocable trust that provided for Donna Beth and her children - is the outcome the same?

Example 2: *Assume that Paul designated his revocable trust as beneficiary of his plan. His trust leaves everything free of trust to his only child Donna Beth, and names Donna Beth's three children as the next alternate beneficiaries (also to receive free of trust). Paul's trust will be recognized as having Donna Beth and her children as its beneficiaries, and the oldest life expectancy (Donna Beth's) will control. If Donna Beth disclaims her entire interest in the trust, then she is no longer a trust beneficiary under the new rules and the life expectancy of Donna Beth's oldest child controls for all three. If Donna Beth dies before the Post-Mortem Date, her life expectancy continues to control and the designation of the revocable trust does not affect the life expectancy used to calculate MRDs.*

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[8] Reg. § 1.401(a)(9)-4, A 4(a).

[9] Reg. § 1.401(a)(9)-4, A 4(c).

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F. Estate Designated.

What if Paul designated his estate instead of a revocable trust? Paul's plan is treated as having no designated beneficiary, even if the estate completes administration and assigns the interests in the plan to the various individual beneficiaries prior to the Post-Mortem Date.

G. Cash Out of Beneficiary.

Another post-mortem planning maneuver allowed under the new rules is the "cash out." Let's go back to the example where Paul designates his revocable trust, but this time the trust provides a small gift to charity and the balance to Donna Beth. This would have been a serious problem under the 1987 proposed regulations, and minimum distributions for the entire plan would be calculated as if there were no designated beneficiary since the charity is one of the beneficiaries of the revocable trust. Under the new rules, if the charitable gift is actually distributed to the charity before the "Post-Mortem Date," then the charity is no longer a beneficiary of the trust, and the trust is recognized as having Donna Beth as its oldest beneficiary (or Donna Beth's oldest child if Donna Beth disclaims or dies).

A variation on the "cash out" can be used to clear up a situation that worried some planners under the old rules. This situation arose when a trust was designated that did not specifically prohibit use of the plan assets to pay death taxes or other estate expenses. The IRS has hinted in the past that this might be the equivalent of designating the participant's estate, which is not recognized as having a life expectancy. Under the new rules, any doubt on this point can be removed if other arrangements are made to pay the death taxes or other estate expenses prior to the "Post-Mortem Date."

H. Final Regulations Apply Regardless of Date of Death.

The final regulations clarify that the MRD year, not the year of death, is used to determine which version of the regulations applies for effective date purposes. With deaths prior to year 2000, it will be a case by case analysis figuring out how well the "old" facts of each case work under the new rules.

I. Beneficiary Designations Should Include the What-Ifs.

To take the fullest advantage of the separate share treatment and post-mortem planning options allowed under the MRD Rules, participants and drafters should prepare death beneficiary designations that spell out (i) each of the individuals (or define a "class" of individuals) who are primary or alternate beneficiaries (covering all of the "what ifs"), and (ii) how to determine the share for each. "Fill in the blank" forms offered by some financial institutions may need to have supplemental information attached to be complete.

J. Dealing With Financial Institutions.

Documenting receipt and acceptance of death beneficiary designations is valuable, perhaps essential. Original designations are often lost by financial institutions, who then rely on short, cryptic entries in their computer database. Also, some financial institutions take the position that a designation is not effective until it has been "accepted" by the institution.

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Thus, the safest course is to somehow document receipt and acceptance with respect to every beneficiary designation.

Financial institutions occasionally reject carefully crafted death beneficiary designation forms for a variety of reasons. First, at least with IRAs, the financial institutions are only being paid an annual custodial fee that could be as low as $25 a year. They would prefer to avoid any exposure that might arise from a complex death beneficiary designation, but they cannot justify the added resources to carefully review the designations, so they simply reject them.

On the other hand, well-informed participants will see the importance of a carefully drafted death beneficiary designation, and may insist that the financial institution accept it, or otherwise move the plan or IRA to another institution that will do so.

It will be interesting to see whether financial institutions will need to raise their custodial fees to cover the costs of sorting out these death beneficiary designation issues (and also to comply with additional reporting requirements imposed under the new rules). An alternative approach might be to charge an additional fee whenever a death beneficiary designation is submitted that goes beyond a "fill in the blank" format.

In the meantime, the day to day practice of preparing death beneficiary designations for clients involves using pre-printed forms provided by financial institutions and working with the financial institutions to resolve questions that arise. Persistence and patience are prerequisites to getting through this process, both for the planner and the client. Here are a few pointers:

> *Not Enough Room On the Form.* See if the financial institution's form is downloadable from an internet web site. If so, you may be able to complete it in Adobe Acrobat with a small font, or perhaps modify it to create enough space. If not, you may have to prepare an attachment and write "see attached" in the blank on the form.
>
> *Avoid References to State Laws.* The odds of rejection increase considerably if a form makes reference to "California Probate Code Section xxxx." Try referring to "applicable state law."
>
> *Avoid Reference to Community Property.* Some financial institutions on the East Coast view community property as an offshoot of voodoo, and they will reject any form that refers to "community property."
>
> *If At First You Don't Succeed.* If you don't like the answer the customer service representative gives you on Tuesday, try again on Thursday.

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V. SAMPLE FORM: "Basic" DB Designation for Cindy Smith - Children as DBs.

A. Fact Pattern.

Cindy Smith is age 68, divorced, with two daughters, ages 42 and 48. The 42 year old daughter is married with children. The 48 year old daughter is unmarried with no children. You draft the usual assortment of documents, including a revocable trust that leaves the estate in equal shares to the two children. How should the IRA death beneficiary designation be drafted?

B. IRA Death Beneficiary Form.

The following form is formatted as an attachment to the standard form used by Cindy's IRA custodian, which is completed as usual except that where beneficiaries are designated the language, "See Attached" is inserted.

IRA DEATH BENEFICIARY DESIGNATION

IRA OWNER:	CINDY SMITH
Social Security Number:	______________________________
Birth Date:	______________________________
Financial Institution:	______________________________
Account Number:	______________________________

Primary Death Beneficiary Designation: The IRA OWNER hereby designates, as her primary designation, that the above-referenced IRA (the "IRA") be divided into separate shares in the following manner:

One equal share shall be established for each of the IRA OWNER'S two children, namely RUTH SMITH JOHNSON and SUE SMITH.

Author's Note: *The next phrase is very important. It clarifies that if the daughter with children predeceases, her share goes to shares for her children, and not to the other child's share. The standard forms provided by many IRA Custodians default to a different rule that could exclude the deceased child's descendants.*

With respect to any of said children who predecease the IRA OWNER, the deceased child's share shall be further divided into shares for the deceased child's descendants living at the IRA OWNER'S death on the principle of representation or, if the deceased child has no then living descendants, the deceased child's share shall proportionately augment the other separate shares so established.

Author's Note: *One of the following two clauses is suggested to address minority and lack of capacity. The first clause can be used if "subtrusts" are available under the client's Will or revocable trust. Of course, to ensure a stretched out deferral, each subtrust must be drafted and administered to comply with the MRD Rules, as discussed in Section VI, and "separate share" treatment is not assured for multiple subtrusts, as discussed in Section VI.B.1. The second clause can be used if subtrusts are not available or desirable. This second clause attempts to avoid the need for court supervision by providing custodianships for minors (reflecting California law allowing termination as late as age 25), and by relying on general provisions in the revocable trust, if applicable, for beneficiaries who lack capacity. Some adjustments to the general provisions may be necessary to ensure the IRA will receive a stretched out deferral under the MRD Rules, as discussed below.*

[IF SUBTRUSTS] Each share, if any, for a person who has not attained Thirty (30) years of age or who is "disabled" at the IRA OWNER'S death shall be held for his or her benefit by the then acting Trustee of the "[Name of Subtrust]" established for that person under the CINDY SMITH REVOCABLE TRUST established June 22, 2003.

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[If No Subtrusts] Each share, if any, for a person who has not attained Twenty-Five (25) years of age at the IRA Owner's death shall be held by the person's legal guardian as custodian until the person attains Twenty-Five (25) years of age under the Uniform Transfers to Minors Act. Each share, if any, for a person who is "disabled" at the IRA Owner's death shall be held for his or her benefit by the then acting Trustee of the Cindy Smith Revocable Trust established June 22, 2003.

[Continue Under Either Option] A person is "disabled" if he or she suffers from a mental or physical condition (other than minority) that renders said person mentally incapable of managing his or her business or personal affairs, whether or not there is an adjudication of incapacity or disability, which condition is likely to extend for a period of greater than ninety days. Any such condition shall be evidenced by written declaration of two licensed physicians under penalty of perjury filed with the IRA Custodian. Neither the IRA Custodian nor any licensed physician who executes such a declaration (other than under circumstances of fraud or gross negligence) shall be subject to liability because of such execution.

Alternate Death Beneficiary Designation: The IRA Owner hereby designates, as her alternate designation, that if none of the persons described in her primary designation are living at her death, the entire IRA shall instead be designated to the Trustee of the Cindy Smith Revocable Trust established June 22, 2003.

Further Death Beneficiary Designations. This Death Beneficiary Designation shall not be construed as preventing any beneficiary from making further death beneficiary designations after the IRA Owner's death, it being the IRA Owner's desire that each be allowed to do so.

Assignments. This Death Beneficiary Designation shall not be construed as preventing any "assignment" of part or all of the IRA by a custodian, trustee, executor, agent, or other fiduciary in carrying out the terms of an estate or trust, it being the IRA Owner's desire that said assignments be allowed to occur. "Assignment" refers to the transfer of ownership and authority over the IRA without making distributions from the IRA including by way of example and not limitation an assignment described in Treasury Regulation Section 1.691(a)-4(b).

No Liability for IRA Custodian. The IRA Custodian shall incur no liability to any person interested in the IRA for relying on information provided by or acting upon the written instruction of (i) an agent acting for the IRA Owner under a durable power of attorney; (ii) an agent acting for an individual entitled to an interest hereunder following the IRA Owner's death; or (iii) the trustee or executor of a trust or estate entitled to an interest hereunder following IRA Owner's death.

Executed this date of ________________________.

____

Cindy Smith - IRA Owner

[Notary attestation optional, but suggested]

C. Sample Provisions to Include in Revocable Trust.

The "boilerplate" provisions of the Will or revocable trust may need adjustment to clarify the Trustee's authority to hold the shares of disabled persons. "Conduit" provisions may also be needed to ensure "stretch out" under the MRD rules for trusts.

Sample clauses to be included in administrative section of revocable trust ***(bold language adds "conduit provisions" to trusts for minors or disabled beneficiaries):***

Delayed Distributions For Disabled Beneficiary. If a beneficiary entitled to distribution of all or part of a trust is under age Twenty-Five (25) or is disabled, the Trustee shall hold and administer the beneficiary's portion of the trust estate for his or her benefit, and shall pay to or apply for the benefit of the beneficiary as much of the trust income and principal as the Trustee considers necessary for the beneficiary's proper health, education,

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support, and maintenance after considering any other income or resources of the beneficiary known to the Trustee. At such time as the beneficiary is neither under age Twenty-Five (25) nor disabled, the Trustee shall distribute to the beneficiary the remaining balance of property retained in trust for his or her benefit under this Section. If the beneficiary dies before the distribution of such interest, the Trustee shall distribute such interest to such beneficiary's estate. **Notwithstanding the foregoing, the Trustee shall distribute to or for the benefit of the beneficiary for as long as the beneficiary shall live or the earlier termination of his or her trust all amounts the Trustee receives from "Stretch-Out Retirement Plans" (net of expenses, and net of income, estate, inheritance, generation-skipping transfer tax, or any other tax, to the extent said expenses and taxes are chargeable to or otherwise payable by the Trustee with respect to said amounts received or the balance remaining in Stretch-Out Retirement Plans). During the Beneficiary's lifetime, the Trustee shall not withdraw amounts from a Stretch-Out Retirement Plan in excess of those amounts reasonably necessary to (i) comply with the Minimum Distribution Rules; (ii) comply with the legal obligation to pay income, estate, inheritance, generation-skipping transfer tax, or other taxes specifically chargeable or otherwise payable by the Trustee with respect to amounts received from or the balance remaining in Stretch-Out Retirement Plans; or (iii) provide for payment of trust expenses reasonably allocable to amounts received from or the balance remaining in Stretch-Out Retirement Plans. The term "Stretch-Out Retirement Plans" refers, with respect to a trust for a beneficiary hereunder, to those Qualified Retirement Plans from which the Trustee can take minimum distributions "stretched out" over the trust beneficiary's life expectancy (or the life expectancy of an older member of a class to which the beneficiary belongs, *e.g.* the Settlor's descendants) under the Minimum Distribution Rules, assuming for purposes of this sentence that the distribution requirements contained in the preceding sentence apply to all Qualified Retirement Plans. By way of example and not limitation, an employer sponsored retirement plan that mandates a payout in the form of a lump sum or over a five year period would not be a "Stretch-Out Retirement Plan."**

Payments to Disabled Persons. Distributions (whether of income or principal) by the Trustee to or for the benefit of a minor or a beneficiary otherwise disabled may, at the sole discretion of the Trustee, be made: (a) directly to such beneficiary, (b) to any person with whom the beneficiary resides or who has actual custody of such beneficiary, without the intervention of a guardian or conservator, (c) by expending money for the benefit of such beneficiary, (d) to a guardian or conservator, or (e) to a custodian under the California Uniform Transfers to Minors Act or similar act of any other state. The Trustee shall not be required to see to the application of any such payments so made, but such payees' receipts shall be a full discharge to the Trustee. The decision of the Trustee as to direct payments or application of such funds shall be conclusive and binding on all parties in interest.

Retirement Plan Deferral. The Settlor intends that each trust hereunder that is designated as the beneficiary of Qualified Retirement Plan assets enjoy the longest possible deferral period under the Minimum Distribution Rules. Accordingly, the Trustee of a trust so designated shall, within the time limit prescribed under said rules, deliver documentation required under said rules to the respective Qualified Retirement Plan administrators.

For purposes of this instrument, when the Trustee is directed to "distribute" an interest in a Qualified Retirement Plan to an individual or another trust, unless specifically directed otherwise, the Trustee shall make an "assignment" of the interest without causing a "taxable distribution" from the Qualified Retirement Plan for income tax purposes. "Assignment" refers to the transfer of ownership and authority over the Qualified Retirement Plan interest without making distributions from the IRA including by way of example and not limitation a transfer described in Treasury Regulation Section 1.691(a)-4(b). A plan administrator, IRA Custodian, or other fiduciary shall incur no liability to the trust or to any of its beneficiaries for acting upon the written instruction of the Trustee pursuant to this Section.

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Three terms used in the above clauses that should be included in the definitions section of the revocable trust and coordinated with the death beneficiary designation and other documents:

Disability. Terms such as “unable to act” or “unable to serve” refer to a person who is a minor, disabled, or deceased. Terms such as “disability,” “disabled,” or “incapacity,” refer, with respect to a person, to the existence of a mental or physical condition (other than minority) that renders said person mentally incapable of managing his or her business or personal affairs, whether or not there is an adjudication of incapacity or disability, which condition is likely to extend for a period of greater than ninety days. Any such condition shall be evidenced by written declaration of two licensed physicians under penalty of perjury filed with the Trustee, or in the case of a disabled Trustee, with the successor Trustee.

No licensed physician or other individual who executes such a declaration shall be subject to liability because of such execution. The Settlor hereby authorizes the release of medical information about the Settlor to any Trustee hereunder, or to any licensed physician, and in connection therewith, the Settlor hereby waives any privilege that might otherwise apply. In this regard, the Settlor specifically authorizes any Trustee hereunder, or any licensed physician to request, receive and review any information regarding her physical or mental health, including, without limitation all health information, medical and hospital records protected by the Health Insurance Portability and Accountability Act of 1996 and its regulations (“HIPAA”). By signing this instrument, the Settlor empowers and authorizes any physician, hospital or health care provider to release such information to any Trustee, or any licensed physician. Further, the Settlor hereby releases any physician, hospital or health care provider from liability for disclosing such information.

Minimum Distribution Rules. The term “Minimum Distribution Rules” refers to the rules governing minimum required distributions under Code section 401(a)(9) and comparable rules arising under other Code sections including by way of example and not limitation Code sections 408 and 408A.

Qualified Retirement Plan. A Qualified Retirement Plan is a plan that is subject to the Minimum Distribution Rules including, by way of example and not limitation, plans described under Code sections 401, 403, 408, 408A, and 457. A Qualified Retirement Plan includes a plan that is reasonably believed to qualify under one or more such Code provisions even if it is subsequently determined that such plan does not so qualify.

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VI. Trusts as Beneficiaries Under the MRD Rules.

The MRD Rules impose two steps of analysis to determine if a trust that has been designated as beneficiary qualifies for the most favorable results:

Step 1 - Does Trust Qualify as a DB Trust. If the trust satisfies certain requirements ("DB Trust"), MRDs will be calculated as if certain trust beneficiaries had been designated ("DB Trust Beneficiaries").

Step 2 - Determine the DB Trust Beneficiary With the Shortest Life Expectancy. If the trust is a DB Trust, the next step is to identify the DB Trust Beneficiary with the shortest life expectancy.

A. Qualifying As a DB Trust.

Generally, the MRD Rules only recognize individuals as "Designated Beneficiaries."[10] This effectively excludes charities, business entities, estates, and trusts,[11] but an exception is allowed for any trust that meets the following requirements:[12]

1. Valid Under State Law.

The trust is a valid trust under state law, or would be but for the fact that there is no corpus. The Final regulations specifically approve the use of testamentary trusts.[13]

2. Irrevocable.

The trust is irrevocable or will, by its terms, become irrevocable upon the death of the Participant.

3. Beneficiaries Are Identifiable.

The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the Participant's Plan are "identifiable" from the trust instrument. "Identifiable" refers to general requirements that apply to any beneficiary designation.[14] Under these requirements, an individual does not necessarily have to be specified by name so long as he or she is identifiable as of the date the Designated Beneficiary is determined. In particular, members of a class that is capable of expansion or contraction will be treated as being identifiable if it is possible, as of the date the Designated Beneficiary is determined, to identify the class member with the shortest life expectancy.

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[10] "Designated Beneficiary" and "DB" are terms of art that refer to a designated beneficiary that is recognized under the MRD Rules as having a life expectancy that can be used to calculate MRDs.

[11] Reg. § 1.401(a)(9)-4, A 3.

[12] Reg. § 1.401(a)(9)-4, A 5.

[13] Reg. § 1.401(a)(9)-5, A 7, Example 2.

[14] Reg. § 1.401(a)(9)-4, A 1.

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4. Documentation Provided to Plan Administrator.

Participant's Lifetime. A DB Trust will impact lifetime distributions in only one situation, which does not come up very often, which is when (i) the Participant's Spouse is more than ten years younger than Participant; and (ii) the Participant has designated a DB Trust for Spouse rather than the Spouse individually. When this situation arises, a documentation requirement applies. To satisfy this requirement, the Participant must provide the plan administrator with either:[15]

> A copy of the trust instrument, accompanied by the Participant's promise that whenever the trust is amended the Participant will provide the plan administrator with a copy of the amendment within a reasonable time; or

> A list of all of the beneficiaries of the trust (including contingent and remainder beneficiaries with a description of the conditions on their entitlement *sufficient to establish that the spouse is the sole beneficiary*) for purposes of Section 401(a)(9). The italicized language was added by the final regulations. The list must be accompanied by the Participant's certification that, to the best of the Participant's knowledge, the list is correct and complete and that the other requirements above are satisfied, and further accompanied by the Participant's promise that, whenever the trust is amended the Participant will provide the plan administrator with an updated list and, if applicable, an updated certification. The Participant must also promise to provide a copy of the trust to the plan administrator upon demand.

The regulations do not provide a time deadline for providing this documentation in the context of lifetime MRDs. Your author recommends that the documentation be submitted prior to the Participant's RBD, or as soon as possible thereafter. It is doubtful that the young Spouse's life expectancy in this situation may be considered in any MRD year if the documentation requirement has not been satisfied by the beginning of that year.

Death of Participant. To satisfy the documentation requirement in connection with post-death MRDs, the *trustee* must provide the plan administrator with either:[16]

> A copy of the trust instrument as of the Participant's date of death; or

> A final list of all of the beneficiaries of the trust (including contingent and remainder beneficiaries with a description of the conditions on their entitlement) as of the Post-Mortem Date (September 30 of the calendar year following year of death), accompanied by the trustee's certification that, to the best of the trustee's knowledge, the list is correct and complete and that the other requirements above

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[15] Reg. § 1.401(a)(9)-4, A 6(a).

[16] Reg. § 1.401(a)(9)-4, A 6(b).

are satisfied. The trustee must also promise to provide a copy of the trust to the plan administrator upon demand.

In the context of post-death MRDs, the deadline for providing this documentation is October 31 of the calendar year following the year of death (one month after the Post-Mortem Date of September 30).[17] The consequence of failing to meet this deadline is that the DB Trust is not recognized in any year of post-death distributions.

Relief for Missed Documentation Deadline. The final regulations provided a grace period until October 31, 2003 for any trust that "flunked" the requirements of the MRD Rules solely because the trust failed to submit the required documentation for post-death MRDs on a timely basis.[18] This grace period was available regardless of how long ago the failure to submit documentation occurred; but, there is no authority for recognizing such a trust as a DB Trust for MRD years prior to 2002, the first year in which the rules of the final regulations may be used. Thus, the benefits of the grace period will vary from case to case.

Plan Will Not Be Disqualified Based On Inaccurate Documentation. In the context of maintaining a plan's qualified status, the regulations provide that a plan has not failed to comply with Section 401(a)(9) if MRDs were too small only because the plan administrator relied on trust documentation.[19] However, the excise tax for failure to take MRDs is calculated based on the actual shortfall, regardless of what the trust documentation may have provided.[20]

Plan Administrator of IRA. The regulations clarify that the "plan administrator" of an IRA is the IRA trustee, custodian, or issuer, and not the IRA owner.[21]

5. Drafting Suggestion - Documentation Requirement.

The author suggests including language to remind the trustee of the documentation requirement. For a sample clause, see Section V.

B. Identifying the Oldest DB Trust Beneficiary.

If a trust is recognized as a DB Trust, MRDs are calculated as if the "beneficiaries of the trust" have been designated,[22] and these materials use the term "DB Trust Beneficiary(ies)" to refer to these beneficiaries. The first step is to identify the "pool" of DB Trust Beneficiaries - the smaller the pool, the more likely a good MRD outcome is possible. The second step is to identify the member of the "pool" of DB Trust Beneficiaries who has

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[17] *Id.*

[18] Reg. § 1.401(a)(9)-1, A 2(c).

[19] Reg. § 1.401(a)(9)-4, A 6(c)(1).

[20] Reg. § 1.401(a)(9)-4, A 6(c)(2).

[21] Reg. § 1.408-8, A 1(b).

[22] Reg. § 1.401(a)(9)-4, A 5(a).

the shortest life expectancy, consistent with the rules that apply to multiple DBs under the MRD Rules.[23]

1. "Separate Share" Treatment for Multiple Subtrusts.

The final regulations provide that "separate share" treatment is not allowed with respect to multiple beneficiaries of a DB Trust.[24] Thus, minimum distributions for the entire DB Trust must be calculated based on the DB Trust Beneficiary with the shortest life expectancy.

The I.R.S. issued a group of private rulings in April, 2003 that deny separate share treatment with respect to an IRA being distributed to three different subtrusts.[25] The rulings do not provide as much factual background as the author would have preferred. From the scant information provided, it appears as though an IRA was designated something like this:

"The IRA shall pass to the T Family Trust established [date], to be divided into three equal shares and allocated to the A subtrust, B subtrust, and C subtrust arising at the IRA Owner's death thereunder."

This type of designation is not quite the same as the following designation, which this author still believes would qualify for separate share treatment:

"The IRA shall be divided into three equal shares for the A subtrust, B subtrust, and C subtrust arising at the IRA Owner's death under the T Family Trust established [date]."

The difference between these two versions is subtle, but critical. Under the first designation, the entire plan goes to Trust T, and the division occurs afterwards. Under the second designation, the division into shares truly occurs under the plan (taking the designation into account), and the plan interests pass directly to the respective subtrusts without passing through Trust T.

What are the options for clients who want separate share treatment but need to designate trusts rather than the individual beneficiaries?

- *Stay the Course.* Your author still believes that using language such as the second example results in separate shares, but is the first to admit that his confidence has been shaken by these rulings.[26]

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[23] Reg. § 1.401(a)(9)-5, A 7.

[24] Reg. § 1.401(a)(9)-4, A 5(c).

[25] Priv. Ltr. Rul. 2003-17-041, 043, and 044.

[26] Your author's confidence improved considerably after an informal conversation with Natalie Choate (who also believes that said language should work) in which she promised to arm-wrestle anyone who disagrees with us.

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• *Fund Early; Fund Often.* For additional safety, at least one commentator has suggested taking steps to ensure that the subtrusts to be designated are actually in existence at the plan owner's death, presumably by contributing a modest, initial funding to each subtrust. Perhaps this suggestion arises from language in the rulings discussing the requirement under final regulations section 1.401(a)(9)-4, Q&A-4 that an individual beneficiary must be designated as of the date of the plan owner's death (the subtrusts in the ruling were created post-death by the Trustee pursuant to the trust instrument). Your author is not so sure that this is what the I.R.S. was getting at in these sections of the ruling, but setting up the subtrusts early certainly can't do any harm (other than the extra cost and effort to do so).

