EXECUTIVE SUMMARY:

Naming the family revocable trust as the beneficiary of one's IRA often seems the most practicable and logical alternative. The client may well have spent significant time and effort (not to mention fees) in deciding upon the various alternatives on how to transfer the family assets down to the children and to do it in the most tax efficient way. Private Letter Ruling 201021038 provides an excellent example of the various traps for the unknowledgeable when such trust is indeed listed as the IRA beneficiary. This PLR underscores the differences between "conduit" provisions and "accumulation" provisions, and between "contingent beneficiary" and "successor beneficiary." It demonstrates how that commonly used "power of appointment" results in having to consider "undesirable" beneficiaries for IRA distribution purposes. The PLR strongly expresses the view of the IRS that the rule in the Regulations that dictates that to be a "designated beneficiary" such beneficiary must be so listed on the beneficiary form as of the date of death of the IRA owner cannot be altered. Finally, the PLR points out the clear jurisprudence that permits the IRS to ignore and disregard a state court order that attempts to retroactively name a beneficiary effective as of the date of death.

FACTS:

Dad and Mom created a revocable trust as part of their estate plan and restated it at some later date ("Restated Trust"). The Restated Trust had fairly typical provisions in that on the first death, the trust would divide into the traditional Survivor's trust, Bypass trust, Marital Deduction trust and a Disclaimed Property trust.

The key subtrust of this PLR was the Bypass Trust. Under its terms, the Trustee shall distribute income from the Bypass trust in installments, at least quarterly, for the health care, maintenance, support and welfare of the beneficiary of the Bypass Trust but only if other resources are clearly inadequate. The beneficiary of the Bypass trust (i.e. the surviving spouse) possessed the power to allocate principal from the Bypass Trust to the "Secondary Beneficiaries" of the Bypass Trust and their descendants as long as such grantor beneficiary remained competent. The balance of the Bypass Trust not so appointed or allocated would be disposed of under Article X of the Restated Trust upon the death of the surviving spouse/grantor.

Article X first provided for specific bequests and an amount, determined by a formula, to be distributed outright to the grandchildren of Mom and Dad.

In addition, Article X created and provided for the administration of two separate "Protective Trusts," one for each of the two children of Mom and Dad.

The provisions of these Protective Trusts become the focus of the PLR.

Under the Restated Trust, the Trustee of the Protective Trusts was to distribute "appropriate amounts of income and principal for the health care, maintenance, support and education" to the beneficiary of the Protective Trust. Note: Neither the distribution of the income nor the principal was mandatory; thus the income as well as the principal could be retained and thus "accumulated."

In addition each of the beneficiaries of the Protective Trusts who attained a "Designated Age" had a lifetime power of appointment over the assets his/her Protective Trust and <u>such power extended to charities</u>. Note: Each child had attained the "Designated Age."

Moreover, each beneficiary of a Protective Trust who died after attaining the Designated Age could appoint (i.e. a testamentary power of appointment) the assets of the Protective Trust to persons and entities, including charities, with certain specified exceptions.

Article XI of the Restated Trust provided for the distribution of assets not disposed of under Article X. This Article XI provided for specific bequests to persons named in Schedule H. In addition, this Article provided that any residue would be divided among the persons named or described in Schedule I. While a charity or other non-natural person was eligible to be a contingent beneficiary, none was listed on Schedule I.

At some later date, Dad and Mom apparently discussed with their advisor the possibility of naming either the Restated Trust or one of the subtrusts formed upon the first death as the designated beneficiary of his or her IRA. The advisor apparently drafted an amendment to the Restated Trust which was approved by Dad and Mom.

Because of its importance to the ruling it is fully quoted below:

> With respect to any IRA, 401K or other retirement plan payable to the trust on the death of either Trust Creator, it is the Trust Creators' desire that the Trustee utilize the minimum distribution rules described in the Internal Revenue Code ("IRC") and applicable regulations when making withdrawals from said retirement account. . . . In particular, the trustee should be guided by the following: (a) The Trustee should first determine whether the custodian allows for long-term deferral of income taxes by the Trustee; . . .(c) the Trustee should determine what requirements exist, if any, in order to elect the longest tax-deferral period; (d) Having made the appropriate election in order to elect the longest tax-deferral period of time, the Trustee should withdraw funds from the retirement plan in the minimum amounts required under IRC and applicable regulations without penalty; additional amounts should be withdrawn only if the Trustee determines that a need exists; . . .(f) … The provisions of this instrument are intended to inform the Trustee of the Trust Creators' desire that the rules commonly known as the "stretch IRA" rules should be applied to all retirement plans. It is the Trust Creators' hope that the Trustee will use his or her best efforts to minimize income taxes on these assets for the maximum duration permitted by law. . . .For purposes of qualifying as a Designated Beneficiary under IRC and applicable regulations, each Beneficiary may amend the terms of the trust which govern the distribution of his or her trust at death in the absence of a complete and effective exercise of any applicable power of appointment; . . .