• *Create Multiple Trust Instruments Now.* Another possible interpretation of these rulings is that the I.R.S. truly intends *never* to allow separate share treatment when all of a plan is passing to subtrusts arising under a common trust or Will. Under this interpretation, if the trusts arise under a common instrument the advance funding may not work, and there is nothing that can be written into the death beneficiary designation to salvage separate share treatment. Based on informal conversations with Marjorie Hoffman, principal draftsperson of the regulations, your author believes this is the issue that concerns the I.R.S. Thus, a more conservative approach is to draft multiple trust instruments for the respective beneficiaries. This approach raises the bar considerably in terms of cost and effort, but may appeal to clients with large plan balances or who are particularly risk averse. Given the effort involved, it only makes sense to fund each trust or subtrust during the plan owner's lifetime as part of the effort.

• *Create Separate Shares Now.* A Participant may be able to circumvent this whole problem by dividing the Plan into separate share accounts during life. This approach may ring strangely familiar, since it was commonly used prior to 2001 to obtain separate share treatment under the 1987 proposed regulations. The disadvantages of this approach may include multiple annual fees, multiple statements, and logistical problems maintaining the investments of each account and the relative values of the accounts.

In any event, clients who have designated subtrusts in the past may appreciate an alert of this latest development and the options available.

How much is at stake if "separate share" treatment is lost? In the traditional family context, if all of the children are living the economic hit is not as much as one might think, as illustrated in the "Jones - Separate Share" case study in Section ?. However, if some of the shares are passing to grandchildren or more remote descendants (*e.g.* a child has predeceased the Participant), the economic cost of losing "separate share" treatment is quite substantial.

2. Beneficiaries Entitled to Plan Assets.

The term "beneficiaries of the trust" is not defined in the regulations, although the term is provided in response to a question that uses the phrase "beneficiaries of the trust with respect to the trust's interest in the employee's benefit." Thus, it is reasonable

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to conclude that a trust beneficiary whose interest is limited to non-plan assets is disregarded as a DB Trust Beneficiary.

Example 1: *Paul designates a DB Trust that provides a specific gift of a non-Plan asset to George, and directs the balance of the trust to John. George may be disregarded - he is not a DB Trust Beneficiary.*

3. Beneficiaries Entitled to Current Distributions.

Any beneficiary entitled to current distribution of Plan assets is a DB Trust Beneficiary (*i.e.*, the trustee "shall" or "must" distribute).

Example 2: *Paul designates a DB Trust directing that income shall be paid to George as long as he lives, and at George's death the balance shall pass to John. George is a DB Trust Beneficiary.*

Example 3: *Paul designates a DB Trust directing that trust distributions shall be paid to George if his other resources are not enough to satisfy a certain standard, such as health, education, or support, for as long as he lives. At George's death the balance shall pass to John. George is a DB Trust Beneficiary.*

4. Permissible Beneficiaries.

Similarly, any beneficiary who is a permissible recipient of current distributions of Plan assets is a DB Trust Beneficiary (*i.e.*, the trustee "may" distribute).

Example 4: *Paul designates a DB Trust that provides the trustee with broad discretion to make or not make distributions to George during George's lifetime, and at George's death the balance shall pass to John. George is a DB Trust Beneficiary.*

5. Successor Beneficiaries.

What about John in the above examples? As discussed below, John is a DB Trust Beneficiary, too. The regulations provide a rule for determining when successor trust beneficiaries are counted in the pool of DB Trust Beneficiaries, and when they are not. This rule was changed with the release of final regulations.

Rule Under Proposed Regulations. The rule under the 1987 and 2001 proposed regulations included all successor beneficiaries in the pool of DB Trust Beneficiaries subject to one exception: a successor beneficiary was excluded if his or her entitlement would only arise if another beneficiary dies before receiving the entire benefit to which that other beneficiary is entitled.[27]

Rule Under Final Regulations. The final regulations narrow this exception by providing that a successor beneficiary may not be excluded if he or she has any right (including a contingent right) to a plan interest beyond being a "mere potential successor" to the interest of another beneficiary upon that other beneficiary's death.[28] To illustrate, consider the following example, which describes a type of trust commonly requested by clients:

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[27] 2001 Prop. Reg. § 1.405(a)(9)-5, A 7(c).

[28] Reg. § 1.401(a)(9)-5, A 7(c).

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Example 5: *Paul designates his IRA in two equal shares to two DB Trusts for his two children. Each trust provides for distributions to the child of income and principal as needed for health, education, or support until the child attains thirty-five years of age, at which time the child's trust terminates. (Upon termination, any remaining IRA interest would be "assigned" to the child without accelerating recognition of income.*[29]*) If a child dies prior to reaching age thirty-five, his or her trust passes to similar trusts for the child's living descendants or, if none, to a similar trust for the other child (or his or her descendants) or, if none, free of trust to Paul's heirs at law.*

The "pool" of DB Trust Beneficiaries is determined on the date of Paul's death, and finalized on the Post-Mortem Date following Paul's death. Each child who, as of Paul's death, is living and has attained age thirty-five, and who has not disclaimed the benefits by means of a qualified disclaimer prior to the Post-Mortem Date, will be the only DB Trust Beneficiary of his or her trust, since the trust does not continue past age thirty-five. His or her successors may be disregarded since they have no interest in the IRA.

The balance of this section analyzes who is included as a DB Trust Beneficiary of a trust for a child then living who has not attained age thirty-five:

Is the child a DB Trust Beneficiary? Yes.

If the child has living descendants as of the Post-Mortem Date, must they be counted as DB Trust Beneficiaries? Yes. Under the proposed regulations, your author thought that the descendants were not DB Trust Beneficiaries since they were entitled to a portion of the plan only if the child died before the entire benefit was distributed to the child. The proposed regulations were interpreted by your author and others as implicitly assuming that the child would live to a normal life expectancy and therefore would receive the entire benefit. Under the final regulations, the descendants *are* DB Trust Beneficiaries since the descendants have more of an interest in the trust, as of the Post-Mortem Date, than a mere survivorship interest. Their interests are greater because of the limitations placed on the child's interest, *i.e.* a standard that limits distributions until age thirty-five. The implicit assumption that child will live to life expectancy and receive the entire benefit is clearly absent in the final regulations. Perhaps this assumption was not a correct interpretation of the proposed regulations, either, as suggested by a 2002 private letter ruling that includes contingent beneficiaries in the pool of DB Trust Beneficiaries even though the primary beneficiaries receive full distribution upon reaching age thirty.[30]

Is the other child a DB Trust Beneficiary? Yes. Thus, it is possible that the older child's life could govern MRDs on the younger child's DB Trust. As discussed above, under the proposed regulations your author thought that a child's brothers

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[29] I.R.C. § 691(a)(2).

[30] Priv. Ltr. Rul. 2002-28-025.

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and sisters were not DB Trust Beneficiaries since they were entitled to a portion of the plan only if the child died before the entire benefit was distributed to the child. The analysis under the final regulations is complicated, as follows:

> (i) If the child does not have any living descendants as of the Post-Mortem Date, the other child is counted as a DB Trust Beneficiary under the final regulations for the same reasons that the descendants, above, would have been counted.
>
> (ii) If the child *does* have living descendants as of the Post-Mortem Date, those descendants would be considered the successor beneficiaries who take if the child dies before age thirty-five. Therefore, it is tempting to argue under the final regulations that the other child, as the next successor, does not have any interest in the trust other than a "mere survivorship interest." This would be accurate if the descendants take free of trust. However, if the descendants are also subject to an ascertainable standard for distributions and a delayed termination until age thirty-five, the other child has more of an interest than a "mere survivorship interest," and must be included as a DB Trust Beneficiary if the final regulations are read literally.

Are the descendants of the other child DB Trust Beneficiaries? It depends. Under the proposed regulations, your author thought that the "other child's" descendants would not be DB Trust Beneficiaries for the reasons described above. Under the final regulations, it depends on the "other child's" age at the Post-Mortem Date. If he or she has attained thirty-five years of age, his or her descendants can be disregarded under the final regulations since they truly have a "mere survivorship interest." However, if the "other child" has not attained thirty-five years of age as of the Post-Mortem Date, then his or her descendants are DB Trust Beneficiaries under the final regulations. Fortunately, they are likely to be younger than either of the children in most cases.

Must Paul's heirs at law be counted as DB Trust Beneficiaries? It depends. Under the proposed regulations, your author thought that Paul's heirs at law would not have been counted for the reasons described above. Under the final regulations, it depends on whether the preceding successor(s) take outright because he, she, or they have all reached age thirty-five as of the Post-Mortem Date. If so, the heirs at law have a "mere survivorship" interest and can be disregarded. If not, they must be counted. If the heirs at law must be included in the pool of DB Trust Beneficiaries, there is a strong likelihood that oldest member of the pool will be quite a bit older than the children, resulting in a shorter deferral period.

6. Permissible Appointees Under Power of Appointment.

If Paul's trust in Example 5 provides each beneficiary a power of appointment that could be used to appoint plan assets, are the permissible appointees also DB Trust Beneficiaries? The MRD Rules are silent, and a number of private letter rulings

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have been promulgated with respect to trusts that included powers of appointment without analyzing this issue.

Based on informal conversations with other commentators, your author observes that most commentators think the permissible appointees *are included* among the pool of DB Trust Beneficiaries. Your author's view, on the other hand, is that a power of appointment is an enhancement of the power holder's interest in the DB Trust, and does not create a beneficial interest in the permissible appointees prior to exercise. Accordingly, your author believes an individual should not be considered a DB Trust Beneficiary solely because he or she is a permissible appointee under a power of appointment. Notice 97-49 supports this conclusion, but in the context of electing small business trusts under Internal Revenue Code Section 1361, stating:[31]

> *The term "beneficiary" does not include a person in whose favor a power of appointment could be exercised. Such a person becomes a beneficiary only when the holder of the power of appointment actually exercises the power of appointment in such person's favor.*

Even if permissible appointees are included in the "pool" of DB Trust Beneficiaries, including a power of appointment in a "conduit trust" (discussed next) will not interfere with stretched-out distributions. For non-conduit trusts, it is possible to limit the class of permissible appointees to those who are no older than the intended beneficiary. This approach appears to have resulted in the favorable rulings discussed next. Of course, the client and planner must evaluate the potential for economic distortions if certain individuals are included and others excluded.

Planners wrestling with these rules are understandably eager for more guidance, and historically private letter rulings have been the only supplemental source of guidance. A group of private letter rulings were issued in August, 2002 analyzing trusts as IRA beneficiaries under the final regulations.[32] These rulings appear favorable, but leave too many questions unanswered to be of much use.

The rulings pertain to the same fact pattern, in which subtrusts were established for a decedent's three children. Each subtrust was recognized as having the oldest child's life expectancy under the final regulations, even though it was not a conduit trust. Each trust provided distributions to the child of income, and of principal subject to an ascertainable standard. The trust also provided the child with a power of appointment that limited the class of permissible appointees to those who are not older than the oldest child. Based on these facts, the I.R.S. ruled that the oldest DB Trust beneficiary was decedent's oldest child. The ruling does not state who the takers in default would be if the power of appointment is not exercised, and does not analyze whether those takers in default should be included in the pool of DB Trust Beneficiaries. Further, although the ruling makes mention of the limited class of permissible appointees under the power of appointment, the

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[31] 1997-2 C.B. 304.

[32] Priv. Ltr. Ruls. 2002-35-038 through 041.

ruling *does not* analyze whether the permissible appointees are treated as DB Trust Beneficiaries. Your author cautions that the reasoning in these rulings is incomplete, and that it would be unwise to rely on them.

7. Conduit Trusts.

The final regulations create a "safe harbor" for "conduit trusts" by providing that the primary beneficiary of such a trust is the only DB Trust Beneficiary.[33] The term "conduit trust" does not appear in the regulations, but refers to a trust that requires that all distributions taken from the Plan must be distributed to the trust's primary beneficiary rather than accumulated in the trust. The final regulations reason that the alternate takers can be excluded from the pool of DB Trust Beneficiaries as "mere potential successors," since the primary beneficiary is entitled to all plan distributions while living. This interpretation seems inconsistent with the narrow provisions of the "mere potential successor" rule, but your author chooses not to look a gift horse in the mouth.

The primary disadvantage of the "conduit trust" structure is that plan distributions must be passed out to the beneficiary, whether it is in the beneficiary's best interest or not. Fortunately, for younger beneficiaries these distributions are likely to be a very small percentage of the plan balance. It may also be possible to apply the distributions to costs that would otherwise be paid from other sources. This disadvantage seems a small price to pay in return for certainty under the MRD Rules. ***Sample forms and discussion of drafting "conduit trusts" appear in Section VII.***

8. Treasury's Rationale On Trust Requirements.

Why are the rules for trusts so difficult? Based on several conversations with Marjorie Hoffman, principal draftsperson of the proposed and final regulations, your author understands that Treasury is concerned that plan participants will use trusts as vehicles to take undue advantage under the MRD Rules. Specifically, Treasury worries that a younger person's life expectancy will be used to accomplish stretched out deferral of plan assets that eventually benefit an older beneficiary. Although your author does not share this view, it at least explains why the regulations focus on whether a contingent beneficiary has any interest beyond a "mere potential successor."

It is interesting, however, that by extending special treatment to conduit trusts the Service is willing to ignore accumulation for the possible benefit of older successor beneficiaries *occurring inside a plan*. If the same accumulation occurs outside the plan and in the trust, the older successor beneficiaries must be included in the pool of DB Trust Beneficiaries.

C. Planning and Drafting Alternatives to Conduit Trust.

As discussed above, the conduit trust may be the best choice for many clients. But here is a rundown of some alternatives to the conduit trust:

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[33] Reg. § 1.401(a)(9)-5, A 7(c)(3), Example 2.

1. Outright Distribution.

After digesting the difficulties in designating trusts for children or other primary beneficiaries, some clients may conclude that designating them as individuals is the lesser of the various evils. Outright designation precludes the option of creating a dynasty trust that is "exempt" from transfer tax in the hands of younger generations. Of course, the clients must still consider how to protect young successor beneficiaries if the primary beneficiary predeceases, which may require drafting subtrusts that comply with the MRD Rules. Some options along these lines are illustrated in the Cindy Smith Case Study in Section V.

2. "Last One Standing" Provision.

One technique for excluding alternate takers from the pool of DB Trust Beneficiaries is to provide that when and if there is only one member of a class living, the trust terminates in his or her favor. This supports the argument that any alternate takers who are not class members may be excluded from the pool as "mere potential successors."

3. Variations on Conduit Provisions.

As discussed in Section VI.B.7, the final regulations provide that if a beneficiary is entitled to conduit distributions, any alternate takers are "mere potential successors" and are excluded from the pool of DB Trust Beneficiaries.

It seems a logical extension that even if the primary beneficiary is not entitled to conduit distributions, that conduit provisions for more remote beneficiaries could limit the pool of DB Trust Beneficiaries by excluding any further remote takers as "mere potential successors."

A variation on this approach would be to create a "last one standing" conduit distribution provision that springs into effect if and when there is only one class member living, which could exclude alternate takers who are not class members from the pool. Some additional drafting may be needed under this springing approach to clarify that any amounts in accumulated in trust that represent accumulations of previous plan distributions would need to be distributed out to the remaining class member, too.

It may be possible to provide a "conduit 'pot' trust" that allows the Trustee to sprinkle conduit distributions among a group of beneficiaries.

All of these ideas are logical extensions of the reasoning outlined in the final regulations; of course, the tax law and its administration are not always logical, so caution and good judgment are advised.

4. "Tweak" the Alternate Takers.

Consider the following example, illustrating an unusual adjustment to the term "heirs at law" (the "tweak"):

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Example 7: *Same as Example 5, except the trust provides that the term "heirs at law" shall be interpreted as if all "heirs at law" with respect to a beneficiary's DB Trust who are older than the oldest child have predeceased the beneficiary.*

This "tweak" limits the pool of DB Trust Beneficiaries by excluding alternate takers who are older than the oldest child, resulting in assurance that at least the oldest child's life expectancy will be allowed on each trust. (The outcome would be the same even if the "tweak" was drafted to exclude anyone older than the respective beneficiary of each DB Trust, since the oldest child remains a contingent beneficiary under the dispositive provisions in effect before the "heirs at law" clause applies. See Section VI.B.5)

The "tweak" produces the same outcome as would occur with any other group of subtrusts if "separate share" treatment is not allowed, as discussed in Section VI.B.1. The additional value of obtaining "separate share" treatment depends on the relative ages of the beneficiaries, and is illustrated in the "Jones - Separate Share" case study in Section ?, and discussed again in Section VI.B.1.

The client and drafter should devote careful thought before including the "tweak" because of the possible distortion of economic benefits among the alternate takers. Certain clients may be comfortable with this approach because their heirs at law are distant, or because they perceive a good gamble in view of the likely benefit and the low probability of an economic distortion actually occurring; but other clients may hesitate when they realize that the approach could exclude brothers, sisters, nieces, nephews, *etc.* The "tweak" may also need to be applied to the permissible recipients under the beneficiary's power of appointment, for the reasons discussed in Section VI.B.6.

5. "Tweak" All Dispositive Provisions.

The next example illustrates an even more extreme approach:

Example 8: *Same as Example 5, except that* ***all of the dispositive provisions*** *of a beneficiary's DB Trust are interpreted as if all contingent beneficiaries and alternate takers who are older than the beneficiary have predeceased the beneficiary.*

This "tweaking" of all dispositive provisions limits the pool of DB Beneficiaries in such a way that each beneficiary's DB Trust may use that beneficiary's life expectancy, but could result in severe economic distortion (*e.g.* the younger child could receive part of the older child's trust, but not *vice versa*). This broad "tweak" approach should be used with extreme caution, and only after the planner is satisfied that the clients truly understand the trade-offs involved. Also, if the DB Trusts arise under a common instrument, there may be another obstacle to "separate share" treatment that could result in use of the oldest child's life for all trusts after all. See Section VI.B.1. The "tweak" may also need to be applied to the permissible recipients under the beneficiary's power of appointment, for the reasons discussed in Section VI.B.6.

6. Continuing Grantor Trusts.

A less intrusive approach is to provide continuing subtrusts that function somewhat like a revocable trust for each beneficiary. Each subtrust ensures that an interim estate plan is in place for the beneficiary until such time as he or she updates it. In fact, such a trust may make it easier to build in customized provisions without including them in the death beneficiary designation, such as simultaneous death presumptions, no contest clauses, complex instructions regarding alternate heirs, *etc.*

Although each subtrust is intended to provide the beneficiary with the flexibility associated with a revocable trust, making the subtrusts revocable would flunk the requirement that a DB Trust must be irrevocable at the plan owner's date of death. Thus, each subtrust must be irrevocable.

Flexibility is still possible for these irrevocable subtrusts if, for example, each trust provides the beneficiary the unqualified power to withdraw income and principal, designates the beneficiary as trustee, and provides the beneficiary a power of appointment. However, note that some IRA custodians may not necessarily agree with the notion that the power to withdraw income and principal allows the beneficiary to "assign" the inherited IRA out of the trust and into their own name without causing a taxable distribution. Thus, the client must allow for the possibility that each beneficiary must keep the subtrust in operation, at least as to IRA assets.

The withdrawal powers over income and principal cause each subtrust to be treated as if "owned" by the beneficiary under Internal Code Section 678, which leads to an interesting question: When a "grantor trust" is designated, are the MRD Rules applied as if the individual grantor was designated? If so, the MRD Rules for trusts might not apply. Your author cautions against assuming this is so. The legal analysis is fascinating, but complicated. Here is a capsule summary:

(i) The grantor trust rules require someone who is deemed to "own" a grantor trust to report the income, deductions and credits of the trust ". . . as if the trust were not in existence."[34] This requirement does not necessarily mean that the trust is ignored in the context of other provisions of the income tax code not having to do with reporting of income, deduction and credits.

(ii) Taxpayers and the Service have on occasion argued for or against the notion that a grantor trust should be ignored with respect to certain transactions between owner and trust, rendering the transaction a "non-event" for income tax purposes.[35] The Second Circuit held in *Rothstein* that a sales transaction *was not* a non-event.[36] Shortly

[34] I.R.C. § 671; Treas. Reg. § 1.671-3(a)(1).

[35] Rev. Rul. 77-402, added in 1980 as Treas. Reg. § 1.1001-2(c), Example 5. This regulation was upheld by the Tax Court in *Madorin v. Comm.*, 84 T.C. 667 (1985).

[36] *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984).

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thereafter, the Service ruled that sales transactions *are* non-events and that the Service would not follow *Rothstein*.[37]

Even if transactions are non-events, your author is unaware of any authority that supports the notion that a grantor trust can be entirely disregarded under the MRD Rules as if the individual owner had been designated. In fact, in another context, a trust that is not recognized for income tax purposes because it elected to be treated as an estate under Internal Revenue Code Section 645 is nevertheless treated as a trust under the MRD Rules " . . . as long as the trust continues to be a trust under state law."[38]

The safest course is to draft and administer the continuing subtrusts so as to comply with the MRD Rules for trusts. Since the primary beneficiary has the power to withdraw the entire trust at any time, he or she will be the only DB Trust Beneficiary, and other contingent beneficiaries need not be considered. However, the documentation requirement for trusts[39] and any other applicable formalities should be observed. ***Sample forms and discussion of drafting a continuing grantor trust appear in Section ?.***

7. Dynasty Trusts.

The term "dynasty trust" describes a trust that provides distributions over successive generations but delays termination as long as possible, or continues in perpetuity if established in a state that allows perpetual trusts. This delayed termination is part of what makes it possible for the trust to be "exempt" from transfer taxes in the hands of younger generations. The final regulations make it even more challenging to draft a dynasty trust that qualifies for stretched-out distributions than under the proposed regulations, since all of the alternate takers will be included in the pool of DB Trust Beneficiaries. ***Sample forms and discussion of drafting "dynasty trusts" appear in Section ?.***

D. Drafting Suggestion - Address Taxes and Expenses.

The I.R.S. has hinted that the Participant's estate may be a DB Trust Beneficiary if the DB Trust allows Plan assets to be applied to satisfy general debt and tax obligations arising at the Participant's death.[40] The author suggests including a clause such as the following in the trust instrument (or Will if applicable) so that it cannot be argued that the Participant's estate is a DB Trust Beneficiary, and to provide as much flexibility as possible in arranging payment of death taxes without forcing distributions from the Plan:

Qualified Retirement Plans or Other "Outside" Assets. The Trustee may, in the Trustee's sole discretion, pay all or part (or none) of any Death Tax chargeable against a beneficiary's interest in property held outside of trust (including by way of example and not limitation a Qualified Retirement Plan) using funds provided by the

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[37] Rev. Rul. 85-13, 1985-1 C.B. 184.

[38] Preamble to final regulations.

[39] Reg. § 1.401(a)(9)-4, A 6(b).

[40] Priv. Ltr. Rul. 98-20-021.

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beneficiary, funds from the beneficiary's share of trust assets, or both. The Settlor requests, but does not require, the Trustee to so pay taxes when doing so enhances the beneficiary's ability to benefit from income tax deferred compounding associated with property held outside of trust (including by way of example and not limitation a Qualified Retirement Plan). The Trustee shall not apply Qualified Retirement Plan assets passing under this agreement to pay any debt of the Settlor, expense of administration, or any Death Tax, to the extent such amounts are chargeable to other assets.

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VII. DRAFTING STUDY: Jane Reynolds - Conduit Trusts as DBs.

A. Fact Pattern.

Jane Reynolds is age 42, divorced, with two daughters, ages 14 and 10, a $600,000 IRA, a $250,000 home, and a few other assets. She would prefer to leave her estate to two trusts that "protect" each child until the child reaches age thirty-five. Based on the analysis in the preceding section, the simplest approach is to provide conduit trusts for each child. A brief perusal of the single life table shows that MRDs from the IRA will range from 1/70th to 1/50th of the IRA each year, further divided in two for each child's trust. Jane can live with the lost protection on MRDs since they are small, and she values the simplicity and certainty a conduit trust provides.

B. Drafting Considerations.

Drafting a good "conduit" clause requires more time and thought than one might initially expect. Here is a short list of drafting issues your author considered while drafting the forms that follow:

- *Subtrust Versus Standalone Trust.* The trusts for children could be structured as subtrusts under a common revocable trust or Will, or as a dedicated "stand-alone" trust instrument. The "subtrust" approach is adequate for many clients, but the "stand-alone" approach may be worthwhile for certain clients who want to be sure the separate share rule will apply (see Section VI.B.1), or who want a structure specially drafted to address specific needs or large retirement plan balances. The subtrust approach has been selected for Ms. Reynolds.

- *"Double-Duty" Trust.* It is possible to draft two different sets of subtrusts, one for retirement plan assets and the other for non-retirement assets, but one "double-duty" trust seems easier for many clients, and has been selected for Ms. Reynolds. This requires a little coordination between the "conduit" distribution provisions and the distribution provisions that apply to other assets.

- *May Be Confusing to the Uninitiated.* The conduit clause may be confusing to clients, trust officers, or advisors who are not familiar with the concepts. Your author has attempted to draft a clause that makes clear distinction between the "beneficiary" of the Plan versus the beneficiary of the trust, and has provided an example to help explain some of the terminology.

- *Need to Define "Stretch-Out" Plan.* It is not enough to provide that all Plan distributions be distributed to the trust beneficiary. Otherwise, if a Plan requires a lump sum distribution at the client's death the entire plan could be passed out to the beneficiary regardless of how young he or she might be. Thus, if for some reason a Plan cannot be paid out over the beneficiary's life expectancy (or the oldest life of a class that includes the beneficiary), the Plan is not subject to the conduit distribution clause. The language allowing for a class of beneficiaries is intended to apply the conduit provision even when the beneficiary's life expectancy does not control, in anticipation that the oldest life of the class provides enough deferral to justify the conduit clause. This assumption should hold up with

a traditional family, but may not be appropriate for all clients. An alternative approach might be to apply the conduit clause to Plans that provide a minimum of some specified number of years of deferral, or that distribute over a life that is no more than *x* years older than that of the trust beneficiary. Your author added a phrase to address the "chicken and egg" relationship between the sentence that defines "Stretch-Out Retirement Plan" and the conduit distribution clause (*i.e.*, the conduit distribution clause does not apply unless the plan satisfies the definition of "Stretch-Out Retirement Plan," and the trust might not satisfy the definition unless the beneficiary is the only DB Trust Beneficiary). An example is added to the end of the definition to help clarify the intention and context.

- *Only Applies to Primary Beneficiaries.* There is no benefit to requiring conduit distributions from subtrusts for individuals other than those who are the designated beneficiaries at the Participant's death. For example, Participant dies and designates children. Several years later, a child dies. The deceased child's subtrust may then subdivide for his or her descendants, and his or her share of the Plan continues to be paid out to the new subtrusts according to the balance of the deceased child's life expectancy, regardless of whether the new subtrusts are conduit trusts. Accordingly, such a plan is excluded from the definition of "Stretch-Out Retirement Plans" since the subtrust did not become entitled to the plan by reason of the plan Participant's death. Your author chose to accomplish this through the phrase "by reason of the plan participant or IRA owner's death" rather than language such as "a trust that was designated" to clarify that if a revocable trust was designated and immediately subdivides into conduit trusts that were not specifically designated, conduit trust treatment has not been precluded.

- *Conduit Distributions Not Required After Death of Beneficiary.* Conduit distributions are only required as long as the primary beneficiary is alive. If the conduit provision does not specifically address this issue, unnecessary conduit distributions might be required from a trust that continues beyond the primary beneficiary's death. In addressing this issue, your author added the phrase "or earlier termination of his or her trust" to clarify that the conduit clause does not somehow create an obligation that extends beyond the trust termination.

- *Distributions For Benefit Of.* Your author has chosen to authorize the trustee to distribute conduit amounts outright or to "apply for the benefit of" the primary beneficiary. This extends beyond the facts in the example in the final regulations, but is consistent with the rationale explained therein as to why the beneficiary is the only DB Trust Beneficiary since plan amounts cannot accumulate for any alternate takers. The "apply for the benefit of" language may be helpful in making wisest use of conduit distributions to serve the best interests of a young, disabled, or irresponsible beneficiary. In many trust instruments, additional language may be found in the "boilerplate" section of the trust providing options to the Trustee when a distribution is to be made to a minor or disabled beneficiary. Your author considered relying only on the boilerplate language, but opted instead to include the "apply for the benefit of" language in the conduit provision to provide the clearest guidance to trust officers and other advisors. The "boilerplate" should be

reviewed in any event to eliminate any contradictory language that might interfere with distribution either outright or for the benefit of the beneficiary.

- *Withdrawal Rights.* Another possible approach would be to provide withdrawal rights for a beneficiary, along the lines of the trust described in Revenue Ruling 2002-2 (which was issued in the context of qualifying an IRA as QTIP property under Internal Revenue Code Section 2056). This approach is more complicated, requires careful drafting, and has implications for income, gift, and generation skipping taxes, as explained in more detail in Section XII. This approach was not included in Ms. Reynold's trust.

- *Allow for Payment of Taxes and Expenses.* Depending on the circumstances, a trustee may need to apply plan assets to pay estate or generation skipping transfer tax. Any plan assets so applied are likely to generate an income tax at the trust level, as well. Trustee fees and other administration expenses may also need to be paid from plan assets. Your author's conduit distribution clause clarifies that the trustee may pay the portion of these items chargeable to the plan assets, and may distribute the "net" remaining to the trust beneficiary. The example in the final regulations does not address these issues, and your author is not aware of any authority that specifically sanctions this approach. However, your author believes it would be irresponsible to draft a conduit clause that did not address payment of these items. Your author considered moving the language that addresses these items into the "boilerplate" section of the trust, since that might seem more palatable to the Internal Revenue Service if a challenge arose, but opted to leave all of the language together to provide the clearest guidance to trust officers and other advisors.

- *Clarify Trustee's Authority to Take Plan Distributions.* Since a conduit clause results in "automatic" distribution to the trust beneficiary, some mechanism needs to be included to clarify the scope of the trustee's authority to take plan distributions. Such language is particularly important if the objective is to avoid a general power of appointment in the hands of the person serving as trustee. The authority should be broad enough, however, to allow the trustee to pay expenses or taxes chargeable to the plan assets, and to take more than the minimum required distributions if the beneficiary is in need. Also, since the conduit distributions are no longer required after the beneficiary's death, this clause operates to restrict the trustee's authority only as long as the beneficiary is alive. The language used in Ms. Reynold's trust should work well for most clients, but certain clients may prefer more restrictive language (*e.g.*, the trustee may take only minimum distributions).

C. SAMPLE FORM: "Conduit" Subtrust.

Here are sample clauses that might be used in Ms. Reynold's revocable trust:

2.5 Division Into Shares. Upon the death of the Settlor, the Trustee shall divide the remaining assets in such manner as will create, in the aggregate, equal shares consisting of one such share for each child of the Settlor who is then living and one such share for each child of the Settlor who is then deceased but has descendants then living. Each share set aside for a child of the Settlors who is then deceased but has descendants then living shall be further divided into shares for such descendants on the principle of representation. Each share set aside for

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a child or more remote descendant of the Settlor ("Beneficiary") shall constitute a separate trust to be held and distributed in the manner set forth in Section 2.6 unless such Beneficiary shall have then attained Thirty-Five (35) years of age, in which case such Beneficiary's share shall be distributed to him or her outright and free of trust. If no descendant of the Settlor is then living, the Trustee shall distribute the trust estate in the manner set forth in Section 2.7 below.

2.6 Trusts for Children and More Remote Descendants. Each trust for a child or more remote descendant ("Beneficiary") shall commence upon the first receipt of property by the Trustee. Such property and any subsequent additions of property shall constitute the trust estate, which shall be held, administered and distributed pursuant to this Section 2.6.

2.6.1 Distribution of Income and Principal - In General. The Trustee shall distribute, from time to time, to or for the benefit of each Beneficiary so much of the net income and principal of assets (other than Stretch-Out Retirement Plan assets) held in such Beneficiary's trust as in the reasonable discretion of the Trustee may be required for the health, support or education of such Beneficiary, taking into account the Beneficiary's other resources, including distributions made or anticipated under Section 2.6.2.

2.6.2 "Conduit Distributions" From Stretch-Out Retirement Plans. To the extent the Trustee receives distributions from any Stretch-Out Retirement Plan as to which the Beneficiary is the Stretch-Out Beneficiary (these terms are defined in Section 11.13), the Trustee shall distribute to or apply for the benefit of the Beneficiary all of said distributions (net of expenses, and net of income, estate, inheritance, generation-skipping transfer tax, or any other tax, to the extent said expenses and taxes are chargeable to or otherwise payable by the Trustee with respect to said amounts received or the balance remaining in Stretch-Out Retirement Plans), for as long as the Beneficiary shall live or until the earlier termination of his or her trust.

If the Beneficiary is the sole Trustee of his or her trust, the Trustee shall not withdraw amounts from a Stretch-Out Retirement Plan in excess of those amounts reasonably necessary to: (i) comply with the Minimum Distribution Rules; (ii) provide for the Beneficiary's health, education, and support in his or her accustomed manner of living (including the tuition or medical expense of such Beneficiary's descendants); (iii) comply with the legal obligation to pay income, estate, inheritance, generation-skipping transfer tax, or other taxes specifically chargeable or otherwise payable by the Trustee with respect to amounts received from or the balance remaining in Stretch-Out Retirement Plans; and (iv) provide for payment of trust expenses reasonably allocable to amounts received from or the balance remaining in Stretch-Out Retirement Plans.

2.6.3 Termination. A Beneficiary's trust shall terminate when he or she attains Thirty-Five (35) years of age, and at such time, the Trustee shall distribute the then principal of a Beneficiary's trust to him or her. For purposes of this Section 2.6.4, when the Trustee is directed to "distribute" an interest in any IRA or Roth IRA account, the Trustee is to arrange for the transfer of said interest from the trust to the Beneficiary so that the Beneficiary holds the various powers over such IRA or Roth IRA (*e.g.*, to direct investments and withdrawals) that would otherwise be held by the Trustee, without necessarily causing a distribution of funds out of the IRA or Roth IRA account.

> ***Author's Note:*** *The drafter should consider whether to provide a general power of appointment, a limited power of appointment, both (e.g. if "Exempt" and "Non-Exempt" trusts are contemplated), or neither, depending on tax planning objectives and relevant circumstances. The following clause illustrates a limited power of appointment.*

2.6.4 Limited Power of Appointment. Each Beneficiary who has attained Twenty-Five (25) years of age shall have the limited power to determine the manner in which the principal and any undistributed income of his or her trust shall be distributed at his or her death. This power may be exercised by the Beneficiary in the manner provided in Section 10.11 to provide distributions outright or in further trust in favor of any one or more of [*describe permissible appointees*] (other than his or her creditors, estate, or the creditors of his or her estate) as the Beneficiary shall determine.

2.6.5 Death Before Complete Distribution. Upon the death of a Beneficiary, the Trustee shall distribute said Beneficiary's trust (including such items of property as may pass generally to said trust by reason of said Beneficiary's death) in such manner as the Beneficiary shall have effectively appointed, and shall divide the unappointed balance of the trust into shares on the principle of representation for the then living members of the class of descendants identified earliest below with at least one class member then living:

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1st The deceased Beneficiary's descendants.

2nd If applicable, the descendants of the deceased Beneficiary's closest ancestor who was a descendant of the Settlor.

3rd The descendants of the Settlor.

Each share so established for a descendant shall be distributed to him or her outright and free of trust if he or she has then attained Thirty-Five (35) years of age. Each share so established for a descendant who has not attained Thirty-Five (35) years of age shall either be added to the trust then held hereunder for him or her or, if no trust exists for him or her, shall constitute a trust to be held and distributed for him or her as provided in this Section 2.6 (each descendant shall be referred to as the "Beneficiary" of his or her trust). If none of the descendants described above are then living, the Trustee shall instead distribute said unappointed balance as provided in Section 2.7.

2.7 Alternate Heirs. If disposition be made under this Section 2.7, the Trustee shall distribute the affected trust estate to _________________________________.

11.13 Stretch-Out Retirement Plan; Stretch-Out Beneficiary. The term "Stretch-Out Retirement Plan" refers, with respect to a trust hereunder, to any interest in a Qualified Retirement Plan as to which the Trustee of said trust is permitted under the governing plan provisions to take distributions in the form of minimum distributions "stretched out" over a the life expectancy of a "designated beneficiary" (within the meaning of the Minimum Distribution Rules), assuming said trust otherwise qualifies to do so under the Minimum Distribution Rules.

The term "Stretch-Out Beneficiary" refers to the beneficiary of said trust whose life expectancy is used in determining the "stretched out" distributions (or whose life expectancy would have been used if said trust qualified for "separate share" treatment under the Minimum Distribution Rules).

Thus, by way of example and not limitation, a Qualified Retirement Plan is not a Stretch-Out Retirement Plan if it must be distributed in the form of a lump sum.

See Section ? for other miscellaneous provisions to consider including in the trust.

D. SAMPLE FORM: IRA Death Beneficiary Form Designating Subtrusts.

IRA DEATH BENEFICIARY DESIGNATION

IRA OWNER:	JANE REYNOLDS
Social Security Number:	________________________________
Birth Date:	________________________________
Financial Institution:	________________________________
Account Number:	________________________________

Primary Death Beneficiary Designation: The IRA OWNER hereby designates, as her primary designation, that the above-referenced IRA (the "IRA") be divided into separate shares in the following manner:

> One equal share shall be established for the benefit of (*i.e.*, to be held in trust for) each of the IRA OWNER'S two children, namely REBECCA REYNOLDS and CHRISTINA REYNOLDS.
>
> With respect to any of said children who predecease the IRA OWNER, the deceased child's share shall be further divided into shares for the benefit of (*i.e.*, to be held in trust for) the deceased child's descendants living at the IRA OWNER'S death on the principle of representation or, if the deceased child has no then living descendants, the deceased child's share shall proportionately augment the other separate shares so established.

Each share so created for the benefit of a child or more remote descendant shall be held for his or her benefit by the Trustee of the separate Trust established for his or her benefit under Section 2 of the JANE REYNOLDS REVOCABLE TRUST established March 13, 2003.

> ***Author's Note:*** *The language refers to shares "for the benefit of" to set up the notion that the shares are designated to trusts. The language could simply create two shares, and allow the trust to take care of any further divisions for a predeceased child, but then those shares for the predeceased child's descendants are less likely to benefit from "separate share" treatment; thus, the safest approach is to spell out all the "what-ifs" in the beneficiary designation. Note that language addressing disability that was used in the CINDY SMITH example in Section V is not needed here, since these issues are addressed in the trust.*

Alternate Death Beneficiary Designation: The IRA OWNER hereby designates, as her alternate designation, that if none of the persons described in her primary designation are living at her death, the entire IRA shall instead be designated to the Trustee of the JANE REYNOLDS REVOCABLE TRUST established March 13, 2003.

Further Death Beneficiary Designations. This Death Beneficiary Designation shall not be construed as preventing any beneficiary from making further death beneficiary designations after the IRA Owner's death, it being the IRA OWNER'S desire that each be allowed to do so.

Assignments. This Death Beneficiary Designation shall not be construed as preventing any "assignment" of part or all of the IRA by a custodian, trustee, executor, agent, or other fiduciary in carrying out the terms of an estate or trust, it being the IRA OWNER'S desire that said assignments be allowed to occur. "Assignment" refers to the transfer of ownership and authority over the IRA without making distributions from the IRA including by way of example and not limitation an assignment described in Treasury Regulation Section 1.691(a)-4(b).

No Liability for IRA Custodian. The IRA Custodian shall incur no liability to any person interested in the IRA for relying on information provided by or acting upon the written instruction of (i) an agent acting for the IRA OWNER under a durable power of attorney; (ii) an agent acting for an individual entitled to an interest hereunder following the IRA OWNER'S death; or (iii) the trustee or executor of a trust or estate entitled to an interest hereunder following IRA OWNER'S death.

Executed this date of ________________________.

____

JANE REYNOLDS - IRA OWNER

[Notary attestation optional, but suggested]

VIII. Allocation Between Income and Principal - UPIA in California.

When a trust receives a retirement plan distribution, the distribution must be allocated between income and principal. Important consequences may arise, depending on how the allocation is made. The allocation may define the economic rights of certain trust beneficiaries, and may also have an impact on how the distribution (and accompanying I.R.D. deduction) are reported for income tax.

The first place the Trustee should look for guidance in allocating income and principal is the trust instrument. Absent guidance there, local law generally provides default rules.

A. 1997 Uniform Principal and Income Act.

On July 31, 1997, the National Commissioners on Uniform State Laws approved the 1997 Uniform Principal and Income Act. At that time, the initial 1931 UPIA was in effect in eight states, and the 1962 Revised Uniform Income and Principal Act had been adopted in thirty-four states. The author's state of California has adopted the 1997 UPIA,[41] effective January 1, 2000.[42]

B. 1962 RUPIA Default Rules for Retirement Plans.

Section 12 of the 1962 RUPIA prescribed a default rule for "deferred compensation" (the rule probably applied to retirement plans and other similar assets, too, although they are not specified). Under this rule, deferred compensation payments are allocated to income each year in an amount equal to 5%[43] of the deferred compensation's "inventory value." The inventory value is the present value of the expected payments measured on the date the payments become subject to trust, *e.g.*, date of death. The 1962 rule produces a fixed amount of income each year, even if the payment amounts vary. The fixed amount reflects the discount used to calculate present value on the date the payments become subject to trust, even if this rate is not representative of circumstances after that date.

California chose to modify the 1962 RUPIA rule to delete the 5% and "inventory value" concepts. Instead, the California rule provides that the trustee shall allocate deferred compensation entirely to income, or may apportion between income and principal as the

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[41] Assembly Bill 846 was approved by the governor July 21, 1999, adding §§ 16320-16375 to the Probate Code in place of §§ 16300-16315, and revising other miscellaneous provisions in the Probate Code and other codes; the California Law Revision Commission recommended enactment in its report submitted to the governor and the legislature February 4, 1999.

[42] The new provisions generally apply to every trust and estate existing on or after January 1, 2000. Probate Code § 16339.

[43] § 12 of the 1962 RUPIA provides for allocation to income of an amount "not in excess of 5% per year," which, according to the Uniform Law Commissioners' comment to § 409 of the 1997 UPIA, was treated in practice as prescribing a 5% allocation.

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trustee in its discretion may determine, but in no event shall the amount allocated to principal exceed a reasonable allowance for amortization.[44]

C. A Lot Has Changed Since 1962.

In 1962, trusts did not often receive payments from retirement plans or deferred compensation plans. Payments that did occur were generally modest relative to the overall size of the trust. Since that time, a lot has changed.

Retirement and deferred compensation plans have become much more prevalent, and individuals are making greater use of these plans. The value of these interests has soared with the long running bull stock market to the point that, for many individuals, these assets have become one of the most valuable assets on the balance sheet. Individuals are more aware than ever before of the value of tax deferred compounding, and are making great efforts to maximize this benefit for themselves and their heirs.

Another important change, although less obvious, is the increasing designation of trusts as beneficiaries of deferred compensation and retirement plans. In many cases, the assets are too valuable to leave outright without the sophisticated benefits a trust provides. In specific cases, trusts may serve tax planning objectives (*e.g.*, the credit shelter trust), or as a vehicle to provide for both the current spouse and the children of a prior marriage (*i.e.*, the QTIP marital trust).

Needless to say, our current economic environment has long since outgrown the 1962 default rules. This phenomenon illustrates that the role of any principal and income law is to provide default rules to backstop documents that are silent; the drafter remains responsible for identifying and solving the kinds of problems discussed herein.

D. The 1997 UPIA Default Rule.

The 1997 UPIA brings a new set of rules to the deferred compensation area that answer some questions but raise others, as discussed in the balance of this section.

E. "Payment" Defined; Three Conditions Before Section 16361 Applies.

Probate Code Section 16361 (Section 409 of the 1997 UPIA) was intended to cover a broad scope of assets, as evidenced by the comments of the Uniform Law Commissioners and the California Law Revision Commission that refer generally to "amounts received under contractual arrangements that provide for payments to a third party beneficiary as a result of services rendered or property transferred to the payer." The comments cite as specific examples annuities (including private annuities), deferred compensation, bonuses, IRA distributions, insurance renewal commissions, retirement plans, and employer stock.

We may think we recognize these things when we see them; but drafting the language that defines them can be a challenging assignment. The drafters chose to define the term "payment" by setting two requirements: (i) the "payment" may be received over a

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[44] P.C. § 16310.

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fixed number of years or during the life of one or more individuals; and (ii) the "payment" may be received because of services rendered or property transferred to the payer in exchange for future payments.[45]

Then, the drafters essentially created a third condition for Probate Code 16361 to apply by clarifying that "payments" to which the "liquidating asset" rules of Probate Code 16362 apply are covered by the latter section, not Section 16361.[46] Probate Code Section 16362 defines "liquidating assets" as assets whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration listing as specific examples leaseholds, patents, copyrights, royalty rights, and the right to receive payments under an arrangement that does not provide for the payment of interest on the unpaid balance.[47]

So far, so good. But then, Section 16362 further provides that "liquidating asset" does not include, among other things, payments subject to Section 16361.[48] This sets up a circular reference between Sections 16362 and 16361, since Section 16361 defines "payment" and then provides that a "payment" that is subject to Section 16362 is not subject to Section 16361.

Probate Code Section 16361 has not been coordinated with Section 16350, which provides that any payment received from an "entity" (*i.e.*, corporation, partnership, limited liability company, *etc.*) shall generally be allocated entirely to income subject to specific exceptions. If a trust receives a payment directly from an entity in connection with an unfunded deferred compensation plan, which Section controls? Clarification is needed.[49]

F. Default Rules for Allocating Payments to Income and Principal.

Section 16361(b) applies to "payments" any part of which is characterized as interest, dividends, or an "equivalent payment,"[50] and provides that the portion so characterized *shall* be allocated to income and the balance to principal. IRAs and many other retirement plans are "individual account" plans consisting of identifiable investments held in an account for the Participant. Even though identifying the income arising inside the account is often straightforward, a distribution from such an account does not fall under the

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[45] P. C. § 16361(a); 1997 UPIA § 409.

[46] P. C. § 16361(e); 1997 UPIA § 409(e).

[47] P. C. § 16362(a); 1997 UPIA § 410.

[48] *Ibid.*

[49] The author suggests that P.C. § 16350 (1997 UPIA § 401) should be revised to clarify that the section applies to payments from an entity arising from an ownership interest in the entity.

[50] The term "equivalent payment" is not defined in the statute, but the Uniform Law Commissioners' comments under 1997 UPIA § 409(b) suggest that the term refers to payments in lieu of interest or dividends, such as payments of phantom dividends under a phantom stock plan.

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rule of Section 16361(b) unless it has been specifically characterized as a distribution of interest, dividends, or an equivalent payment.

The first sentence of Section 16361(c) provides that with respect to a payment no part of which is characterized as interest, a dividend, or an equivalent payment, if part or all is "required to be made," the trustee *shall* allocate to income 10% of the part that is required to have been made. The balance of the payment shall be allocated to principal.

The second sentence of Section 16361(c) provides that if no part of a payment is required to be made or if the payment received is the entire amount to which the trustee is entitled, the trustee *shall* allocate the entire payment to principal.

Section 16361(d) adds a special rule designed to preserve the marital deduction, which will be discussed next.

The rule of Section 16361(c) is only a default rule, and is not intended as a substitute for careful drafting. However, it is a poor default rule for "individual account" plans. A better default rule would identify income inside the individual account, and assume that the income is distributed first.

G. Special Rule for Marital Deduction Trusts.

If an IRA is designated to a QTIP marital trust[51] some provision must be made regarding the income earned inside the IRA for the entire arrangement to qualify for the marital deduction. At the time the 1997 UPIA was promulgated, the I.R.S. position was that the IRA must qualify independently as "qualified terminable interest property" under Internal Revenue Code Section 2056(b)(7).[52]

Note that the I.R.S. recently relaxed its requirements in this area by ruling that the marital deduction is allowed in connection with an IRA designated to a QTIP trust that grants the surviving spouse the power to compel withdrawal of income from the IRA and then from the trust.[53]

The Uniform Law Commissioners addressed this issue by providing in Section 409(d) that if, to obtain an estate tax marital deduction for a trust, a trustee *must* allocate more of a payment to income than provided under Section 16361, the trustee *shall* allocate to income the additional amount necessary to obtain the marital deduction.[54]

Does Section 16361 apply if the marital deduction *could be* obtained for the trust, or only if the marital deduction is *actually* obtained? The Uniform Law Commissioners'

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[51] A QTIP trust qualifies for the marital deduction for estate tax only if it satisfies the requirements of I.R.C. § 2056(b)(7), one of which is that all income be paid to the spouse/beneficiary.

[52] Rev. Rul. 89-89, 1989-2 C. B. 231.

[53] Rev. Rul. 2000-2, 2000-3 I.R.B. 1.

[54] California Probate Code Section 16361(d) replaces the word "*must*" with the word "*shall*." This change is not mentioned or explained in the California Law Revision Commission report, and might be a typographical error.

comments do not say, although it is clear that the provision was intended to save the marital deduction in situations where the default allocation rule might otherwise interfere, which perhaps suggests application only when the marital deduction is *actually* obtained. However, at the time the 1997 UPIA was promulgated, the I.R.S. position was that if any part of a trust's income was conditional on the actual QTIP election and not absolute, the marital deduction was lost as to the entire trust.[55] (The I.R.S. abandoned this position in new regulations issued August 19, 1998.)[56] Thus, it could be argued that the Uniform Law Commissioners would have intended that the clause apply whenever the marital deduction *could* be obtained, whether or not it actually was.

Note that this savings clause does not apply when a gift tax marital deduction is desired. This is unlikely to interfere with tax planning for retirement plans, but should be watched with any property interest that the owner can transfer during life.

This savings clause has the effect of defining the economic rights of income and remainder beneficiaries completely differently, depending on whether a marital deduction *could be/is actually* obtained for the trust. The fact that the Commissioners needed to include this savings clause might be the most compelling sign that something is wrong with the rest of the statute.

H. New Legislation.

California Assembly Bill 2347 was signed into law on September 28, 2006. This bill contains several provisions, one of which substitutes a new Probate Code Section 16361 in place of the existing section. The new section provides a new "income first up to 4%" rule for "individual accounts," as defined in ERISA, and continues to apply the "90/10" rule to other retirement plans. The new statute continues the marital deduction savings provision that could potentially cause problems under the reasoning of Rev. Rul. 2006-26, but at least with respect to individual account plans, the new "income first up to 4%" rule should satisfy the requirements of Rev. Rul. 2006-26.

[55] *See* TAMs 9104003, 8916002, 8901005, 8901003, 8635006 and 8611006; *Griffin v. Griffin*, 832 P.2d 810 (Okla. 1992).

[56] Reg. §§ 20.2056(b)-7(d)(3), 20.2056(b)-7(h) Ex. 6 (revised effective August 19, 1998).

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IX. SAMPLE FORM: Drafting Under the 1997 Principal and Income Act.

A. Avoid Reference to "Income" When Defining Economic Interests.

Economic disparities that might occur under the 1997 UPIA rule are likely to arise in traditional "income/remainder" trusts. The most effective way to avoid problems is to structure each subtrust in a way that does not link the economic interests of the beneficiaries to income. Examples of such trusts include "conduit" trusts (trusts that pay the retirement plan minimum distributions to the beneficiary), unitrusts, and discretionary trusts.

B. Leave Determination of Income and Principal to Trustee.

Under the 1997 UPIA,[57] a Trustee may make adjustments to the allocation of income and principal that would otherwise be made under the default provisions of the act, but only if the Trustee is not a beneficiary. A more reliable approach is to include a clause such as the following authorizing the trustee to make determinations of income and principal in the trustee's reasonable discretion, rather than under the 1997 UPIA:

7.23 Allocate Between Principal and Income; Establish Reserves; Budget. To determine what is principal and income of the trust estate and what items shall be charged or credited to either; to maintain or not maintain reserves for any purpose and in the manner the Trustee deems appropriate; and, if applicable, to budget the estimated annual income and expenses of the trusts in such manner as to equalize, insofar as practicable, periodic income payments to beneficiaries. The Trustee's discretion under this Section shall be construed broadly, and no inference of imprudence or partiality shall arise if the trustee exercises said discretion in a manner contrary to the default rules of law that would apply in the absence of this Section. In fact, it is contemplated that the trustee's allocations are likely to deviate from the default rules of law in those situations in which the default rules arbitrarily allocate fixed percentages of receipts to principal and income. In exercising discretion under this Section, the trustee shall act reasonably and treat the beneficiaries impartially.

C. Provide a Specific Rule for the Trustee.

Here is a sample clause for consideration when the drafter prefers not to rely on the default rule under the 1997 Uniform Principal and Income Act and prefers not to leave the determination to the trustee:[58]

8.12 Allocation of Income and Principal of Annuity and Benefit Payments. The Trustee shall allocate each Payment described below as follows:

8.12.1 Payment. For purposes of this Paragraph, the term "Payment" refers to an amount:

(a) that is received or withdrawn pursuant to a contractual, custodial, or trust arrangement that provides for Payments to the trust, including by way of example and not limitation qualified retirement plans, IRAs, Roth IRAs, annuities (including private annuities), and deferred compensation (including payments received directly from an "entity" as defined in Probate Code Section 16350); and

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[57] 1997 UPIA § 104; California Probate Code § 16336.

[58] The author drafted this clause as a "rewrite" of § 16361 (1997 UPIA § 409), and submits that the clause is a useful model for a rewrite of the statute that would address the questions raised herein. Note, too, that this default rule does not disqualify the marital deduction, obviating the need for a savings clause.

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(b) that is one of a series of Payments that have been or will be received over a fixed number of years or during the life of one or more individuals, or is a single Payment that the Trustee could have received over a fixed number of years or during the life of one or more individuals.

8.12.2 Payment Characterized as Interest or Dividend. If any portion of a Payment is characterized as a Payment to the Trustee of interest, dividends, or a dividend equivalent, the Trustee shall allocate the portion so characterized to income, and the balance to principal.

8.12.3 Payment From Plan Account. If no part of a Payment is allocated under Section 8.12.2 and the Payment is received from a plan that maintains separate accounts for its participants, including by way of example and not limitation defined contribution retirement plans, IRAs, Roth IRAs, and deferred compensation plans) the Trustee shall allocate to income the portion (up to the whole) that equals the amount of "Plan Income" that the Trustee reasonably determines was earned inside the trust's plan account since it became subject to trust (and not previously allocated to trust income), and the balance to principal. The term "Plan Income" refers to the amount inside the plan account that, if the plan account were a trust, would be allocated to income under the California Probate Code rules governing allocation of principal and income for trusts.

8.12.3 Other Payments. If no part of a Payment is allocated under Sections 8.12.2 or 8.12.3, the Trustee shall allocate to income the portion that exceeds the present value of the Payment measured on the date of the preceding Payment (or, if none, on the date the property interest became subject to trust), using a discount rate reasonably determined by the Trustee.

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X. MRD Trade Off: Lost Deferral When Designating QTIP and Bypass Trusts.

There are a number of different structures to consider when designing the estate plan for a married couple who own IRAs or other qualified retirement plans. In a perfect world, the ideal structure would minimize estate tax, provide the protection of an irrevocable trust at the first death (if that is what the clients want), and facilitate maximum deferral under the minimum distribution rules that apply to IRAs and other qualified plans.[59]

The QTIP Marital Trusts and Bypass Trusts commonly used at the first spouse's death are subject to the same rules discussed in Section VI for purposes of determining the DB Trust Beneficiaries under the MRD Rules. A QTIP or Bypass Trust that provides for the surviving spouse and then passes outright to children (or more remote descendants) at the survivor's death will be deemed to have the survivor and the children (or more remote descendants) who are living as of the Post-Mortem Date as the DB Trust Beneficiaries. Thus, the survivor will be the DB Trust Beneficiary with the shortest life expectancy, and his or her life will govern. Under the final regulations, if the interests of the children or more remote descendants are subject to limitations (*e.g.*, accumulation until a specified age), it may not be possible to rule out heirs at law who might be older than the survivor, and the trust may not be recognized as having any life expectancy at all. See the discussion in Section VI.

Whether or not the survivor's life expectancy is recognized for the trust, a "stretched out" deferral for children or younger beneficiaries will be unavailable with a QTIP Trust, or with a Bypass Trust that includes the survivor as a beneficiary. For this reason, it is tempting to designate the surviving spouse to receive retirement plan assets outright, since the survivor can accomplish a "stretched out" deferral period by electing a spousal rollover and designating the children or younger beneficiaries.

Although the spousal rollover can provide powerful economic benefits, it does not provide the checks and balances that exist with a QTIP or Bypass Trust.[60] Many clients choose to structure their *non-retirement plan assets* using QTIP or Bypass Trusts - why should they handle retirement plan assets differently? There is an incentive to handle the retirement assets differently, but this is an individual decision for each client. The incentive consists of the substantial economic value of stretched out deferral that is available with a spousal rollover, and is not available if the client designates a QTIP Trust or a Bypass Trust that includes the survivor as a beneficiary. The Brady Case Study in the next Section attempts to quantify these trade-offs. (An additional set of issues presents itself when the non-retirement assets are insufficient to fully fund the Bypass Trust. These issues are discussed separately beginning in Section XVIII.)

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[59] I.R.C. §§ 401(a)(9), 403(b)(10), 408(a)(6), and 457(d)(2); final regulations were published in the Fed. Reg. Vol. 67, No. 74, p. 18834 (4/17/2002).

[60] *E.g.*, creditor protection for the survivor, and assurance that the remainder will pass as the client has directed.

XI. Case Study: Mr. and Mrs. Brady - MRD Trade-Off.

There are a number of different structures to consider when designing the estate plan for a married couple who own IRAs or other qualified retirement plans. In a perfect world, the ideal structure would minimize estate tax, provide the protection of an irrevocable trust at the first death (if that is what the clients want), and facilitate maximum deferral under the minimum distribution rules that apply to IRAs and other qualified plans.[61]

However, real world planning under the minimum distribution rules often forces a balancing of competing interests to determine the optimal structure. To obtain the tax savings of a credit shelter trust or the protection of a marital QTIP trust, deferral may be lost. What is the "cost" of giving up the benefit of deferral? That is the focus of this Case Study.

The Case Study illustrates planning options for Mr. and Mrs. Brady. Each was born January 1, 1938, and they have one child who was born January 1, 1973. Their estate consists of the following property:

Mr. Brady's IRA	$ 1,200,000
Liquid Investments	$ 1,200,000
Residence	$ 400,000

Mr. and Mrs. Brady want to leave as much as possible to their child, and they think their child is smart enough to take full advantage of "stretched out" minimum distributions. However, Mr. and Mrs. Brady also value the protection that an irrevocable trust provides. They would like some idea of the "cost" of the deferral that would be lost if they designate the IRA to such a trust.

To evaluate this "cost," your author has built a financial program that models all of the investment, income tax, estate tax, and cash flow activity for the entire deferral period, *i.e.*, the balance of Mr. and Mrs. Brady's lifetimes plus an additional period of time reflecting the child's single life expectancy.[62] The financial model measures the "pile of money" that the child owns at the end of this period (net of all taxes) under each planning option and identifies the portion that reflects "value added" from retirement plan distributions. This approach makes it possible to compare various planning options on an "apples to apples" basis. Here is a review of the key assumptions that were made:

- Investment assumptions have a big impact on the projection results. Investment performance is assumed to be the same inside or outside the IRA, with a mix of 50% invested in the stock market and 50% in fixed income. Although it seems like a

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[61] I.R.C. §§ 401(a)(9), 403(b)(10), 408(a)(6), and 457(d)(2); final regulations were published in the Fed. Reg. Vol. 67, No. 74, p. 18834 (4/17/2002).

[62] This and a number of other financial models were included in the materials for the May 23, 2002 ALI-ABA Video Law Review Program, "Estate Planning for Distributions from Qualified Plans and IRAs."

distant memory lately, your author continues to use investment assumptions that reflect the average yield from long term investing in the stock and fixed income markets. Thus, it is assumed that all investments earn 8% annual return, consisting of 3.75% ordinary income and 4.25% growth. Portfolio turnover is assumed to be 10% per year, which is relevant in modeling the amount of capital gains realized each year and the amount of deferred gain that disappears with a cost basis "step up" at death.

- The residence is assumed to appreciate at the rate of 2% per year.
- The rest of Mr. and Mrs. Brady's cash flow picture reflects a $48,000 "joint and survivor" pension each year, $10,000 of social security (indexed for inflation), and cash outflow of $36,000 per year (indexed for inflation).
- Annual inflation is assumed to be 1.5%.
- The child's cash flow picture reflects earnings of $40,000 per year (indexed) and cash outflow of $30,000 per year (indexed). When the child reaches age 65 he will receive social security benefits of $8,000 per year (in 2003 dollars, indexed for inflation).
- The model applies the income tax rules that apply in each year of the projection recognizing the changes under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA 2001"), and assuming the law "sunsets" after 2010. The rules include, for example, alternative minimum tax, taxation of a portion of social security, "I.R.D." deduction, 3% "haircut" of itemized deductions (including the "phase-out" in years 2006-2009), limitations on charitable deductions, compressed rate brackets for trusts, *etc.* The I.R.D. deduction is utilized on the earliest dollars distributed. A 9% state income tax is also assumed, and is included among the deductions claimed for federal income tax.
- The model applies the transfer tax rules that apply in each year of the projection recognizing the changes under EGTRRA 2001, and assuming the law "sunsets" after 2010. (The model assumes a state "pick up" estate tax that is not modified to avoid reduction under EGTRRA 2001.)
- Neither Mr. or Mrs. Brady has made any prior taxable gifts.
- Mr. Brady is assumed to die at age 64 in the year 2002, and Mrs. Brady is assumed to die at age 82, in the year 2020.
- In each scenario: the bypass trust accumulates income and Mrs. Brady does not need any distributions from the bypass trust during her lifetime; QTIP marital deduction elections are made to the extent necessary to avoid payment of estate tax at the first death; QTIP marital trust accounting income reflects the 3.75% ordinary income described above; and Mrs. Brady does not enforce the rights, if any, she might have under state law to receive any portion of the assets held in Mr. Brady's name.

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The following scenarios have been included for comparison in the Brady financial model:

Scenario 1: "Non-Deferral" - Distribute IRA in 2003. This first scenario is included for the sole purpose of providing a "non-deferral" scenario that can serve as a point of reference in comparing the other strategies. Under this first scenario, Mrs. Brady is designated as the death beneficiary and she takes distribution of the entire IRA immediately after Mr. Brady's death. (All other assets pass to QTIP and bypass trusts, with the bypass trust receiving the maximum amount that can pass without estate tax.)

Scenario 2: Spousal Rollover of IRA. Under this second scenario, Mr. Brady's IRA passes to Mrs. Brady, who elects to treat the IRA as her own and designates their child as beneficiary ("DB"). (All other assets pass to QTIP and bypass trusts, with the bypass trust receiving the maximum amount that can pass without estate tax.) Mrs. Brady takes only the minimum required distributions ("MRDs") from the IRA. Mrs. Brady's MRDs begin in 2008 when she reaches age 70-½, and the divisor used to calculate MRDs is obtained by looking up her life expectancy each year in the "Uniform Lifetime Table."[63]

Scenario 3: IRA to QTIP. Under this third scenario, Mr. Brady's IRA passes to a QTIP trust. (All other assets pass to the QTIP trust and a bypass trust, with the bypass trust receiving the maximum amount that can pass without estate tax.) The trust directs that income arising inside the IRA is to be withdrawn and then distributed to Mrs. Brady along with any other QTIP trust income. The QTIP trust provides outright distribution to their child at Mrs. Brady's death, and otherwise satisfies the requirements under the minimum distribution rules to be recognized as having Mrs. Brady and child as its only beneficiaries. The QTIP trust must begin MRDs in 2003 based on Mrs. Brady's single life expectancy, and the divisor used to calculate MRDs is obtained by looking up Mrs. Brady's life expectancy in the "Single Life Table" based on her attained age in 2003 (age 65) and then reducing by 1.0 each year thereafter.[64] The trustee of the QTIP trust does not take unnecessary IRA distributions; *i.e.*, the trustee takes the greater of the MRD amount or the income earned inside the IRA each year. To the extent of income earned inside the IRA, taxable income from the IRA distributions is passed out to Mrs. Brady with the distributions she receives from the QTIP trust. However, if the MRD in any year is greater than the income earned inside the IRA, the excess remains subject to income tax at the trust level and accumulated. *As it turns out, the MRDs are greater than the 3.75% QTIP trust accounting income every year.*

Scenario 4: IRA to "Conduit QTIP." This is the same as the third scenario, except that the QTIP trust includes "conduit" provisions that require that all amounts withdrawn from the IRA must be distributed to Mrs. Brady. The QTIP trust must begin MRDs in 2003, but Mrs. Brady is considered to be the sole beneficiary of the trust because of the "conduit"

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[63] Treas. Reg. § 1.408-8, A-5. The "Uniform Lifetime Table" can be found in Treas. Reg. § 1.401(a)(9)-9, A-2.

[64] Treas. Reg. § 1.401(a)(9)-5, A-5(c)(1); the "Single Life Table" can be found Treas. Reg. § 1.401(a)(9)-9, A-1.

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provisions. As a result, more deferral is possible since the divisor used to calculate MRDs is obtained by looking up Mrs. Brady's life expectancy in the "Single Life Table" *each year* (also known as a "recalculated life expectancy").[65] Thus, the divisor will decrease by less than 1.0 from year to year. The trustee of the QTIP trust does not take unnecessary IRA distributions; *i.e.*, the trustee takes the greater of the MRD amount or the income earned inside the IRA each year. The taxable income from the IRA distributions is passed out to Mrs. Brady with the distributions she receives from the QTIP trust, and none of the IRA income is subject to income tax at the trust level. *As it turns out, the MRDs are greater than the 3.75% QTIP trust accounting income every year.*

Scenario 5: IRA to Bypass Trust for Mrs. Brady. Under this fifth scenario, the largest possible portion of the IRA that can pass without estate tax passes to the bypass trust. The balance of the IRA and all other assets pass to a QTIP trust. The bypass trust provides outright distribution to their child at Mrs. Brady's death, and otherwise satisfies the requirements under the minimum distribution rules to be recognized as having Mrs. Brady and child as its only beneficiaries. The bypass trust must begin MRDs in 2003 based on Mrs. Brady's single life expectancy, and the divisor used to calculate MRDs is obtained by looking up Mrs. Brady's life expectancy in the "Single Life Table" based on her attained age in 2003 (age 65) and then reducing by 1.0 each year thereafter. The MRDs and any other income earned in the trust are subject to income tax at the trust level and accumulated.

Scenario 6: IRA to Bypass Trust for Child. This is the same as the fifth scenario, except that the bypass trust does not provide for Mrs. Brady, and is recognized under the minimum distribution rules as having the child as its oldest beneficiary. The bypass trust must begin MRDs in 2003 based on the child's single life expectancy, and the divisor used to calculate MRDs is obtained by looking up child's life expectancy in the "Single Life Table" based on his attained age in 2003 (age 30) and then reducing by 1.0 each year thereafter. The portion of MRDs and any other income that is actually distributed to child is taxable income to him, and the balance is subject to income tax at the trust level and accumulated.

Scenario 7: IRA to Child. In this seventh scenario, the portion of the IRA that can pass without estate tax passes directly to the child. The balance of the IRA and all other assets pass to a QTIP trust. The child must begin MRDs in 2003 based on his single life expectancy, and the divisor used to calculate MRDs is obtained by looking up his life expectancy in the "Single Life Table" based on his attained age in 2003 (age 30) and then reducing by 1.0 each year thereafter. All taxable income arising from IRA distributions will be reported by the child.

Minimum Distribution Divisors. The following table shows the MRD divisors that apply to these various scenarios:

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[65] Treas. Reg. § 1.401(a)(9)-5, A-5(b).

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MRD Divisors: Mr. And Mrs. Brady						
Calendar Year	*Mrs. Brady's Age*	*Child's Age*	*Divisor if Spousal Rollover (Scenario 2)*	*Divisor if QTIP and Bypass Trusts (Scenarios 3 & 5)*	*Divisor if Conduit QTIP Trust (Scenario 4)*	*Divisor if Child is DB (Scenarios 6 & 7)*
2003	65	30		21.0	21.0	53.3
2004	66	31		20.0	20.2	52.3
2005	67	32		19.0	19.4	51.3
2006	68	33		18.0	18.6	50.3
2007	69	34		17.0	17.8	49.3
2008	70	35	27.4	16.0	17.0	48.3
2009	71	36	26.5	15.0	16.3	47.3
2010	72	37	25.6	14.0	15.5	46.3
2011	73	38	24.7	13.0	14.8	45.3
2012	74	39	23.8	12.0	14.1	44.3
2013	75	40	22.9	11.0	13.4	43.3
2014	76	41	22.0	10.0	12.7	42.3
2015	77	42	21.2	9.0	12.1	41.3
2016	78	43	20.3	8.0	11.4	40.3
2017	79	44	19.5	7.0	10.8	39.3
2018	80	45	18.7	6.0	10.2	38.3
2019	81	46	17.9	5.0	9.7	37.3
2020	82	47	17.1	4.0	8.7	36.3
2021		48	36.0	3.0	7.7	35.3
2022		49	35.0	2.0	6.7	34.3
2023		50	34.0	1.0	5.7	33.3
2024		51	33.0		4.7	32.3
2025		52	32.0		3.7	31.3
2026		53	31.0		2.7	30.3
2027		54	30.0		1.7	29.3
2028		55	29.0		1.0	28.3
2029		56	28.0			27.3
2030		57	27.0			26.3
2031		58	26.0			25.3
2032		59	25.0			24.3
2033		60	24.0			23.3
2034		61	23.0			22.3
2035		62	22.0			21.3
2036		63	21.0			20.3
2037		64	20.0			19.3
2038		65	19.0			18.3
2039		66	18.0			17.3
2040		67	17.0			16.3
2041		68	16.0			15.3
2042		69	15.0			14.3
2043		70	14.0			13.3
2044		71	13.0			12.3
2045		72	12.0			11.3
2046		73	11.0			10.3
2047		74	10.0			9.3
2048		75	9.0			8.3
2049		76	8.0			7.3
2050		77	7.0			6.3
2051		78	6.0			5.3
2052		79	5.0			4.3
2053		80	4.0			3.3
2054		81	3.0			2.3
2055		82	2.0			1.3
2056		83	1.0			1.0

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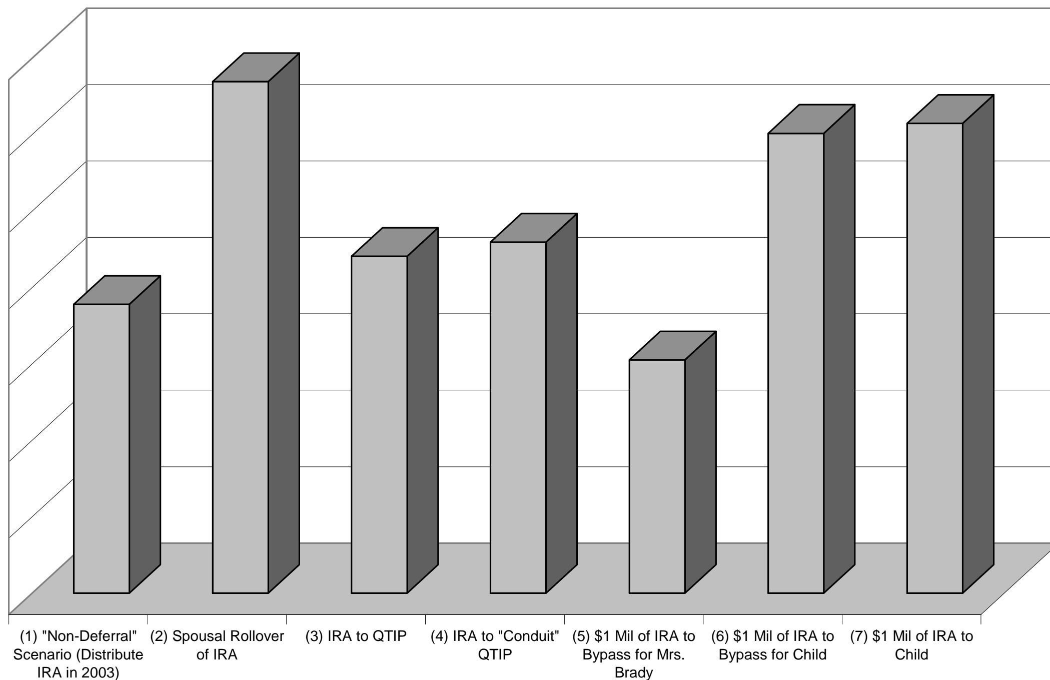
Results of Financial Projection. The results of the financial model appear in the following charts. The first chart shows the portion of the child's "pile of money" that reflects "value added" from retirement plan distributions as of the end of the deferral period (year 2056) under each scenario, including a percentage comparison to the first, "non-deferral" scenario. The second chart shows the same amounts in the form of a bar graph.

Case Study Analysis for Mr. And Mrs. Brady							
Retirement Plan in Yr 2003:	**1,200,000**						
Deferral Period Ends:	**2056**						
Distribution Strategy:	**(1) "Non-Deferral" Scenario (Distribute IRA in 2003)**	**(2) Spousal Rollover of IRA**	**(3) IRA to QTIP**	**(4) IRA to "Conduit" QTIP**	**(5) $1 Mil of IRA to Bypass for Mrs. Brady**	**(6) $1 Mil of IRA to Bypass for Child**	**(7) $1 Mil of IRA to Child**
Net Value of Retirement Plan Distributions at End of Deferral Period *(Future Dollars)*:	**8,321,931**	**14,736,085**	**9,704,856**	**10,113,704**	**6,720,535**	**13,248,055**	**13,532,157**
Net Value of Retirement Plan Distributions at End of Deferral Period *(Current Dollars)*:	**3,780,279**	**6,693,941**	**4,408,480**	**4,594,201**	**3,052,837**	**6,017,996**	**6,147,051**
% Comparison:	**100%**	**177%**	**117%**	**122%**	**81%**	**159%**	**163%**



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What the Results Tell Us. As might be expected, the spousal rollover in Scenario 2 produces the largest "pile of money," reflecting the maximum deferral available to the Brady family. The benefit of maximum deferral allows the retirement plan distributions to build a "pile of money" that is 177% compared to the "non-deferral" scenario. Of course, this approach means foregoing the protections of an irrevocable trust.

(As an aside, your author notes one other important benefit of the spousal rollover scenario that is not reflected in the charts. The spousal rollover MRDs are smaller during Mrs. Brady's lifetime than with any of the irrevocable trusts for Mrs. Brady because of the joint-recalculated life expectancies in the Uniform Lifetime Table. This difference becomes larger as each year passes. As a result, the IRA will grow more and provide greater "back end" protection to pay living or medical costs if Mrs. Brady lives longer than expected.)

Most, but not all, of the benefit of deferral is lost if a QTIP trust is designated (Scenario 3), and the "pile of money" grows to 117% compared to the "non-deferral" scenario. Thus, the "cost" of lost deferral is a shrinkage from 177% to 117% (a reduction of 60%).

A slight improvement is possible with a "conduit-QTIP" (Scenario 4), which produces a "pile of money" of 122% (5% higher than the traditional QTIP). This slight improvement reflects both (i) lower income taxes since the taxable income from IRA distributions avoids the compressed tax rates that apply to trusts; and (ii) lower MRDs since Mrs. Brady's life expectancy may be "recalculated" each year. Mrs. Brady receives larger distributions from a conduit QTIP than a traditional QTIP trust, because the entire MRD must be distributed each year even if it is larger than the income earned inside the IRA. As a result, fewer assets will remain subject to the protection of an irrevocable trust. This phenomenon will become more exaggerated during the later years of Mrs. Brady's life, since the MRDs will grow considerably relative to the income earned inside the IRA. The following table compares shows the size of the traditional and conduit QTIPs at Mrs. Brady's death under Scenarios 3 and 4:

	Traditional QTIP at Mrs. Brady's death	Conduit QTIP at Mrs. Brady's death
Undistributed Balance of IRA as of 12/31/2020	799,442	1,355,715
Other QTIP Trust Assets as of 12/31/2020	1,379,453	423,057
Total (pre-estate tax and pre-income tax)	2,178,895	1,778,772

Designating the IRA to a bypass trust for Mrs. Brady (Scenario 5) is a surprising disappointment, producing a "pile of money" that is even smaller (81%) than under the "non-deferral" scenario. This poor performance arises because income-taxable IRA assets are used to satisfy the applicable exclusion amount that can fund the bypass trust. As a result,

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income tax on IRA distributions is paid from bypass trust assets rather than from assets that will be subject to estate tax in Mrs. Brady's estate. Further, the income is taxed at the compressed income tax rates that apply to trusts. Finally, there will be no "income in respect of a decedent" deduction for income tax under Internal Revenue Code Section 691(c) because no estate tax was paid in Mr. Brady's estate.

Designating the IRA to a bypass trust for child (Scenario 6) does not avoid these pitfalls, but they are somewhat mitigated by the long deferral period allowed based on the child's single life expectancy. This results in a "pile of money" of 159%. However, this bypass trust structure does not allow Mrs. Brady access to the assets - a serious disadvantage. The only possible benefit compared to an outright designation of child is that Mrs. Brady may at least manage the assets if she serves as trustee.

The outright designation to child (Scenario 7) eliminates the problem of paying income tax during Mrs. Brady's lifetime at the compressed income tax rates that apply to trusts, resulting in a "pile of money" of 163% (a 4% increase). Again, Mrs. Brady will not have any access to the assets designated to the child - a serious disadvantage.

Conclusion. If Mr. and Mrs. Brady choose to direct the IRA to an irrevocable trust, they must accept a "cost" of lost deferral of roughly 55-60% (based on these facts and assumptions). Designating a bypass trust for Mrs. Brady is particularly unattractive. The conduit QTIP offers slightly better economic results than a traditional QTIP, but protects substantially less principal, especially during the later years of Mrs. Brady's life.

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XII. Preserving Marital Deduction for Estate Tax When QTIP Trust is DB.

A. Rev. Rul. 2006-26: IRS Addresses UPIA.

In Revenue Ruling 2006-26,[66] the IRS issued further guidance addressing issues arising under the Uniform Principal and Income Act. This new ruling raises important issues relating to qualification for the marital deduction for estate tax.

The balance of this Section is derived from an article your author co-wrote with Michael Jones in the year 2000.[67]

B. Rev. Rul. 2000-2: IRS Relaxes Its Position.

In Revenue Ruling 2000-2,[68] the IRS relaxed its requirements for allowing a marital deduction for estate tax when a Qualified Terminable Interest Property ("QTIP") trust is designated as retirement plan beneficiary.

Prior to the issuance of Revenue Ruling 2000-2, the IRS required the terms of the retirement plan to satisfy all of the requirements of Internal Revenue Code Section 2056(b)(7) in order to qualify as QTIP property. Rev. Rul. 89-89, 1989-2 C.B. 231.[69] This position was problematical in several ways:

> *Language Added to Plan.* For the retirement plan to qualify as QTIP property, the plan itself somehow had to provide for mandatory distribution of income to the surviving spouse. This requirement is not normally present in a retirement plan. With IRAs and certain other types of plans, the requirement could be met by language added to a beneficiary designation, but with other types of plans, such as defined benefit plans, the plan language was inconsistent with mandatory income distribution and it was thus impossible to qualify the plan under Section 2056(b)(7).
>
> *Easy to Fail.* Not all clients and estate planners were aware that this extra step was required by the IRS, increasing the chances of a failed marital deduction.
>
> *Income Must Come Out.* There was no alternative to an actual distribution of income from the retirement plan, regardless of how young the spouse might be or what other assets were available in the QTIP trust.

Revenue Ruling 2000-2 supersedes Revenue Ruling 89-89 and allows the retirement plan and the QTIP trust to be viewed together in determining whether the requirements of Section 2056(b)(7) have been satisfied. Since the QTIP trust in the ruling granted the surviving spouse the power to compel the trustee to withdraw and distribute IRA income, the IRS ruled that both the QTIP trust and the IRA qualified for the marital deduction.

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[66] Rev. Rul. 2006-26, IRB 2006-22.

[67] Michael Jones, CPA, Thompson Jones LLP, Monterey, CA.

[68] Rev. Rul. 2000-2, IRB 2000-3.

[69] *See also,* Tech. Adv. Mem. 92-20-007; Priv. Ltr. Rul. 94-18-026

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Generally, in order for a bequest of property to qualify for the QTIP election under Section 2056(b)(7), the surviving spouse of the decedent must be entitled to all income of the property for life, payable annually or more frequently. Citing Reg. Section 20.2056(b)-5(f)(8), the IRS ruled that a trust that grants the spouse the power to withdraw trust income satisfies this requirement. The IRS ruled that the IRA also qualified for a QTIP election, since, based on the terms of the testamentary trust described above, the spouse was entitled to the income of the IRA. After reaching its conclusion, the ruling states that the result would be the same if the trustee had been directed by the trust instrument to withdraw the income of the IRA and distribute that income to the surviving spouse.

The ruling goes on to point out that the QTIP election should be made for both the testamentary trust and the IRA.

Although the facts and the holding of the ruling involve an IRA, the holding should logically apply to certain other types of retirement plans *that allow the trustee to measure and withdraw income from inside the plan*. Furthermore, the result should not be limited to testamentary trusts, but should also extend to inter-vivos QTIP trusts.

C. What Does the New IRS Position Mean.

How does the new IRS position affect the problems cited above under the old position, and what steps should be taken in connection with arrangements made under the old position?

No Language Needs to be Added to Plan. Retirement plans do not need to qualify separately as QTIP property, and do not need to have language added that provides for mandatory distribution of income. Any plan that allows the trustee of the QTIP trust to *measure* and *withdraw* all plan income can potentially qualify. Each client should consider whether to remove any language that was added under arrangements put into place prior to this ruling.

Still Easy to Fail. Clients and estate planners still need to be aware of the current IRS position, and include the proper language in the QTIP trust. Each client should review and reevaluate the language of any QTIP trust that is designated as beneficiary in light of this ruling.

Income Might Not Have to Come Out. If the QTIP trust provides appropriate alternatives, it may now be possible for the surviving spouse to reduce or delay income distributions from the retirement plan, allowing greater benefit from tax-deferred compounding. Obviously, the trustee of the QTIP trust will have to account, in the trustee's books and records, for any income of the IRA not withdrawn. Eventually, minimum required distributions are likely to exceed income. This is because each successive required minimum distribution is based on an ever decreasing remaining life expectancy. At that point, if the surviving spouse's right to withdraw the accumulated income has not yet lapsed under the terms of the QTIP trust, it may be desirable from a tax standpoint to pay any withdrawn accumulated income amounts over to the surviving spouse. Doing so

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passes distributable net income out to the survivor, who may be in a lower tax bracket. However, do not assume that the survivor always pays lower income tax. If the survivor is in the top tax bracket, the overall tax bill may be lower if taxes are paid in the QTIP trust since the trust is not subject to the 3% "haircut" on itemized deductions that applies to individuals under I.R.C. Section 68, as discussed in Section ?.

D. Watch Out for Additional Restrictions Unique to Plan.

Some plans add additional terms for non-tax reasons (*e.g.*, administrative convenience). In particular, a small minority of plans include an additional term that calls for immediate distribution at death if a marital trust has been designated. Although this additional term does not jeopardize the marital deduction, it may still be an unwelcome surprise for the survivor if this issue has not been ferreted out at the time of the planning.

E. Be Sure to Designate Subtrust.

Whenever a subtrust under a will or revocable trust is to be a retirement plan beneficiary (for example, a QTIP trust, bypass trust or child's trust), the safest course is to designate the subtrust and not the will or revocable trust. Otherwise, the I.R.S. might argue that retirement plan assets are available to pay the decedent's taxes and expenses, resulting in the estate being a beneficiary, which negates any life expectancy that might otherwise be recognized for minimum distribution purposes.

F. Increased Importance of Allocation Between Income and Principal.

Since access to income of the plan is necessary to comply with Rev. Rul. 2002-2, it is necessary to deal with two issues relating to the definition of income. One issue is to ascertain the amount of income of the plan. The second issue is that it is necessary to be able to claim that amounts withdrawn from the plan constitute income and not principal.

In determining the amount of income of a plan, a definition of income contained in the plan document would be helpful. Absent such a definition, state law should control, but it may be difficult to ascertain which state. The plan may be subject to a trust or custodial arrangement of a state that is not the state of residence of the trust named as beneficiary or of the state of residence of the QTIP income beneficiary. In the case of defined benefit plans, the concept of income and principal may be completely foreign; however, annuity rules may apply.

State law income and principal rules can be problematical. In California, the general rule is that only 10% of any mandatory withdrawal is deemed to be distributed out of income.[70] The other 90% (or 100% if a discretionary withdrawal) is deemed to be distributed from principal. However, an exception to the general rule directs the trustee to allocate more

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[70] Calif. Probate Code § 16361(c); 1997 Uniform Principal and Income Act § 409(c).

to income to the extent necessary to obtain the marital deduction,[71] which is not terribly helpful since the estate tax marital deduction definition of income depends on state law, here completely undefined. These issues are discussed in more detail in Sections VIII and IX.

In any event, none of this changes the amount of income earned inside of a retirement plan, it just designates how much of any distribution is sourced in income of the plan.

For the sake of providing clarity to the QTIP trust beneficiaries and ensuring the QTIP election, consider including provisions in the QTIP trust that provide for measurement and withdrawal of plan income. A sample form appears in Section IX.

G. Tax Consequences of Income Withdrawal Power.

Revenue Ruling 2000-2 does not discuss whether the survivor's power to take retirement plan income lapses if he or she does not exercise it each year. This factual issue has no bearing on whether the retirement plan qualifies as QTIP property.[72]

A lapsing power may hold a high degree of attraction for those retirement plan participants who want to preserve as much tax deferred growth as possible for the remainder beneficiaries. However, this approach could backfire, since a lapsing income right creates a strong incentive to withdraw income currently.

Another risk is that the power to take retirement plan income could lapse inadvertently due to inattention, lack of tax sophistication or advancing years. There may also be gift tax implications (as discussed in the following paragraphs).

The better plan is to give the surviving spouse a non-lapsing power that allows him or her to leave income in excess of minimum distributions invested in the tax-deferred retirement plan "for a rainy day." This avoids the risks, and also gives the survivor an incentive to postpone retirement plan distributions as long as possible, because the survivor will share the benefits of the additional tax-deferred compounding that results.

Lapse of the survivor's power to take retirement plan income may represent a release of a power of appointment to the extent the amount of retirement income exceeds the greater of $5,000 or five per cent of the trust's value (taking into account retirement plan

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[71] Calif. Probate Code § 16361(c); 1997 Uniform Principal and Income Act § 409(d).

[72] A lapse of the right to withdraw income can occur while still satisfying the QTIP requirement that the surviving spouse be entitled to all income. In describing what meets the definition of "entitled for life to all of the income from the entire interest," Reg. § 20.2056(b)-7(d)(2) adopts the principles of Reg. § 20.2056(b)-5(f). Reg. § 20.2056(b)-5(f)(8) defines the terms "entitled for life" and "payable annually or at more frequent intervals" in the case of property held in trust. In order to meet these definitions, it is required that "under the terms of the trust the income referred to must be currently ([meaning] at least annually...) distributable to the spouse or that [the spouse] must have such command over the income that it is virtually [the spouse's]. *Thus, the conditions ... are satisfied in this respect if, under the terms of the trust instrument, the spouse has the right exercisable annually (or more frequently) to require distribution to herself of the trust income, and otherwise the trust income is to be accumulated and added to corpus."* [Emphasis added.]

assets and other assets).[73] Normally, a release of a power of appointment is a taxable gift, although no taxable gift occurs if the trust grants the survivor a power of appointment over the entire trust, since the gift is incomplete.[74]

To the extent a release of a power of appointment has occurred, at first blush it would seem that the potential amount of the taxable gift under I.R.C. Sections 2511 and 2512 is only the portion that corresponds to the remainder, since the survivor retains the income portion. However, I.R.C. Section 2702 assigns a zero value to a retained income interest causing the full amount subject to the power that was released to be a taxable gift. The gift will not qualify for the annual exclusion under I.R.C. Section 2503, triggering a gift tax filing for each year in which a taxable gift occurs.

The following approaches may avoid a taxable gift with respect to the release of the power to take retirement plan income:

(a) As mentioned above, provide a non-lapsing power.

(b) Grant a limited power of appointment over the trust, or at least over the lapsed amounts. However, this does nothing to remove the incentive to withdraw income during the survivor's lifetime.

(c) Provide that the power does not lapse faster than the lesser of $5,000 or five per cent of the value of the entire trust. Again, this does nothing to remove the incentive to withdraw income during the surviving spouse's lifetime.

H. Ownership Under Grantor Trust Provisions.

The surviving spouse is treated for income tax purposes as if he or she owns:

(a) the portion of the trust income or principal subject to withdrawal in any given year;[75] plus

(b) the portion of the trust principal that corresponds to lapsed withdrawal powers.[76]

As a result, some portion of income and capital gains of the QTIP will be reported by the surviving spouse. Note that the survivor may not necessarily have access to QTIP assets to pay the capital gains taxes arising with respect to the portion of principal that corresponds to lapsed withdrawal powers.

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[73] I.R.C. § 2514(e).

[74] Reg. § 25.2511-2.

[75] I.R.C. § 678(a).

[76] I.R.C. §§ 678(b) and 677(a).

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I. Basis for Inclusion in Survivor's Estate.

A QTIP trust (for which a marital deduction was allowed) is included in the survivor's estate under I.R.C. Section 2044. Any portion of the trust that corresponds to retirement plan income added to corpus can also be included in the survivor's estate:

(a) under the general principles of I.R.C. Section 2033 if the power has not lapsed; or

(b) under I.R.C. Section 2036(a) if the power has lapsed, because of the survivor's retained income interest.

Property that is includible under more than one Section is only counted once.[77] To the extent taxable gifts have occurred, as discussed above, an estate tax adjustment is permitted in order to avoid double counting the gift.

J. "Reverse QTIP" Election.

The Generation Skipping Transfer Tax (GSTT) permits an election to reverse the general rule that the GSTT transferor is the last person subject to either a gift tax or the estate tax on the property. If this so-called "reverse QTIP election" is made, the deceased spouse's election to treat property as QTIP property is ignored for purposes of determining the GSTT transferor.[78]

A properly drafted QTIP trust is not includible in the survivor's estate under any Section of the Internal Revenue Code other than I.R.C. Section 2044, which requires inclusion of property for which a QTIP marital deduction was allowed in the deceased spouse's estate. Thus, if the "reverse QTIP election" is made, the GSTT transferor is determined without regard to inclusion in the survivor's estate under I.R.C. Section 2044 as if the deceased spouse were the last person subject to estate tax on the property.

But what if the surviving spouse's power to withdraw retirement plan income causes portions of the QTIP trust to be includible in the survivor's estate under another Section (*e.g.*, Sections 2033 or 2036(a))? It appears that the benefit of the "reverse QTIP" election is probably lost as to these portions of the trust, since these portions remain includible even if I.R.C. Section 2044 is ignored.

K. Recovery Rights Under Sections 2207A and 2207B.

I.R.C. Section 2207A allows the survivor's estate to recover estate taxes paid by the estate on QTIP trust property included under I.R.C. Section 2044. If a portion of the QTIP trust can also be included under another Section (*e.g.*, Sections 2033 or 2036(a)), does this

[77] Rev. Rul. 82-84, 1982-1 C.B. 134, involving §§ 2033 and 2037. See also Rev. Rul. 75-259, 1975-2 C.B. 361.

[78] I.R.C. § 2652(a)(3)(B); Reg. § 26.2652-2(a).

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diminish the recovery right? No. The only requirement under the statute is that the property be includible under I.R.C. Section 2044.[79]

However, if the property can also be included under I.R.C. Section 2036(a), a right of recovery also exists under I.R.C. Section 2207B. Presumably, the estate could elect to recover under either Section 2207A or Section 2207B, but not both. The right of recovery is calculated differently under these two sections. The Section 2207A recovery calculates the tax on a "marginal" basis, and the Section 2207B recovery calculates the tax on a "pro rata" basis. Thus, the Section 2207A recovery right is likely to be the preferable choice for the estate.

Note that some surviving spouses prefer to modify or elect out of the Section 2207A estate tax recovery by including appropriate language in their wills or trusts.[80] If the language refers only to Section 2207A, the Section 2207B recovery right remains. One possible solution is to refer to the subchapter containing both code sections, as is expressly permitted under the provisions of each. However, this solution may not be enough if the clients wish to preserve the Section 2207B right of recovery with respect to other property that might also be included under Section 2036.

L. Planning Ideas for Second Marriage Estate Plans.

A common, yet difficult, estate planning scenario presents itself when: (i) one or both spouses has children from previous marriages; and (ii) one or both spouses wants to make provision for the other spouse with some sort of remainder interest to those children. Here are a few planning options for this situation:

(a) *The "Honor System."* Under the "honor system," the participant designates his or her spouse, who would then roll over the plan. The surviving spouse is on his or her "honor" to designate the intended remainder beneficiaries as the beneficiaries of the rollover plan.

Only the client can decide if the pros and cons of the honor system are acceptable. The obvious advantage is that this approach is the most tax efficient, if it works. But the clients must understand the many different ways this approach could fail. In particular, the author cautions against any sort of "side agreement," since such an agreement (i) at best, is unenforceable; and (ii) at worst, jeopardizes the survivor's rollover since he or she may not be "treating the account as his or her own."

(b) *"Rough Justice."* The "rough justice" approach involves dividing the retirement plan into two shares; one share is designated outright to the surviving spouse and the other share is designated directly to the remainder beneficiaries. This approach can provide greater benefits after tax to both the spouse and the remainder beneficiaries. It is relatively easy to explain and implement. The primary disadvantage is that the participant

[79] I.R.C. § 2207A(a)(1).

[80] I.R.C. § 2207A(a)(2).

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must set the size of the respective shares during the planning stage, not knowing how much the surviving spouse will really need.

(c) *Aggregate Theory Property Agreement.* For clients with community property, an aggregate theory agreement (discussed at Section ?) may also represent a solution. Such an agreement makes it possible for more of the retirement plan assets to pass to the survivor and more of the non-retirement assets to pass to the QTIP trust.

XIII. PPA of 2006 Allows IRA Rollovers by Non-Spouse Beneficiaries.

Section 829 of the Pension Protection Act of 2006[81] ("PPA") adds I.R.C. Section 402(c)(11),[82] allowing non-spouse beneficiaries to make direct rollovers into individual retirement plans. Important clarifications were issued by the I.R.S. in Notice 2007-7.[83] Here are the specifics of these new rollover provisions:

- Any portion of a deceased employee's **"Eligible Retirement Plan"** (defined below in the context of I.R.C. Section 402(c)(11)),
- That passes to a non-spouse **"Designated Beneficiary"** (defined below in the context of I.R.C. Section 402(c)(11)),
- May be "rolled over" in a direct trustee-to-trustee transfer (sometimes referred to as a "direct rollover"),
- To either an I.R.C. Section 408(a) individual retirement account, or an I.R.C. Section 408(b) individual retirement annuity (collectively, an "IRA"), established for the purpose of receiving the distribution on behalf of the "Designated Beneficiary."[84]
- In the context of I.R.C. Section 402(c)(11), the term **"Eligible Retirement Plan"** refers to any plan that is:
  - (i) an individual retirement account described in I.R.C. Section 408(a);
  - (ii) an individual retirement annuity described in I.R.C. Section 408(b) (other than an endowment contract);
  - (iii) a so-called "qualified plan," *i.e.*, an employees' trust described in I.R.C. Section 401(a), which is exempt from tax under I.R.C. Section 501(a);
  - (iv) an annuity plan described in I.R.C. Section 403(a);
  - (v) an eligible deferred compensation plan described in I.R.C. Section 457(b), which is maintained by an eligible employer described in I.R.C. Section 457(e)(1)(A); or
  - (vi) an annuity contract described in I.R.C. Section 403(b).[85]
- There is an issue as to whether a deceased employee's Roth 401(k) account can be rolled into a Roth IRA. The literal provisions of the statute do not appear to allow this, since they refer to an individual retirement account under I.R.C. Section 408.

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[81] The Pension Protection Act of 2006, P.L. 109-280, 8/17/2006.

[82] Cross-references were also added to I.R.C. Sections 403 and 457.

[83] 2007-5 I.R.B. 395.

[84] I.R.C. § 402(c)(11).

[85] I.R.C. § 402(c)(8)(B).

However, there is language in I.R.C. Sections 408A(a), 408A(b), and 7701(a)(37), that could be argued to support a broader interpretation of the statute that might allow such a rollover. Hopefully, further clarification on this point will be provided sooner rather than later.

- In the context of I.R.C. Section 402(c)(11), the term **"Designated Beneficiary"** is defined by reference to I.R.C. Section 401(a)(9)(E),[86] which refers to "individuals," but has been amplified by regulations to include trusts, or to be more precise, to include certain individual beneficiaries of trusts if specific requirements are satisfied.[87] Notice 2007-7 confirms that an Eligible Retirement Plan may make a direct rollover to an IRA on behalf of a trust named as the beneficiary, provided the trust's beneficiaries meet the requirements under I.R.C. Section 401(a)(9)(E) and Treas. Regs. Section 1.401(a)(9)-4, Q&A-5.[88]

- There is a curious phrase in this section of Notice 2007-7 that requires that a trust must meet the requirements under I.R.C. Section 401(a)(9)(E) and Treas. Regs. Section 1.401(a)(9)-4, Q&A-5 "with respect to the IRA." However, the language of I.R.C. Section 402(c)(11) allows direct rollovers for the benefit of a designated beneficiary of the "employee," indicating that the determination is made with respect to the Eligible Retirement Plan, and not the IRA. This makes more sense. In many cases, the IRA would not and could not exist until the direct rollover occurs, and begins its existence as an "inherited" IRA. However, consider this example: A trust that otherwise meets said requirements will fail to do so with respect to a plan or IRA if certain information is not provided to the plan or IRA on or before October 31 of the calendar year following the year of death.[89] Thus, if the trust provides this information to the plan, but not to the IRA, a direct rollover on behalf of the trust would not be allowed under a literal reading of Notice 2007-7. Your author suggests that the safest approach is to provide the information to both the Eligible Retirement Plan and the IRA.

- A potential problem: As discussed in more detail below, a direct rollover is generally allowed under I.R.C. Section 402(c)(11) on or after January 1, 2007, even if it relates to a death that occurred prior to that date. If a decedent died in 2005, designating a trust as beneficiary of her Eligible Retirement Plan, a literal reading of Notice 2007-7 suggests that a direct rollover on behalf of the trust would not be possible at any time if the required information had not been provided to the IRA by October 31, 2006 (which probably did not happen, especially if the IRA was not yet in existence at that time).

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[86] I.R.C. § 402(c)(11)(A) flush language.

[87] Treas. Reg. § 1.401(a)(9)-4, A-5(b).

[88] Notice 2007-7, 2007-5 IRB 395.

[89] Treas. Reg. § 1.401(a)(9)-4, Q&A-6(b).

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- Notwithstanding the foregoing, any part of a distribution that is required to be currently distributed by the Eligible Retirement Plan under the Minimum Distribution Rules may *not* be rolled over.[90]
- A direct rollover under I.R.C. Section 402(c)(11) is an eligible rollover for purposes of I.R.C. Section 402,[91] and the resulting IRA is treated as an inherited IRA within the meaning of I.R.C. Section 408(d)(3)(C),[92] subject to the minimum distribution rules that generally apply to inherited IRAs.[93]
- Note that once amounts are rolled into the Designated Beneficiary's "inherited IRA," the amounts are no longer in the deceased employee's Eligible Retirement Plan, and further rollovers are not possible. Of course, the inherited IRA can be moved from one financial institution to another, provided it is transferred on a direct "institution to institution" basis.
- There is no time limit under I.R.C. Section 402(c)(11) for the Designated Beneficiary of an Eligible Retirement Plan to make a direct rollover. However, as a practical matter, if a rollover is needed it is likely to best to make the rollover as soon as possible, subject to the issues discussed next.
- A "post-mortem" planning period is generally allowed under the minimum distribution regulations, postponing the final determination of the Designated Beneficiary of plan until the September 30 of the calendar year following the calendar year of death. Although one could argue that it might not be possible to make a rollover prior to the September 30 date, since the identity of the Designated Beneficiary is not certain until then, your author views this position as unnecessarily extreme. Thus, as a practical matter, your author believes (but has no authority to cite) that anyone who is a Designated Beneficiary may proceed at any time. However, in those cases in which a rollover is contemplated, and in which a disclaimer or other post-mortem planning transaction may occur, some careful thought should be devoted to the optimal ordering of these events, and the details of documenting them. Your author anticipates that in most cases, it will be best to complete the post-mortem planning first, and then have those who are the ultimate Designated Beneficiaries proceed with the rollover. Since there is often an advantage to completing the rollover in the year of death (before another minimum distribution for the following year comes due), it may be advisable to proceed quickly with each step of the process.

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[90] I.R.C. § 402(c)(4)(B).

[91] I.R.C. § 402(c)(11)(A)(i).

[92] I.R.C. § 402(c)(11)(A)(ii).

[93] I.R.C. § 402(c)(11)(A)(iii).

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- This provision applies to distributions occurring after December 31, 2006, regardless of whether the employee's death occurred before or after said date.
- "We Were Just Kidding Department" - Part 1: When I.R.C. Section 402(c)(11) was first enacted, there was excitement in financial circles that beneficiaries who would be denied "stretch out" of distributions under the terms of a qualified plan could now use the direct rollover to move their benefit into an IRA that would allow them to take a "stretch out." Notice 2007-7 appears to say this is not so, although the language is subject to interpretation. One thing is clear - if the beneficiary could not have qualified for "stretch out" under the minimum distribution rules with respect to the Eligible Retirement Plan, the direct rollover is not even an option under I.R.C. Section 402(c)(11). Assuming the beneficiary does qualify for "stretch out" (*i.e.*, is a "Designated Beneficiary" in the context of I.R.C. Section 402(c)(11)), but the terms of the plan deny "stretch out" that would otherwise be permissible under the minimum distribution rules, will the direct rollover allow the Designated Beneficiary a full "stretch out"? Notice 2007-7 appears to answer "no."[94] If this is the correct interpretation, one can not help but wonder, why was I.R.C. Section 402(c)(11) enacted at all?
- "We Were Just Kidding Department" - Part 2: Although I.R.C. Section 4029c)(11) makes a direct rollover to an IRA possible for a non-spouse Designated Beneficiary of an Eligible Retirement Plan, the direct rollover is not permissible under the terms of any plan document in effect at the time of enactment, and would only become permissible upon amendment of the plan document. Some plans have chosen not to amend documents in this regard. There is no assurance that plan documents prepared now or in the future will allow a direct rollover.
- California income tax rules will be in conformity with this new rollover provision.[95]

[94] Notice 2007-7, 2007-5 IRB 395, Q&A 17, 18, and 19.

[95] California Rev. & Tax. Code § 17501(b).

XIV. Summary of Other PPA of 2006 Provisions.

Your author has summarized certain provisions of The Pension Protection Act of 2006[96] ("PPA") that may be of interest to estate planners:

A. Roth IRA Conversions from Non-IRA Plans.

Prior to the PPA, only an IRA could be converted to a Roth IRA. A taxpayer who wished to convert any plan other than an IRA had to first roll the plan balance into an IRA and then proceed with the Roth IRA conversion.

PPA 2006 allows direct transfer from any "eligible retirement plan" to a Roth IRA,[97] effective for transfers occurring after December 31, 2007.[98] Such a transfer is taxable to the same extent as if there were no qualified rollover, but the pre-59-½ penalty under I.R.C. Section 72(t) does not apply.[99] The term "eligible retirement plan" currently refers to any plan that is:

(i) an individual retirement account described in I.R.C. Section 408(a);

(ii) an individual retirement annuity described in I.R.C. Section 408(b) (other than an endowment contract);

(iii) a so-called "qualified plan," *i.e.*, an employees' trust described in I.R.C. Section 401(a), which is exempt from tax under I.R.C. Section 501(a);

(iv) an annuity plan described in I.R.C. Section 403(a);

(v) an eligible deferred compensation plan described in I.R.C. Section 457(b), which is maintained by an eligible employer described in I.R.C. Section 457(e)(1)(A); or

(vi) an annuity contract described in I.R.C. Section 403(b).[100]

Prior to the PPA, a conversion of an IRA to a Roth IRA could subsequently be recharacterized by transferring the balance, plus any additional earnings, to an IRA on or before the extended due date of the owner's income tax return. Your author has not yet formed a conclusion as to whether this flexibility extends to conversions from other types of plans under the PPA regime. The Committee Reports state that Roth IRA conversions of non-IRA plans are allowed under the new law, "subject to the present law rules that apply to rollovers from a traditional IRA into a Roth IRA." However, the PPA did not revise I.R.C. Section 408A(d)(6), which refers only to individual retirement plans (*i.e.,* individual

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[96] The Pension Protection Act of 2006, P.L. 109-280, 8/17/2006.

[97] I.R.C. § 408A(d)(3).

[98] 2006 Pension Act §824(c).

[99] I.R.C. § 408A(d)(3)(A).

[100] I.R.C. § 402(c)(8)(B).

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retirement accounts and individual retirement annuities). Perhaps Congress contemplated that a Roth IRA conversion of a non-IRA plan could later be recharacterized by transferring the assets from the Roth IRA to an IRA. Nevertheless, any individual contemplating a conversion from another type of plan should evaluate this issue, and if there is any doubt about the ability to recharacterize later, should evaluate whether it is preferable to first roll the plan balance into a traditional IRA and then convert to a Roth IRA.

B. Roth IRA Conversion Eligibility Requirements.

Roth IRA conversions, regardless of whether from an IRA or non-IRA plan, continue to be subject to requirements that the plan participant satisfy, for the year of conversion, both (i) the adjusted gross income ("AGI") limitation and (ii) the filing status requirement.[101]

1. AGI Requirement.

A taxpayer's AGI must be $100,000 or less[102] for the taxable year to which the conversion relates.[103] The $100,000 limit is applied to single taxpayers, and to married taxpayers on a "per couple" basis (*e.g.*, if husband and wife each have income of $51,000, neither qualifies for a conversion). However, if two spouses live apart for the entire year and file separately, they are treated under this rule as if they were single, and the $100,000 limit is applied on a "per spouse" basis.[104]

AGI is calculated consistent with I.R.C. Section 219(g)(3),[105] except that (i) income created by a Roth IRA conversion is not counted;[106] (ii) deductions for standard IRAs or other retirement plans are ignored;[107] and (iii) beginning in years after 2004, income from "lifetime" minimum distributions is ignored.[108] Note that a beneficiary receiving minimum distributions after the death of the Participant is not allowed to exclude the distribution income from AGI.

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[101] I.R.C. § 408A(c)(3)(B).

[102] I.R.C. § 408A(c)(3)(B)(i).

[103] I.R.C. § 408A(c)(3)(B) was revised by the 98 Act to clarify that these tests must be met for the taxable year to which the conversion relates, even if the actual Roth IRA contribution occurs in the following year. The Roth IRA contribution can occur in the following year if the IRA distribution is taken within the last 59 days of the taxable year, since the taxpayer has 60 days to complete the transaction.

[104] I.R.C. § 408A(c)(3)(D).

[105] I.R.C. § 408A(c)(3)(A) flush language.

[106] I.R.C. § 408A(c)(3)(C)(i).

[107] *Ibid.*, as amended by 98 Act § 6005(b)(1).

[108] I.R.C. § 408A(c)(3)(C)(i)(II), added by 98 Act § 7004(a), effective for taxable years beginning after December 31, 2004.

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2. Filing Status Requirement.

A taxpayer's filing status must not be married filing separately[109] (except that if two spouses live apart for the entire year and file separately, they are treated under this rule as if they were single).[110]

C. Roth IRA Conversion Eligibility Requirements Repealed After 2009.

The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA") repealed the Roth IRA conversion eligibility requirements relating to AGI and filing status, effective for tax years beginning after December 31, 2009.[111] Roth IRA conversions in 2010 are eligible for a "two year spread," whereby half of the income is reported in 2010 and the other half reported in 2011, unless the taxpayer elects otherwise.[112] The election, once made, cannot be changed after the tax return due date.[113]

D. EGGTRA Pension Provisions Made Permanent.

EGGTRA contained numerous pension provisions that were subject to EGGTRA's "sunset" provisions at the end of 2010. The PPA generally made these provisions permanent.[114]

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109 I.R.C. § 408A(c)(3)(B)(ii).

110 I.R.C. § 408A(c)(3)(D).

111 I.R.C. § 408A(c)(3)(B), as amended by Tax Increase Prevention Act §512(a)(1).

112 I.R.C. §408A(d)(3)(A)(iii).

113 *Id.*

114 2006 Pension Act §811.

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XV. PPA of 2006 Allows Direct Rollover to Charity.

The Pension Protection Act of 2006[115] ("PPA") adds I.R.C. Section 408(d)(8), allowing so-called "direct charitable rollovers" from IRAs for a limited time. There have been several unsuccessful attempts to enact such a provision in previous years. Proponents have argued that such a provision is needed so those who wish to make lifetime contributions of IRA funds can do so without being penalized by the cutbacks and limitations that otherwise apply to itemized deductions for charitable contributions. Here are the specifics of the PPA provision that was ultimately enacted:

- A distribution from an IRA owned by an individual after attaining age 70-½ made directly by the IRA trustee or custodian to certain charitable organizations (described below) during the years 2006 and 2007 (a "Qualified Charitable Distribution" or "QCD"), may qualify for special tax treatment as follows.
- "Qualified Charitable Distributions" ("QCDs") made in any taxable year that, in the aggregate, do not exceed $100,000 are excluded from gross income.[116]
- The plan owner does not claim a charitable deduction,[117] and QCDs are not taken into account in determining limitations that might apply to the plan owner's other charitable deductions under Internal Revenue Code Section 170, which imposes deduction limitations based on a percentage of Adjusted Gross Income ("AGI").[118] However, the QCD must satisfy the substantiation requirements that would otherwise apply to support a charitable deduction under I.R.C. Section 170.[119]
- For calendar year taxpayers, the provision is generally limited to distributions occurring during calendar years 2006 and 2007, since the new provision (i) is effective for distributions occurring in taxable years beginning after December 31, 2005,[120] and (ii) does not apply to distributions occurring in taxable years beginning after December 31, 2007.[121]

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[115] The Pension Protection Act of 2006, P.L. 109-280, 8/17/2006.

[116] I.R.C. § 408(d)(8)(A).

[117] I.R.C. § 408(d)(8)(E).

[118] ¶ 5175, Joint Committee on Taxation Report [JCX-38-06].

[119] Notice 2007-7, 2007-5 IRB 395, Q&A-39.

[120] Sec. 1201(c)(1), Pension Protection Act of 2006, P.L. 109-280, 8/17/2006.

[121] I.R.C. § 408(d)(8)(F).

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- Distributions must be from an individual retirement plan (*i.e.*, an individual retirement account or individual retirement annuity), other than a "simplified employee pension"[122] or a "simple retirement account,"[123] to qualify as QCDs.[124]

- A distribution must occur on or after the date on which the "person for whom the plan is maintained" attains age 70-½.[125] Notice 2007-7[126] clarifies that the exclusion is available for QCDs from "any type of IRA" except ongoing SEP IRAs and SIMPLE IRAs, including "inherited" IRAs. In the case of an "inherited" IRA, the individual for whom the inherited IRA is maintained must have attained age 70-½.[127]

- To qualify as QCDs, distributions must be made directly by the plan trustee to so-called "public" charities"[128] (other than so-called "supporting organizations"[129] or "donor advised funds"[130]),[131] and must otherwise be fully deductible.[132] Notice 2007-7 clarifies that a check from an IRA payable to a charitable organization satisfies the direct payment requirement, even if delivered by the IRA owner. As a practical matter, many IRA owners will want to deliver the check to ensure the charitable recipient knows where the gift came from, and to coordinate substantiation paperwork.

- The new provision clarifies that a distribution qualifies as a QCD only if the distribution would otherwise be includible in gross income.[133] Since the general rules governing taxation of distributions require aggregating all IRAs and all distributions as if from one contract,[134] the owner of a plan that includes non-taxable contributions could potentially have a non-taxable component to his or her overall distributions in any year. The new provision addresses this issue by including a special rule that provides (i) for purposes of determining whether a

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122 As defined in I.R.C. § 408(k).

123 As defined in I.R.C. § 408(p).

124 I.R.C. § 408(d)(8)(B) (flush language).

125 I.R.C. § 408(d)(8)(B)(ii).

126 2007-5 IRB 395, Q&A 36-37.

127 *Id.*, Q&A 37.

128 As defined in I.R.C. § 170(b)(1)(A).

129 As defined in I.R.C. § 509(a)(3).

130 As defined in I.R.C. § 4966(d)(2).

131 I.R.C. § 408(d)(9)(B)(i).

132 *I.e.*, fully allowable under I.R.C. § 170, disregarding subsection (b) thereof. See I.R.C. § 408(d)(8)(C).

133 I.R.C. § 408(d)(8)(B) (flush language).

134 I.R.C. § 408(d)(2).

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distribution qualifies as a QCD, the entire distribution is treated as otherwise includible in gross income if it does not exceed the aggregate amount of gross income that would be determined by applying the general rule of aggregation to all distributions; and (ii) for purposes of determining the taxability of other distributions in the current and subsequent years, "proper adjustments shall be made" to recognize the QCD distributions as having come entirely from taxable amounts, thus allocating non-taxable amounts to non-QCD distributions.[135]

- QCDs count towards satisfying minimum distribution requirements.[136]
- California income tax rules will be in conformity with this new charitable rollover provision.[137]

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[135] I.R.C. § 408(d)(8)(D); see also ¶ 5175 of the Joint Committee on Taxation Report [JCX-38-06].

[136] ¶ 5175, Joint Committee on Taxation Report [JCX-38-06].

[137] California Rev. & Tax. Code § 17501(b).

XVI. Case Study: Ms. Wellington.

A. Fact Pattern.

Ms. Wellington owns an estate as follows:

IRA	$ 2,000,000
Liquid Investments	$ 4,000,000
Residence	$ 1,000,000

She wants to make a gift to her favorite "public" charity of $2,000,000 in present value - for non-tax reasons - to help the charity meet a specific funding goal. She wants to know how to maximize what is left for her child. Should she give IRA assets or non IRA assets? Should she make the gift now or at death? She also wants to know what sort of asset base the charity ends up with under the various approaches, assuming the charity has expenditures of about $100,000 a year (indexed).

B. Charitable Gift Strategies Considered.

Strategy	Explanation
(1) Distribute in 2003; Donate to Charity	Ms. Wellington distributes entire IRA in 2003 and donates an equal amount to charity.
(2) Rollover to Charity If Law Allows	If allowed under the tax law, Ms. Wellington makes a "direct rollover" of IRA to charity in 2003. *(Note: This Case Study was prepared prior to enactment of PPA of 2006 and has not been updated. Nevertheless, the results are useful in evaluating planning options under PPA of 2006.)*
(3) Gifts to Charity From IRA Over Deferral Period	Ms. Wellington takes greater of 100k or MRDs and donates like amounts of cash to charity, and designates charity to receive balance of IRA at death.
(4) Gifts to Charity From Non-IRA Cash; Stretch Out for Child	Ms. Wellington takes only MRDs from IRA, and donates greater of MRDs or 100k cash to charity, and provides a comparable gift of non-IRA assets to charity at death, and designates her daughter to receive balance of IRA at death.
(5) Make Gifts With Non-IRA Cash Over Life Expectancy; No Charitable Gift At Death	Same as (4), except Ms. Wellington steps up the annual cash gifts to meet the funding target prior to death, so she can obtain an income tax deduction for all the charitable gifts.

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(6) Make Gifts With Non-IRA Securities Over Life Expectancy; No Charitable Gift At Death	Same as (5), except Ms. Wellington structures the donations to include the maximum deductible portion of marketable securities instead of cash, which in this case works out to be 60% of each donation. The projection assumes that she can select securities with cost basis equal to 10% of current value.

C. Minimum Required Distribution Divisors If Charity Is Designated.

Ms. Wellington - Charitable Gift			
Calendar Year	*Distribution Year*	*Participant's Age*	*Divisor (Charity)*
2008	1	70	27.4
2009	2	71	26.5
2010	3	72	25.6
2011	4	73	24.7
2012	5	74	23.8
2013	6	75	22.9
2014	7	76	22.0
2015	8	77	21.2
2016	9	78	20.3
2017	10	79	19.5
2018	11	80	18.7
2019	12	81	17.9
2020	13	82	17.1
2021	14		8.1
2022	15		7.1
2023	16		6.1
2024	17		5.1
2025	18		4.1
2026	19		3.1
2027	20		2.1
2028	21		1.1
2029	22		1.0

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D. Minimum Required Distribution Divisors If Daughter Is Designated.

Calendar Year	*Distribution Year*	*Participant's Age*	*Beneficiary's Age*	*Divisor (Daughter)*
2008	1	70	35	27.4
2009	2	71	36	26.5
2010	3	72	37	25.6
2011	4	73	38	24.7
2012	5	74	39	23.8
2013	6	75	40	22.9
2014	7	76	41	22.0
2015	8	77	42	21.2
2016	9	78	43	20.3
2017	10	79	44	19.5
2018	11	80	45	18.7
2019	12	81	46	17.9
2020	13	82	47	17.1
2021	14		48	36.0
2022	15		49	35.0
2023	16		50	34.0
2024	17		51	33.0
2025	18		52	32.0
2026	19		53	31.0
2027	20		54	30.0
2028	21		55	29.0
2029	22		56	28.0
2030	23		57	27.0
2031	24		58	26.0
2032	25		59	25.0
2033	26		60	24.0
2034	27		61	23.0
2035	28		62	22.0
2036	29		63	21.0
2037	30		64	20.0
2038	31		65	19.0
2039	32		66	18.0
2040	33		67	17.0
2041	34		68	16.0
2042	35		69	15.0
2043	36		70	14.0
2044	37		71	13.0
2045	38		72	12.0
2046	39		73	11.0
2047	40		74	10.0
2048	41		75	9.0
2049	42		76	8.0
2050	43		77	7.0
2051	44		78	6.0
2052	45		79	5.0
2053	46		80	4.0
2054	47		81	3.0
2055	48		82	2.0
2056	49		83	1.0

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E. Case Study Results - Equal Benefits to Charity.

Ms. Wellington's Case Study introduces a new parameter: whatever charitable gift strategy is chosen, it must satisfy a specific funding target for the charity. Your author ran additional financial calculations to verify that the "pile of money" received by the charity is equal for each strategy. This allows an "apples to apples" comparison of the assets left for the daughter. The following is a summary table showing the present value of the charitable gifts:

Ms. Wellington - Charitable Gift						
Retirement Plan in Yr 2003:	$ 2,000,000					
Deferral Period Ends:	2056					
VALUE OF CHARITY'S ASSETS At End of Deferral Period:	145,468,369	145,468,369	145,468,369	145,468,369	145,468,369	145,468,369
VALUE OF CHARITY'S ASSETS At End of Deferral Period (In Today's Dollars):	66,079,741	66,079,741	66,079,741	66,079,741	66,079,741	66,079,741
% Comparison:	100%	100%	100%	100%	100%	100%

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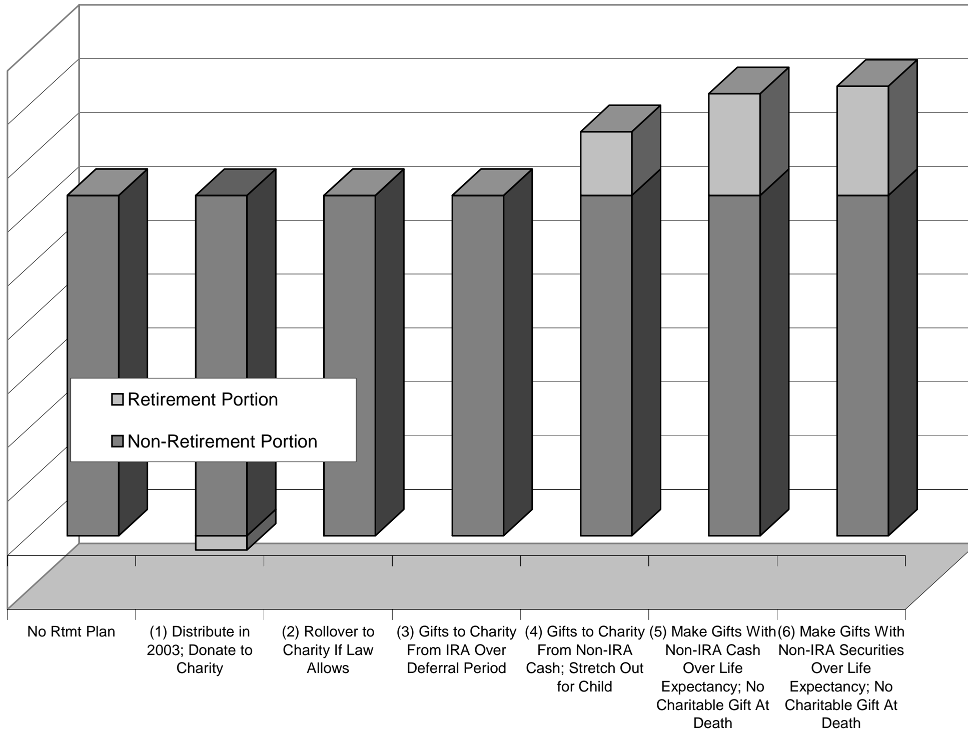
F. Case Study Results - What's Left for Daughter.

Ms. Wellington - Charitable Gift						
Retirement Plan in Yr 2003:	**$ 2,000,000**					
Deferral Period Ends:	**2056**					
Distribution Strategy:	**(1) Distribute in 2003; Donate to Charity**	**(2) Rollover to Charity If Law Allows**	**(3) Gifts to Charity From IRA Over Deferral Period**	**(4) Gifts to Charity From Non-IRA Cash; Stretch Out for Child**	**(5) Make Gifts With Non-IRA Cash Over Life Expectancy; No Charitable Gift At Death**	**(6) Make Gifts With Non-IRA Securities Over Life Expectancy; No Charitable Gift At Death**
VALUE OF CHILD'S ASSETS At End of Deferral Period:	**66,670,364**	**69,557,814**	**69,557,814**	**82,566,298**	**90,356,164**	**91,880,165**
VALUE OF CHILD'S ASSETS At End of Deferral Period (In Today's Dollars):	**30,285,349**	**31,596,988**	**31,596,988**	**37,506,158**	**41,044,744**	**41,737,028**
% Comparison:	**100%**	**104%**	**104%**	**124%**	**136%**	**138%**



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G. Analysis - What Is This Case Study Telling Us.

Your author offers some conclusions about the charitable gift strategies analyzed in the Ms. Wellington case study:

Strategy	Conclusions
(1) Distribute in 2003; Donate to Charity	**Conclusion:** Taking current distribution is the worst choice for Ms. Wellington. Not surprising. This strategy is included for comparison purposes.
(2) Rollover to Charity If Law Allows	Proponents have been fighting for several years for a law change to allow lifetime charitable gifts directly from IRAs. A donor's income tax is likely to be lower if the law change allows her to exclude the IRA distribution, compared to reporting it and taking a charitable deduction. **Conclusion:** The benefit of this law change is slight, only 4% in this case study, or even less compared to the next strategy that stretches charitable gifts over time
(3) Gifts to Charity From IRA Over Deferral Period	**Conclusion:** This approach also provides a 4% benefit, but adds flexibility to make adjustments over time.
(4) Gifts to Charity From Non-IRA Cash; Stretch Out for Child	**Conclusion:** The 24% benefit shows that the IRA is more valuable to daughter than to charity, at least in this case.
(5) Make Gifts With Non-IRA Cash Over Life Expectancy; No Charitable Gift At Death	**Conclusion:** The additional 12% benefit (36% altogether) shows the benefit of the income tax deductions secured by making all of the charitable gifts during life.
(6) Make Gifts With Non-IRA Securities Over Life Expectancy; No Charitable Gift At Death	**Conclusion:** The additional 2% shows (38% altogether) shows the additional benefit of using appreciated securities to fund the charitable gifts. Ms. Wellington had moderate cost basis in her securities. The benefit would be higher for securities with low cost basis.

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XVII. Completing the DB Designation for a Married Participant.

A. "Default" Approach: Retirement Plans.

The "default" approach for a married Participant is to designate the other spouse as primary beneficiary, so that he or she can complete a spousal rollover. The "default" for alternate beneficiaries reflects the same ideas discussed in the prior section, "Completing the DB Designation for Single Participant." In some situations it may be appropriate to add language providing that the Bypass Trust is designated if the spouse disclaims (see sample form below).

B. Spousal Consents.

Retirement plans subject to ERISA require a spousal "waiver and consent" (discussed elsewhere in these materials) whenever a beneficiary other than the spouse is designated. Under the default approach, the spouse is designated and no "waiver and consent" is needed.

California law also requires a spousal consent when a "non-probate asset" is community property and a beneficiary other than the spouse is designated as to more than half of the asset (also discussed elsewhere in these materials). These laws are preempted when a plan is subject to ERISA rules.

In California, a California-type spousal consent is advisable on a non-ERISA plan that is community property, even when the spouse is designated. Specific spousal consent language (illustrated below) must be present if the clients want the Participant to be able to change the death beneficiary designation as to the entire asset if the spouse dies first. Absent specific language, the death beneficiary designation "freezes" as to half.[138]

C. IRA Death Beneficiary Form - Children Designated as Individuals.

IRA DEATH BENEFICIARY DESIGNATION

IRA Owner:	MARK MARRIED
Social Security Number:	______________________________
Birth Date:	______________________________
IRA Custodian:	______________________________
Account Number:	______________________________

[138] California Probate Code § 5023.

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Primary Beneficiary: The IRA Owner hereby designates as Primary Beneficiary:

Name:	MARY MARRIED*
Relationship:	Wife
Social Security Number:	______________________________
Birth Date:	______________________________
Address:	______________________________

* If Mary Married disclaims any part of her interest, the disclaimed interest shall pass instead to the Trustee of the BYPASS TRUST arising under the MARRIED FAMILY REVOCABLE TRUST established April 1, 1994 as amended from time to time.

Alternate Beneficiary: The IRA Owner hereby designates as Alternate Beneficiaries his four children, namely CHILD ONE, CHILD TWO, CHILD THREE, and CHILD FOUR, in equal shares.

If a child predeceases the IRA Owner, the child's share shall be further divided into shares for the child's descendants on the principal of representation or, if none, shall lapse and augment the other shares proportionately.

Each share, if any, for a person who has not attained Twenty-Five (25) years of age at the IRA OWNER'S death shall be held by the person's legal guardian as custodian until the person attains Twenty-Five (25) years of age under the Uniform Transfers to Minors Act. Each share, if any, for a person who has attained Twenty-Five (25) years of age but is "disabled" at the IRA OWNER'S death shall be held for his or her benefit by the then acting Trustee of the MARRIED FAMILY REVOCABLE TRUST established April 1, 1994. A person is "disabled" if he or she suffers from any physical, mental, or emotional condition that renders him or her unable to conduct his or her financial affairs in a prudent and efficient manner and that is likely to extend for a period longer than Ninety (90) days, as evidenced by a written statement of the person's regularly attending physician.

Further Death Beneficiary Designations. This Death Beneficiary Designation shall not be construed as preventing any beneficiary from making further death beneficiary designations after the IRA OWNER'S death.

Assignments. This Death Beneficiary Designation shall not be construed as preventing any custodian or fiduciary holding an interest in this IRA for a person after the IRA OWNER'S death from "assigning" part or all of said interest to said person. ("Assigning" refers to the transfer of ownership and authority over the IRA without making distributions from the IRA.)

State Law Spousal Consent: For purposes of state law, the IRA Owner's wife hereby consents to this beneficiary designation as it pertains to her property interest, if any, in the IRA asset described above at the time of the first spouse's death. The IRA Owner's wife enters into her consent hereunder with full knowledge of the material features of the IRA asset and the nature and relative values of various benefits available under the IRA asset including the potential for appreciation, investment performance, and future contributions. She understands that if the IRA Owner is the first to die, state law may provide that she is to receive all or a portion of the IRA asset and she has made an informed decision to direct her interest under this beneficiary designation instead. She also understands that if she is the first to die, state law may allow her to make her own, unilateral disposition of her interest in the IRA asset under her Will, and she has made an informed decision to direct her interest under this beneficiary designation instead. The IRA Owner and his wife acknowledge that her consent hereunder may be revoked, but they agree that such revocation shall be effective only upon the delivery of a written revocation to the IRA Owner while the IRA Owner is competent and at least three (3) days prior to the IRA Owner's death, and his wife irrevocably waives her rights, if any, arising under applicable state law (*e.g.*, California Probate Code §§ 5030-5032) to revoke the consent in any fashion except as agreed herein. Further, if IRA Owner's wife is the first to die, she authorizes IRA Owner to execute modifications to this beneficiary designation that shall apply to the entire IRA asset including her property interest therein, if any. It is her intention that such authority to execute modifications

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shall satisfy applicable state law requirements (*e.g.*, California Probate Code § 5023(b)(3)) and that her property interest in the asset, if any, shall be deemed transferred to IRA Owner upon her death.

Executed and accepted on this date of August 5, 2002.

____
MARK MARRIED - IRA OWNER

____
MARY MARRIED - SPOUSE

[Notary attestation optional, but suggested]

D. IRA Death Beneficiary Form - Subtrusts Designated.

IRA DEATH BENEFICIARY DESIGNATION

IRA Owner:	MARK MARRIED
Social Security Number:	____________________________
Birth Date:	____________________________
IRA Custodian:	____________________________
Account Number:	____________________________

Primary Beneficiary: The IRA Owner hereby designates as Primary Beneficiary:

Name:	MARY MARRIED*
Relationship:	____________________________
Social Security Number:	____________________________
Birth Date:	____________________________
Address:	____________________________

* If MARY MARRIED disclaims any part of her interest, the disclaimed interest shall pass instead to the Trustee of the BYPASS TRUST arising under the MARRIED FAMILY REVOCABLE TRUST established April 1, 1994 as amended from time to time.

Alternate Beneficiary: The IRA Owner hereby designates as Alternate Beneficiaries the Trustees of the respective DB TRUSTS provided under the MARRIED FAMILY REVOCABLE TRUST established April 1, 1994 for his four children, namely CHILD ONE, CHILD TWO, CHILD THREE, and CHILD FOUR, in equal shares. If a child so named predeceases the IRA Owner that child's share shall be further divided into shares for that child's then living descendants on the principle of representation or, if none, shall lapse and augment the other shares proportionately. Each share so created for a descendant shall be designated for that descendant's benefit to the Trustee of the DB TRUST provided for that descendant under the MARRIED FAMILY REVOCABLE TRUST established April 1, 1994.

Further Death Beneficiary Designations. This Death Beneficiary Designation shall not be construed as preventing any beneficiary from making further death beneficiary designations after the IRA OWNER'S death.

Assignments. This Death Beneficiary Designation shall not be construed as preventing any custodian or fiduciary holding an interest in this IRA for a person after the IRA OWNER'S death from "assigning" part or all of said interest to said person. ("Assigning" refers to the transfer of ownership and authority over the IRA without making distributions from the IRA.)

State Law Spousal Consent: For purposes of state law, the IRA Owner's wife hereby consents to this beneficiary designation as it pertains to her property interest, if any, in the IRA asset described above at the time of the first spouse's death. The IRA Owner's wife enters into her consent hereunder with full knowledge of the material features of the IRA asset and the nature and relative values of various benefits available under the IRA asset

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including the potential for appreciation, investment performance, and future contributions. She understands that if the IRA Owner is the first to die, state law may provide that she is to receive all or a portion of the IRA asset and she has made an informed decision to direct her interest under this beneficiary designation instead. She also understands that if she is the first to die, state law may allow her to make her own, unilateral disposition of her interest in the IRA asset under her Will, and she has made an informed decision to direct her interest under this beneficiary designation instead. The IRA Owner and his wife acknowledge that her consent hereunder may be revoked, but they agree that such revocation shall be effective only upon the delivery of a written revocation to the IRA Owner while the IRA Owner is competent and at least three (3) days prior to the IRA Owner's death, and his wife irrevocably waives her rights, if any, arising under applicable state law (*e.g.*, California Probate Code §§ 5030-5032) to revoke the consent in any fashion except as agreed herein. Further, if IRA Owner's wife is the first to die, she authorizes IRA Owner to execute modifications to this beneficiary designation that shall apply to the entire IRA asset including her property interest therein, if any. It is her intention that such authority to execute modifications shall satisfy applicable state law requirements (*e.g.*, California Probate Code § 5023(b)(3)) and that her property interest in the asset, if any, shall be deemed transferred to IRA Owner upon her death.

Executed and accepted on this date of August 5, 2002.

____
MARK MARRIED - IRA OWNER

____
MARY MARRIED - SPOUSE

[Notary attestation optional, but suggested]

E. Other Nonprobate Assets.

At the risk of going on a tangent, this is a good time to mention that other nonprobate assets deserve attention. For example, any nonprobate asset in California is subject to the spousal consent requirements of Probate Code Sections 5000-5032. The following is a designation attachment for life insurance that represents the "default" approach used by the author.

LIFE INSURANCE DEATH BENEFICIARY DESIGNATION

Owner:	MARK MARRIED
Social Security Number:	555-55-5555
Insurance Company:	Equitable Whole Life Insurance
Policy Number:	____________________

THE OWNER HEREBY DESIGNATES AS DEATH BENEFICIARY:

The Trustee of the MARK AND MARGO MARRIED REVOCABLE TRUST established January 15, 1995.

California Spousal Consent. The Owner's wife hereby consents to this beneficiary designation as it pertains to the Non-Probate Asset described above. She enters into her consent hereunder with full knowledge of the nature and value of this Non-Probate Asset, which is community property. She is also informed that California law may allow her to make her own, unilateral disposition of her interest in the Non-Probate Asset under her Will, and she has made an informed decision to direct her interest under this beneficiary designation, instead. Further, in the event of her death she authorizes Owner to execute modifications to this beneficiary designation that shall apply to the entire Non-Probate Asset. It is her intention that such authority to execute modifications shall satisfy the requirements of Probate Code Section 5023(b)(3) and that her community property interest in the account shall be deemed transferred to Owner upon her death.

Executed and accepted on this date of ________________________.

____

MARK MARRIED - IRA OWNER

____

MARY MARRIED - SPOUSE

[Notary attestation optional, but suggested]

F. Add Clarifying Language to Wills.

The following clause is very important. It clarifies that non-probate assets pass by death beneficiary designation, and not under the Will. The law in California is not clear (discussed elsewhere in these materials), but it is possible that a non-participant spouse has the power to direct his or her community property interest in non-probate assets by Will. If so, it could be argued that the residual gift provided in the Will picks up all of the spouse's interests in non-probate property. This uncertainty is avoided with the following clause.

3.1 Dispose of All Property Other Than Nonprobate Property. I intend to dispose of all property that I can dispose of by Will at the time of my death, except that I intend that any devisable interest I may have in nonprobate community property subject to Sections 5000-5032 of the California Probate Code shall pass in accordance with the beneficiary designation in force at my death, the terms of the applicable agreement(s) governing such property, or both. To the extent such property may pass under my Will, I give my wife absolute ownership of such property, including full power of disposition or, if she does not survive me, such property shall pass as part of the residue of my estate.

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XVIII. Planning to Avoid Waste of the Unified Credit.

The qualified retirement assets are, for more and more clients, the single most valuable asset in the estate. If the entire retirement plan stays with the survivor (either because he or she is the Participant or because he or she takes a rollover), the other assets may be insufficient to fully fund a Bypass Trust, and the first spouse's unified credit may go to waste.

A. Redistribute Assets Among Spouses.

Occasionally, a fact pattern may present itself that allows assets to be transmuted from community property or the separate property of one spouse to that of the other spouse. (However, the author doubts that it is possible to transmute the Participant's retirement plan to the separate property of the NPS, since such a transmutation would be unenforceable in light of the anti-alienability clauses that apply to retirement plans.) This approach often requires "betting" on which spouse will die first, and may produce a negative outcome if the bet does not pan out.

B. Designation of Bypass Trust; Disclaimer.

Another approach is to designate the Bypass Trust to receive all or part of the retirement assets. This decision can be postponed until the first spouse's death by providing in the beneficiary designation that the Bypass Trust is the designated beneficiary if the surviving spouse executes a qualified disclaimer. The portion of retirement assets that passes to the Bypass Trust cannot be rolled over, and the distribution deferral period will be limited. The Bypass Trust may or may not qualify to use the surviving spouse's life for minimum distribution purposes and, in some cases, including a conduit clause may be helpful in this regard. In some cases the benefit of funding the Bypass Trust will be outweighed by the economic advantage of spousal rollover and "stretched out" distributions. Numerical analysis may be necessary to guide the client. In any event, this approach only works if the Participant dies first.

C. Life Insurance Not A Solution.

The author does not believe that life insurance provides a meaningful solution to this dilemma, and may do more harm than good if retirement plan assets are distributed earlier than required to pay premiums.

D. Designate Revocable Trust.

Another approach is to designate the joint revocable trust as the beneficiary. This allows the retirement assets to be included in the pool of assets that are to be divided among the various subtrusts. This approach only works if the Participant dies first, and if the survivor correctly carries out the administration and allocation inside the trust (*i.e.*, if the survivor lacks capacity, the rollover will not occur). Also, since it is the joint revocable trust that is named as beneficiary, the

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joint revocable trust must qualify as a DB upon the first spouse's death. Depending on the nature of subtrusts or other gifts involved, some careful review and drafting may be required.

E. Aggregate Theory Agreement.

This approach is discussed next.

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XIX. How to Obtain A Spousal Rollover And Still Fund the Bypass Trust.

Most estate planners have at one time or another faced a client situation such as that of Ted and Mary Jones, who accumulated $2,000,000 of assets during their long term marriage, including $1,000,000 in Ted's IRA.

Mary as IRA DB. If Ted dies first and Mary is designated, a spousal rollover and "stretched out" deferral period is possible for Mary and the children under the minimum required distribution rules.[139] However, Ted's Bypass Trust is likely to be underfunded, wasting part of his applicable credit for estate tax.[140]

Bypass Trust as IRA DB. If Ted dies first and the Bypass Trust is designated, Ted's applicable credit for estate tax is better utilized; note, however, that if the entire IRA is designated to the Bypass Trust, there is a risk that the Bypass Trust could be over funded resulting in payment of estate tax unless additional safeguards are in place.[141] Another consideration is that Ted's applicable credit may shelter less after-tax assets than one might expect, since (i) IRA distributions are subject to income tax; and (ii) the Bypass Trust must pay income tax at compressed rates on the portion of IRA distributions that are not passed out to Mary. Perhaps the biggest disadvantage of all is that the IRA (or portion thereof) that passes to the Bypass Trust does not enjoy a "stretched out" deferral period, which makes the IRA less valuable to Mary and the children.[142]

Mary Disclaims. If Mary is designated as primary death beneficiary and the Bypass Trust is designated as alternate beneficiary, Mary can evaluate the trade-offs during the nine months following Ted's death, and disclaim accordingly. This solution provides flexibility over time, but still puts Mary to the choice. She may only have one of the two possible benefits, or with a partial disclaimer she may have one benefit on one portion of the account and the other benefit on the other portion. Also, the disclaimed assets may not be subject to a sprinkling power or a limited power of appointment in the Bypass Trust. Further, the plan

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[139] I.R.C. §§ 408(a)(6) and 401(a)(9), and Reg. thereunder, released January, 2001.

[140] The author has run numbers comparing the value of the applicable credit to the value of tax-deferred compounding, and has observed that there is not a wide difference in value. In some cases, the credit is more valuable and in other cases the tax-deferred compounding is more valuable. The author also observes that the applicable credit is not a "sure thing" in light of the uncertainties arising from the 2001 Tax Act. The tax-deferred compounding is a "sure thing," but only if Mary and the children take full advantage by limiting distributions to the minimum amounts.

[141] One safeguard is to include a formula clause in the death beneficiary designation, which some IRA custodians may be reluctant to accept. Another safeguard is to draft the Bypass Trust to be eligible for the marital QTIP election, which causes income on assets that have been sheltered from estate tax to "leak" back into the survivor's estate. The "leakage" problem can be avoided using the "Clayton QTIP" technique.

[142] The author has studied the financial benefits of "stretched out" deferral in great depth, and observes that the long term benefit to family is quite substantial. A dollar that is left in an IRA over a "stretched out" deferral period can become worth two to three times as much, compared to what it is worth if pulled out of the IRA. If grandchildren or a Roth IRA are involved, the multiple is more like five or six times as much.

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only works if Mary affirmatively acts. If she forgets, or is unable to act due to incapacity, the plan fails. One other imperfection is that this solution is only helpful when Ted is the first to die.

Mary Dies First. If Mary dies first, Ted ends up with the IRA and a "stretched out" deferral period will be possible for Ted and the children. However, Mary's Bypass Trust is likely to be underfunded, wasting part of her applicable credit for estate tax.

In Search of the Perfect Solution. Each choice described above for Ted and Mary has its drawbacks. However, another approach may be available. This approach involves orchestrating an "aggregate division" at the first death of all assets so that as much of the retirement plan assets as possible are characterized as the survivor's property and as much of the non-retirement plan assets as possible are characterized as the deceased spouse's property.

Is this approach the Holy Grail that Ted and Mary are seeking? That is the subject of this Section. The balance of this Section reviews the community property origins of this approach, how the technique works, and its availability to couples in common law states. The discussion also analyzes whether the technique exposes the clients to income tax risks, and warns of an important issue that arises in connection with ERISA[143] preemption of state law.

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[143] Employee Retirement Income Security Act of 1974 ("ERISA").

XX. Aggregate Divisions Inside and Outside of Revocable Trust.

There are several ways that, mechanically, an aggregate division of assets could occur. Income tax risks may be present, and these are discussed further below.

A. Inside the Revocable Trust - Participant Dies First.

One way to orchestrate an "aggregate division" is to (i) designate retirement plan assets to pass to a joint revocable trust[144] in which *all* of the non-retirement plan assets are subject to administration at the first death, and (ii) include a clause authorizing non pro rata distributions - but is this a good idea? Actually, yes, in certain situations. Take the Ted and Mary Jones situation for example. If Ted designates the revocable trust that holds the non-retirement assets[145] as the death beneficiary of Ted's IRA and if Ted dies first, the IRA joins the pool of other assets available for funding the Bypass Trust. As a result, it should be possible to fully fund the Bypass Trust with non-IRA assets. But what about the spousal rollover? There are numerous private letter rulings that allowed the surviving spouse to "salvage" a spousal rollover when the revocable trust was designated instead of the surviving spouse.[146] These rulings generally required that the surviving spouse have sufficient control over the trust to allow her to unilaterally allocate the IRA to herself. Thus, if the revocable trust is drafted carefully to fit within these guidelines, and if Mary in fact carries out the plan, she will receive a spousal rollover and *both* benefits will have been accomplished. *Note, however, that designating the revocable trust only works if Ted is the first to die.*

B. Inside the Revocable Trust - Spouse Dies First.

Even if Mary dies first, it might theoretically be possible to accomplish an "aggregate division" inside the joint revocable trust if state law allows Mary to pass an ownership interest in Ted's IRA under her Will.

In the State of Washington, for example, a non-participant spouse's Will may bequeath her one-half community property ownership interest in the other spouse's IRA (or any other plan not subject to ERISA).[147] If Ted and Mary Jones live in Washington and all of their property is community property, Mary could use her power to bequeath her half of the IRA to their joint revocable trust. Then Ted could assign the one-half interest in the IRA to the revocable survivor's trust and other non-retirement assets to the Bypass Trust. Ted could then assign the one-half interest in the IRA from the survivor's trust to himself,

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[144] A revocable trust estate plan is less risky than a Will-based plan since estates cannot be recognized as having a life expectancy under the minimum distribution rules, and since a non pro rata allocation followed by a rollover is more reliable with a revocable trust.

[145] Depending on the circumstances, this may be Ted's trust or this may be a joint revocable trust. Joint revocable trusts are normally associated with community property state jurisdictions, but they are also available to spouses in common law states.

[146] *See for example,* Priv. Ltr. Rul. 90-45-050; Priv. Ltr. Rul. 94-50-041; Priv. Ltr. Rul. 1999-13-048.

[147] RCW § 6.15.020.

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with the end result that he continues to own the entire IRA but a greater amount of non-IRA assets are in the Bypass Trust.

If Ted and Mary live in a community property state, however, they are more likely to be interested in the "inside and outside" approach discussed next.

C. Inside and Outside the Revocable Trust.

It may not be necessary for the retirement plan assets to pass through the revocable trust for there to be an effective "aggregate division." Depending on the state law property rights involved, it may be possible for an estate or joint revocable trust to subject *all* of the non-retirement assets to administration, directing the trustee to allocate them taking into account the retirement plan assets passing outside the estate or trust. For example, if Ted dies first and his IRA passes to Mary, their joint revocable trust could direct that the IRA is counted towards her half of the overall property and that a comparable amount of trust property shall be allocated to the Bypass Trust. Their trust could also provide that, if Mary dies first, the IRA that Ted ends up with is counted towards his half of the overall property and, again, that a comparable amount of trust property must be allocated to the Bypass Trust.

1. State Property Law Rights.

Understanding the applicable state law property rights is essential in determining whether this sort of "inside and outside" approach is possible.

2. Community Property States.

This "inside and outside" approach was first suggested by San Francisco practitioner Keith Bilter.[148] The approach is possible in California (or any other community property state) because each spouse owns an undivided interest in both the retirement and non-retirement assets under community property law, and because *all* of the non-retirement assets are normally subject to administration in the typical California joint revocable trust. In fact, one could view the arrangement as a sort of spousal "partnership" that allows non pro rata distributions to partners at termination.

3. Common Law States.

Are common law states left out in the cold where this technique is concerned? Not necessarily. It may be possible for spouses to affirmatively agree that they jointly own all of their property, both retirement and non-retirement assets,[149] and to structure their estate plan to subject *all* of the non-retirement assets to administration at the first death. Of course, agreements as to property rights are effective in all contexts, *e.g.*

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[148] D. Keith Bilter, *Estate Planning for Community property Qualified Retirement Plan Benefits*, 1993 Estate Planning - U.C.L.A./C.E.B. Institute 685.

[149] Subject to preemption by ERISA, which is discussed later.

divorce, and the income tax risks of this arrangement are different in common law states than in community property states (as will be discussed further below).

Practitioners in common law states should also remember that certain clients may own community property that they brought with them from a community property state. Clients in common law states also have the option of creating community property ownership rights under the elective community property regime of the State of Alaska.

4. Property Agreement May Be Required In Certain States.

Some sort of property agreement is needed to create the appropriate property rights in a common law state. An agreement is also needed in those community property states that direct division of community property at death on an "item by item" basis (the "item theory"), and the agreement directs that the community property shall be divided on an aggregate basis (the "aggregate theory") rather than on an item by item basis.

5. The Jones Example.

Let's review how an "inside and outside" aggregate division works in the case of Ted and Mary Jones:

If Ted dies first, Mary receives the entire IRA of $1,000,000 as the sole death beneficiary. After a spousal rollover, she designates the children as death beneficiaries, and the family enjoys a "stretched out" distribution period. The IRA is counted towards Mary's half of the overall property, and their joint revocable trust directs that a comparable amount of estate or trust assets is counted towards Ted's half, making them eligible for funding his Bypass Trust.

If Mary dies first, Ted continues as the sole owner of the $1,000,000 IRA.[150] He updates the death beneficiary designation to name the children, and the family enjoys a "stretched out" distribution period. The IRA is counted towards Ted's half of the overall property, and their joint revocable trust directs that a comparable amount of estate or trust assets is counted towards Mary's half, making them eligible for funding her Bypass Trust.

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[150] Ted continues as sole owner only if Mary has signed a consent that complies with California law and indicates her intent that Ted be able to do whatever he chooses with the entire account. California Probate Code §§ 5000-5032.

XXI. Income Tax Risks of Aggregate Division.

This Section evaluates the risk that an aggregate division at the first death triggers recognition of income where retirement plans and IRAs are concerned.

A. Not a Disposition Under I.R.C. Section 1001.

Internal Revenue Code Section 1001 directs recognition of gain or loss upon the disposition of property. A sale or exchange may constitute a disposition. In an exchange, the properties exchanged must be "materially different" for the exchange to be a disposition of property under Code Section 1001.[151]

1. Property Division By Spouses.

It is well established that an equal but non pro rata division of community property is not a taxable sale or exchange at divorce,[152] at death,[153] or other event causing division of community property.[154] Similarly, the division of other jointly owned property is not a sale or exchange if the co-owners are (or were) related by marriage.[155]

2. Property Division By Co-Owners Not Related By Marriage.

An equal partition of a specific asset between co-owners who are not related by marriage is not a taxable sale or exchange.[156] A pro rata division of a group of assets among co-owners who are not related by marriage is not a taxable sale or exchange.[157] However, an equal but non pro rata division of group of assets is a taxable exchange among co-owners who are not related by marriage.[158]

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[151] *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (4/17/1991); Reg. § 1.1001-1(a).

[152] *United States v. Davis*, 370 U.S. 65 (1962) pp. 69-70; Rev. Rul. 76-83, 1976-1 C.B. 213; Priv. Ltr. Rul. 85-16-095; Priv. Ltr. Rul. 84-48-066; Priv. Ltr. Rul. 84-51-076; Priv. Ltr. Rul. 84-45-049; Priv. Ltr. Rul. 84-34-088; Priv. Ltr. Rul. 84-18-033; Priv. Ltr. Rul. 78-29-072.

[153] Priv. Ltr. Rul. 80-16-050; Priv. Ltr. Rul. 1999-25-033, approving a non pro rata division of IRA and other assets held in a joint revocable trust at first spouse's death.

[154] Priv. Ltr. Rul. 86-33-027; Priv. Ltr. Rul. 80-37-124; Priv. Ltr. Rul. 80-07-024 (non pro rata allocation during marriage or property including IRAs); Priv. Ltr. Rul. 80-03-109 (non pro rata allocation during marriage of retirement plans).

[155] Rev. Rul. 81-292, IRB 1981-50, p. 11; GCM 37716 (10/05/78); GCM 38640 (02/20/81); Priv. Ltr. Rul. 85-12-098; *see* Asimow, *The Assault On Tax-Free Divorce: Carryover Basis and Assignment of Income,* 44 Tax Law Rev. 65 (1988), pp. 66-67.

[156] Rev. Rul. 56-437, 1956-2 CB 507.

[157] Rev. Rul. 90-7, 1990-1 CB 153.

[158] Rev. Rul. 79-44, 1979-1 CB 265; Rev. Rul. 73-476, 1973-2 C.B. 300.

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B. Assignment of Income Doctrine.

The assignment of income doctrine originated to prevent the taxpayer who earns income (or owns an income producing asset) from shifting the income to another.[159] The assignment of income doctrine does not apply to the transfer of an interest in a retirement plan or IRA at divorce or death, since these transfers are governed by a specific statutory framework under Internal Revenue Code Sections 402 and 414.[160]

C. Not a Plan Distribution Under I.R.C. Section 402.

The non pro rata division of property at divorce, part of which is an IRA or qualified retirement plan, is not a distribution for purposes of Internal Revenue Code Section 402.[161]

D. Not a Transfer Under I.R.C. Section 691(a)(2).

Internal Revenue Code Section 691(a)(2) directs recognition of income upon the transfer of a right to receive I.R.D.[162] The Service ruled in Private Letter Ruling 1999-25-033 that the proposed non pro rata distribution was not a "transfer" within the meaning of Code Section 691(a)(2).[163]

E. Two Favorable Private Rulings.

Two private letter rulings were issued in 1999, each involving an aggregate division of property, including IRAs, inside a joint revocable trust. The I.R.S. ruled in each ruling that the proposed non pro rata allocation of trust assets was not a disposition under Internal Revenue Code Section 1001. The analysis in Private Letter Ruling 1999-12-040 focused on whether the proposed non pro rata distribution resulted in a distribution of assets from the trust that was "materially different" than the required funding under the

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[159] *Lucas v. Earl*, 281 U.S. 111 (1930); *see* Asimow, *The Assault On Tax-Free Divorce: Carryover Basis and Assignment of Income*, 44 Tax Law Rev. 65 (1988), pp. 85-89, for a comprehensive review of the history of the assignment of income doctrine.

[160] Priv. Ltr. Rul. 93-40-032. However, the assignment of income doctrine was applied to the assignment of deferred compensation at divorce on the grounds that such an assignment is not governed by a specific statutory framework, consistent with the I.R.S. ruling position that I.R.C. § 1041 only applies to "gain" or "loss" between spouses and not ordinary income. This ruling position is probably incorrect. *Balding v. Commissioner*, 98 T.C. 368 (March 31, 1992). *See also* Priv. Ltr. Rul. 94-36-051 (assignment of income doctrine applied to reorganization of deferred compensation plan but not qualified retirement plans).

[161] Priv. Ltr. Rul. 84-34-088; Priv. Ltr. Rul. 84-45-049; Priv. Ltr. Rul. 84-48-066; Priv. Ltr. Rul. 84-51-076; Priv. Ltr. Rul. 85-16-095 (community property states); Priv. Ltr. Rul. 85-12-098 (common law state);

[162] Although not an issue in the ruling request, I.R.C. § 691(a)(2) provides that the term "transfer" does not include, "transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent."

[163] Priv. Ltr. Rul. 1999-25-033.

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trust, and concluded it was not.[164] The analysis in Private Letter Ruling 1999-25-033 considered whether the proposed non pro rata distribution was an exchange, and concluded it was not since the proposed non pro rata distribution was an equal but non pro rata division of community property.[165]

F. The Dark Horse: The Roth IRA.

The income tax risks, if any, can be avoided altogether if the only retirement plans involved in the aggregate division are Roth IRAs, since those accounts are entirely non-taxable.

[164] Priv. Ltr. Rul. 1999-12-040, citing *Cottage Savings Association v. Commissioner*, *supra.*

[165] Priv. Ltr. Rul. 1999-25-033, citing Revenue Ruling 76-83, 1976-1 C.B. 213.

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XXII. Impact of ERISA on Aggregate Division.

There is another obstacle that should also be considered before proceeding with an aggregate division: the spousal rights under ERISA that preempt state property law, as articulated by the U. S. Supreme Court in *Boggs v. Boggs*.[166] For purposes of this article, *Boggs* can be summarized as holding that interests in ERISA retirement plans pass at death according to federal law, rather than the state law that might otherwise apply. One of the arguments raised by the losing side in *Boggs* was that even if federal law causes part or all of the retirement plan to pass differently than if state law applied, a "compensating adjustment" (this is the author's term) should be allowed under state community property law to accomplish an even division of community property. The Supreme Court rejected this argument.

What does this have to do with an aggregate division? Let's go back to the Ted and Mary Jones example, but with an ERISA 401(k) plan instead of an IRA. Ted and Mary's estate plan calls for an aggregate division. If Ted dies, Mary receives the 401(k) plan, as she should under ERISA. But if the trust allocates the entire $650,000 trust estate to the Bypass Trust, it is taking something away from Mary that she is entitled to under ERISA.

The only effective way to direct an interest away from the Participant's spouse in an ERISA retirement plan is to accomplish a valid waiver and consent with respect to said interest. Thus, a married couple who include an aggregate division as part of their estate plan should also include an ERISA waiver and consent if there is any chance that they might have an interest in an ERISA retirement plan. Sample waiver and consent clauses are included in the Aggregate Theory Property Agreement sample form further below.

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[166] 117 S. Ct. 1754 (1997).

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XXIII. Other Benefits of Aggregate Division.

A. Second Marriages, Rollovers, and QTIPs.

It is the second marriage for Mike and Cindy Henderson, and each has children from a prior marriage. Each spouse wants his or her assets to pass to a QTIP trust at death for the survivor and then his or her children from the prior marriage. They have accumulated $4,000,000 of assets, including $1,200,000 in Cindy's IRA. All property is community property.

Absent an aggregate division, they must choose between the "stretched out" deferral period and the QTIP planning they would otherwise prefer. If Cindy's IRA is designated to Mike, and she dies first, a spousal rollover and "stretched out" deferral period is possible for Mike and his children, but Cindy's QTIP trust will be underfunded. If Cindy's IRA is designated to her QTIP Trust, her QTIP will be fully funded, but the "stretched out" deferral period will be lost. Also, IRA distributions above and beyond the minimum required distributions may be required to ensure the QTIP qualifies for the marital deduction, and the income tax on IRA distributions that are not passed out to Mike may be higher due to the trust's compressed income tax brackets.

Here is what happens if their estate plan includes an aggregate division inside and outside of their joint revocable trust:

If Cindy dies first, Mike receives the entire IRA of $1,200,000 as the sole death beneficiary. After a spousal rollover, he designates his children as death beneficiaries, and they enjoy a "stretched out" distribution period. Since $1,200,000 of IRA passes to Mike, the next $1,200,000 of trust assets is deemed to represent Cindy's half of community property, along with half of any assets in excess of $1,200,000, and are eligible for funding her Bypass Trust and QTIP Trust. Thus, her Bypass and QTIP Trusts receive a combined $2,000,000, and only $800,000 of estate or trust assets pass to Mike. Mike's $1,200,000 IRA and $800,000 of other assets also totals $2,000,000.

If Mike dies first, Cindy continues as the sole owner of the $1,200,000 IRA.[167] She updates the death beneficiary designation to name her children, and they enjoy a "stretched out" distribution period. Since Cindy ends up with the $1,200,000 IRA, the next $1,200,000 of estate or trust assets is deemed to represent Mike's half of community property, along with half of any assets in excess of $1,200,000, and are eligible for funding his Bypass Trust and QTIP Trust. Thus, his Bypass and QTIP Trusts receive a combined $2,000,000, and only $800,000 of estate or trust assets pass to Cindy. Cindy's $1,200,000 IRA and $800,000 of other assets also totals $2,000,000.

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[167] In California, Cindy continues as sole owner only if Mike has signed a consent that complies with California law and indicates her intent that Cindy be able to do whatever he chooses with the entire account. California Probate Code §§ 5000-5032.

B. Special Basis "Step Up" for Marital Gifts After 2009.

An aggregate division may make it possible for a couple to position more of their non-retirement assets to qualify for the $3.5 million basis step up for marital gifts under the rules added by the 2001 Tax Act.[168]

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[168] Economic Growth and Tax Relief Reconciliation Act of 2001.

XXIV. Sample Forms.

A. Aggregate Theory Agreement.

The following form illustrates an agreement that facilitates an aggregate division under the community property laws of California.

PROPERTY AGREEMENT

GEORGE E. CLIENT AND PATRICIA ANN CLIENT

This Agreement is entered into this date by George E. Client ("Husband") and Patricia Ann Client ("Wife"), sometimes referred to collectively as the "Parties."

RECITALS AND TERMS

Trust Agreement. The Parties have entered into a revocable trust agreement established on February 2, 1996 known as the G. and P. Client Living Trust (hereafter, the "Trust").

First Death; Surviving Spouse. The term "First Death" refers to the death of the first Party to die. The term "Surviving Spouse" refers to the surviving Party. The term "Deceased Spouse" refers to the first Party to die.

Husband's Retirement Proceeds. At the date of this Agreement three retirement accounts are maintained in the Husband's name as set forth in "Exhibit A." Such accounts, including any successor accounts, and any IRA or Roth IRA accounts that may exist in Husband's name at the First Death are hereafter referred to as "Husband's Retirement Proceeds."

Wife's Retirement Proceeds. At the date of this Agreement no retirement accounts are maintained in the Wife's name. Any IRA or Roth IRA accounts that may exist in Wife's name at the First Death are hereafter referred to as "Wife's Retirement Proceeds."

Community Retirement Proceeds. For convenience, the term "Community Retirement Proceeds" refers to both Husband's Retirement Proceeds and Wife's Retirement Proceeds.

Community Property Estate. The term "Community Property Estate" refers to the Community Retirement Proceeds and all other property that is the community property of Husband and Wife at the First Death.

Probate Community Property. The term "Probate Community Property" refers to the portion of the Community Property Estate that is subject to probate at the First Death (including property subject to probate by election of the Surviving Spouse).

Trust Community Property. The term "Trust Community Property" refers to the portion of the Community Property Estate that is held in the Trust at the First Death or that passes to the Trust by reason of the First Death, other than the Probate Community Property.

Parties' Estate Planning Objectives. The Parties desire to enter into a comprehensive agreement concerning the following estate planning objectives: (i) the Parties wish to clarify the status of their various property interests; and (ii) the Parties wish to provide for and facilitate the division of their Community Property Estate when the community terminates on the death of either of them in a manner that results in the allocation of all Community Retirement Proceeds to the Surviving Spouse, but that still results in a division of the Community Property Estate between the Deceased Spouse and the Surviving Spouse that is as equal as possible in aggregate value of assets allocated to each, and (iii) the Parties intend to transmute to community property all joint tenancy property (real or personal) that they own together, except for certain specific assets as provided herein.

AGREEMENT

In order to give effect to their intent, the Parties hereby agree as follows:

[Sections A. - D. *reserved*]

E. Non Pro Rata Division at First Death. The Trust Community Property and the Probate Community Property may be divided in a non pro rata manner at the First Death without the consent of the Surviving Spouse.

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The Parties shall take any action necessary to cause (i) the Trust to grant the trustee the discretion to make a non pro rata division of the Trust Community Property; and (ii) each Party's Will to grant discretion to the Executor to make a non pro rata division of the Probate Community Property.

Further, the Community Retirement Proceeds, the Trust Community Property, and the Probate Community Property shall be divided on a non pro rata basis to the extent necessary to characterize

[Author's Note: Use the following language if funding maximum to Bypass/QTIP and client is not worried about income tax risk:]

the largest possible portion (up to the whole thereof) of the Trust Community Property and the Probate Community Property, in the aggregate, as the Deceased Spouse's share of the Community Property Estate. Said portion shall be determined by valuing assets at their federal estate tax values on the date of the First Death (even if the "alternate valuation date" is elected on the Deceased Spouse's estate tax return).

[Author's Note: Use the following language if funding Bypass only and client wants to hedge income tax risk:]

no less than the smallest possible portion of the Trust Community Property and the Probate Community Property, in the aggregate, necessary to allow maximum utilization of the Deceased Spouse's credits against federal estate tax as the Deceased Spouse's share of the Community Property Estate. Said portion shall be determined (i.e., calculating the Deceased Spouse's estate tax and estate tax credits, and setting the size of the portion) by valuing assets at their federal estate tax values on the date of the First Death (even if the "alternate valuation date" is elected on the Deceased Spouse's estate tax return).

[Author's Note: Use the following language if funding Bypass and Exempt QTIP only and client wants to hedge income tax risk:]

no less than the smallest possible portion of the Trust Community Property and the Probate Community Property, in the aggregate, necessary to allow both (i) maximum utilization of the Deceased Spouse's credits against federal estate tax; and (ii) maximum utilization of the Deceased Spouse's generation skipping tax exemption; as the Deceased Spouse's share of the Community Property Estate. Said portion shall be determined (i.e., calculating the Deceased Spouse's estate tax and estate tax credits, and setting the size of the portion) by valuing assets at their federal estate tax values on the date of the First Death (even if the "alternate valuation date" is elected on the Deceased Spouse's estate tax return).

[Author's Note: It is helpful to clarify what adjustment, if any, applies in comparing the values of "IRD" and "non-IRD" assets.]
For purposes of this Agreement, retirement proceeds or other assets shall be valued without any downward adjustment for income tax that may be payable and without any upward adjustment for the potential benefit of tax-deferred compounding that may occur.

F. Beneficiary Designations and Consents. To facilitate said non pro rata division:

1. Husband's Retirement Proceeds. Wife shall be designated as the primary death beneficiary of Husband's Retirement Proceeds so that if Husband is the first spouse to die, Wife shall become the sole owner of Husband's Retirement Proceeds. Further, if Wife is the first to die, Husband shall continue as the sole owner of Husband's Retirement Proceeds by operation of Wife's "modification type" death beneficiary designation consent under California Probate Code Section 5023(b)(3), which Wife makes herein. Wife hereby agrees to execute any documents necessary to maintain said consent now or in the future.

2. Wife's Retirement Benefits. Husband shall be designated as the primary death beneficiary of Wife's Retirement Proceeds so that, if Wife is the first spouse to die, Husband shall become the sole owner of Wife's Retirement Proceeds. Further, if Husband is the first to die, Wife shall continue as the sole owner of Wife's Retirement Proceeds by operation of Husband's "modification type" death beneficiary designation consent under California Probate Code Section 5023(b)(3), which Husband makes herein. Husband hereby agrees to execute any documents necessary to maintain said consent now or in the future.

G. Wife's Federal Law Consent to Non Pro Rata Allocation. Wife acknowledges her understanding that the provisions of this Agreement may result in a waiver by Husband of benefits due Wife from that portion, if any, of Husband's Retirement Proceeds that is governed by federal law, since under federal law Wife may be entitled to receive Husband's Retirement Proceeds as well as her one-half of all other community property assets, and Wife

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knowingly enters her consent to said waiver. Husband and Wife acknowledge that Husband has received and made available to Wife a general description of the material features of Husband's Retirement Proceeds and an explanation of the relative values of the optional forms of benefit available under Husband's Retirement Proceeds. Wife acknowledges she is informed as to the nature and value of the benefits and other assets affected by Husband's waiver, including the potential for appreciation, investment performance, and future contributions.

H. Husband's Federal Law Consent to Non Pro Rata Allocation. Husband acknowledges his understanding that the provisions of this Agreement may result in a waiver by Wife of benefits due Husband from that portion, if any, of Wife's Retirement Proceeds that is governed by federal law, since under federal law Husband may be entitled to receive Wife's Retirement Proceeds as well as his one-half of all other community property assets, and Husband knowingly enters his consent to said waiver. Husband and Wife acknowledge that Wife has received and made available to Husband a general description of the material features of Wife's Retirement Proceeds and an explanation of the relative values of the optional forms of benefit available under Wife's Retirement Proceeds. Husband acknowledges he is informed as to the nature and value of the benefits and other assets affected by Wife's waiver, including the potential for appreciation, investment performance, and future contributions.

I. Wife's California "Modification Consent" to Beneficiary Designation. Wife hereby enters her California law consent to each beneficiary designation made now or in the future with respect to any of Husband's Retirement Proceeds that designate Wife as the sole primary death beneficiary. Further, if Wife is the first to die, she authorizes Husband to execute modifications to any or all of said beneficiary designations that shall apply to the entire account(s), including her property interest therein, if any. It is her intention that such authority to execute modifications shall satisfy the requirements of California Probate Code Section 5023(b)(3) or similar laws in other states and that her property interest in the account, if any, shall be deemed transferred to Husband upon her death. Wife enters into her consent hereunder with full knowledge of the material features of Husband's Retirement Proceeds and the nature and relative values of the various benefits available under Husband's Retirement Proceeds, including the potential for appreciation, investment performance, and future contributions. She understands that if she is the first to die, state law may allow her to make her own, unilateral disposition of her interest in Husband's Retirement Proceeds under her Will, and she has made an informed decision to direct her interest to Husband instead.

J. Husband's California "Modification Consent" to Beneficiary Designation. Husband hereby enters his California law consent to each beneficiary designation made now or in the future with respect to any of Wife's Retirement Proceeds that designate Husband as the sole primary death beneficiary. Further, if Husband is the first to die, he authorizes Wife to execute modifications to any or all of said beneficiary designations that shall apply to the entire account(s), including his property interest therein, if any. It is his intention that such authority to execute modifications shall satisfy the requirements of California Probate Code Section 5023(b)(3) or similar laws in other states and that his property interest in the account, if any, shall be deemed transferred to Wife upon his death. Husband enters into his consent hereunder with full knowledge of the material features of Wife's Retirement Proceeds and the nature and relative values of the various benefits available under Wife's Retirement Proceeds, including the potential for appreciation, investment performance, and future contributions. He understands that if he is the first to die, state law may allow him to make his own, unilateral disposition of his interest in Wife's Retirement Proceeds under his Will, and he has made an informed decision to direct his interest to Wife, instead.

K. Binding Agreement. This Agreement shall be binding on the administrators, executors, successors, and assigns of the Parties hereto.

L. Written Modifications. The Parties acknowledge that this Agreement is the only Agreement between them. Any modifications or changes to this Agreement must be in writing, must make specific reference to this Agreement, and must be executed by each Party. If a Party is unable to so execute a modification or change by reason of incapacity, such modification or change may be executed only by a court-appointed conservator of such Party's estate or by an agent under such Party's Power of Attorney that specifically grants the agent the power to do so.

M. Separability. If any provision or part of a provision of this Agreement shall be determined to be void or unenforceable by a court of competent jurisdiction, the remainder of the Agreement shall remain valid and enforceable.

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N. **California Law.** All matters pertaining to the validity, construction, interpretation, and effect of this Agreement shall be governed by the laws of the State of California.

O. **Waiver of Nonmarital and Other Rights.** Each Party acknowledges that he or she has had the opportunity to discuss with an independent attorney the rights that each may have gained by reason of contracts between them, their nonmarital relationship, past conduct, and statements made orally to each other; and by this Agreement each of them waives and renounces all claims, interests, or rights that he or she might have acquired by reason of any such contracts, relationships, conduct, or statements.

P. **Representation by Attorney.** George E. Client and Patricia Ann Client have consented to joint representation by Anglin, Flewelling, Rasmussen, Campbell & Trytten LLP, Pasadena, CA 91101, for purposes of drafting and reviewing the contents of this Agreement. In view of the possibility of conflicting legal and property interests between the Parties, each Party has been encouraged to obtain independent counsel to advise him or her concerning this Agreement and each Party knowingly and voluntarily waives the right to do so.

Executed and accepted this _____ day of June, 2003.

____

George E. Client - Husband

____

Patricia Ann Client - Wife

State Of California)
) ss.
County Of _______________)

On _____________, 2003, before me, a notary public in and for said county and state, personally appeared George E. Client and Patricia Ann Client, personally known to me (or proved to me on the basis of satisfactory evidence) to be the persons whose names are subscribed to the within instrument and acknowledged to me that they executed the same in their authorized capacities, and that by their signatures on the instrument the persons, or the entity upon behalf of which the persons acted, executed the instrument.

WITNESS my hand and official seal.

____

B. Language To Be Included in Joint Revocable Trust.

The following language should be included in the joint revocable trust to clarify how the Trustee must allocate property:

Upon the death of the Deceased Settlor, the Trustee shall divide the trust estate, including such items of property as may be received by reason of such death, into three shares as follows:

4.1 **First Allocation.** First, the Trustee shall establish the "Survivor's Trust" and allocate to it the following property:

(a) the Deceased Settlor's interest in all automobiles held for personal use, boats, silver, books, pictures, works of art, furniture, furnishings, clothing, jewelry, personal effects and all similar items of tangible personal property, together with any insurance policies covering the foregoing;

(b) all of the Surviving Settlor's separate property, if any; and

(c) the Surviving Settlor's community property interest in the trust estate, after taking into account any written agreement between the Settlors providing for a non pro rata division of their community property and the effect of such agreement on property passing under the trust and outside of the trust. The Trustee may select the assets to be so allocated, and in so doing is specifically authorized to allocate community property in the trust in a non pro rata manner, but such assets as are selected shall be valued at the date or dates of their allocation.

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The Trustee shall hold and distribute the items allocated to the Survivor's Trust on the terms and conditions set forth in Section 4.4 below.

C. Language To Be Included in Wills.

The following language should be included in the Wills to clarify how the Executor must allocate property, if any:

2.2 Non Pro Rata Division of Community Property. My Executor may divide community property subject to probate jurisdiction (including property not passing under my Will but subject to probate jurisdiction by election of my wife) in a non pro rata manner, and shall take into account any written agreement between my wife and I providing for a non pro rata division of our community property and the effect of such agreement on community property passing elsewhere (i.e., by trust or other nonprobate transfer). My Executor shall have the discretion to select the assets to be so allocated. For purposes of dividing community property, my Executor shall value assets as are selected at the date of my death (even if the "alternate valuation date" is elected on the estate tax return).

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XXV. Additional Comments On Aggregate Theory Agreements in California.

A. California Applies Item Theory At Death.

The case law of California applies the "item theory" in determining the manner in which community property is to be divided upon the death of the first spouse.[169] The item theory is premised on the concept that each spouse owns an undivided interest in each community property asset.[170]

B. California Allows Written Aggregate Theory Agreement.

Under an aggregate theory, each spouse is entitled to a one-half interest in the entire community, but not necessarily on an asset by asset basis. It is well established that a trial court in a marital dissolution proceeding may, where economic circumstances warrant, award community property assets on a non-prorata basis to effect a substantially equal division of the community estate. Family Code Section 2601.[171] Where interests in retirement plan benefits are concerned, the trial court in a marital dissolution proceeding is specifically authorized to exercise broad discretion in fashioning the community property division.[172]

California Probate Code Section 100 specifically provides that spouses may agree in writing that the aggregate theory may be applied at death.[173] This recent enactment removes any doubt as to the spouses' ability to do so; such an agreement was probably effective under prior law. It is doubtful that one spouse can unilaterally impose the aggregate theory upon the other,[174] although a unilateral disposition based upon an aggregate theory was

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[169] For an excellent outline on this subject, see the course materials prepared by Professor Jerry A. Kasner, *Non-Prorata Distributions Of Community Property,* So. Cal. Tax & Estate Planning Forum (March, 1992); see also, Reppy and Samuel, *Community Property Law In The United States,* Third Edition, pp. 19-5 through 19-7; Blumberg, *Community Property in California,* pp. 592-593; *Dargis v. Patterson,* 176 Cal. 714, 169 P. 360 (1917); *Estate of Wilson,* 183 Cal.App.3d 67, 227 Cal. Rptr. 794 (1986).

[170] For example, in *Estate of Wilson, supra.*, a dispute arose after the husband's death as to the distribution of certain Totten trust accounts which consisted of community property and named his children as beneficiaries. The husband's will left his interest in all other community property to the wife. The children argued that their interests in the accounts were less than one-half of the community in the aggregate, and that the husband had a right to pass the entire accounts to them. The trial and appellate courts rejected this argument, holding that the wife owned one-half of each Totten trust account, and that only the other one-half was to be distributed to the Totten beneficiaries. (It is interesting to note that the appellate decision in *Wilson* relies on a line of cases in which one spouse acted during his or her lifetime to effect a gift without the knowledge of the other spouse.)

[171] Which continues former Civil Code § 4800(b) without substantive change.

[172] Family Code § 2610.

[173] Amended by A.B. 2069 enacted September 21, 1998.

[174] For example, if the decedent spouse in the *Wilson* case discussed in footnote 57 of this article had the ability unilaterally to dispose of a given asset, the surviving spouse would be forced to take other assets which might not (for any number of reasons) be as desirable.

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upheld where the surviving spouse had an election to take against the will or other dispositive instrument.[175]

Is a separate ATA really necessary, or could it be combined with the revocable trust instrument? The combined approach is effective, provided (i) the trust is a joint trust, and (ii) the trust instrument is an agreement and not a declaration. However, the author prefers the separate approach because it better highlights to the couple that they are adding special provisions to their estate plan.

C. Non-Prorata Distribution Clause Distinguished.

Regardless of whether or not an ATA exists, when drafting a joint revocable trust, your author has always been conscious that a standard non-prorata distribution clause might be insufficient to override the surviving spouse's ownership interests in each item of property. Probate Code Section 104.5 has resolved this point, and now provides a presumption that the aggregate method is used inside a trust unless the Settlors specifically opt out.

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[175] *Estate of Brubaker,* 21 Cal.App.3d 768, 98 Cal. Rptr. 762 (1971)

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