It seems pretty clear that the drafter of this amendment felt that a Trustee, if so directed by the Trust Creators, had the power and authority to interpret and apply the rules in the IRC and applicable regulations in order to exploit and maximize the referenced "stretch IRA" rules resulting in minimum distributions from the IRA and pension plans and minimized income. The drafter apparently did not understand the significance of the other very relevant provisions of the Restated Trust in determining who (or what) would be the beneficiary whose life expectancy (if any) would determine the required distributions, i.e. who are (1) the "primary beneficiaries," the "contingent beneficiaries" or the "successor beneficiaries." The drafter also appears unaware of the important differences between "conduit' provisions, i.e. mandatory distribution to the beneficiary of the required distributions from the IRA versus "accumulation" provisions, i.e. trustee has discretion as to whether to make the distributions of the funds from the IRA or retain (and accumulate) them. Finally, the drafter doesn't seem to be aware of the four requirements that will allow the beneficiaries of a trust to be treated as the beneficiaries of the IRA even though it was the trust that is named as the beneficiary on the beneficiary designation statement.

Subsequent to the adoption of the above amendment, Mom dies. Dad then becomes the sole trustee of the various subtrusts referenced above. But Dad then decides to name his daughters, Catherine and Doreen, as the Co-Trustees of the Bypass Trust.

At some point before his death, Dad had named the Trustees of the Bypass Trust as the beneficiary of his IRA. Also, Catherine and Doreen had attained the "Designated Age."

After Dad's death, pursuant to Article X of the Restated Trust, all the subtrusts that had been created on the death of Mom were consolidated and equally divided into the above described two Protective Trusts, one each for Catherine and Doreen. In addition, they each became the Trustee of her respective Protective Trust.

It appears at this point the two daughters sought the advice of a different advisor because the daughters, acting as Trustees of the Bypass Trust, filed for a Declaratory Judgment in the local State Court. The daughters asked the State Court to modify the Restated Trust in order to comply with certain requirements under Treas. Reg. 1.401(a)(9). The Court issued an order modifying the Restated Trust retroactively to the date of Dad's death as requested.

The court order modified the Restated Trust, in relevant part, as follows:

1. all amounts received from the custodian of the IRA are to be distributed to the beneficiaries of the Protective Trusts;
2. the Trustee is authorized to arrange direct distributions to the beneficiary;

3. if a Special Independent Trustee is selected, distributions to descendants of beneficiaries born before 1955 are prohibited;
4. descendants of beneficiaries born before 1955, Contingent Beneficiaries and charities are removed as potential appointees of a beneficiary's lifetime power of appointment;
5. any individual born before 1955 is removed as a potential appointee of a beneficiary's testamentary power of appointment;
6. Catherine (the oldest lineal descendant of Dad) is named as the designated beneficiary under section 1.401(a)(9)-4, Q&A-4, and the Restated Trust is to be administered so that all beneficiaries following the two daughters are "successor beneficiaries," as defined in section 1.401(a)(9)-5, A-7(c)(1); and
7. the Trustee is directed to use IRA proceeds to pay debts, administration expenses or taxes of Dad's estate only after other assets are exhausted, and is prohibited from using any IRA proceeds to make such payments after a specified date.

Based on the above, the daughters requested the following letter rulings:

1. That IRA be distributed as though the beneficiaries of the Bypass Trust administered under the Restated Trust, as amended by the Court order, were named beneficiaries of IRA thereby satisfying the guidance set forth in section 1.401(a)(9)-4, Q&As 4 and 5;
2. That Catherine, the oldest daughter, is the "designated beneficiary," as that term is used in IRC section 401(a)(9)(A)(ii), of IRA based on the judicial modification of the Restated Trust ***retroactively*** to Dad's date of death, which modification is valid under State S's Revised Code;
3. Alternatively, that Catherine, the oldest daughter, is the "designated beneficiary, of IRA as a result of removing certain discretionary distributees and potential objects of appointment before a specified date in 2009 through the judicial modification of the Restated Trust under State S's Revised Code; and
4. That the applicable distribution period as used in Section 1.401(a)(9)-5, A-5(c)(1) for the applicable calendar year (2009) is 30.5 years (reduced yearly), which is Catherine's life expectancy based upon her current year (2009) birthday.

ANALYSIS:

The IRS starts its analysis by citing and summarizing several Treasury Regulations sections that address the definitions of a "designated beneficiary," "contingent beneficiary" and "successor beneficiary."

DESIGNATED BENEFICIARY

IRC section 401(a)(9)(E) states that the term "designated beneficiary" means any individual designated as a beneficiary by the employee.

Treas. Reg. 1.401(a)(9)-4, Q&A A-1 provides, in part, that a "designated beneficiary" is an individual who is designated as a beneficiary under the plan. Thus an individual may be designated as a beneficiary under the plan either by (1) the terms of the plan, or, (2) if the plan so provides, by an affirmative election by the employee (or the employee's surviving spouse) specifying the beneficiary. Under these Regulations, a designated beneficiary need not be specified in the name of the plan in order to be a "designated beneficiary" so long as such individual is identifiable uner the plan. In addition, even a member of a class of beneficiaries capable of contraction or expansion will be treated as being identifiable if it is possible to identify the class member with the shortest life expectancy. It is also noted that under these regulations that the passing of an employee's interest to an individual under a will or otherwise under applicable state law will not make that individual a designated beneficiary ***unless*** that individual is **designated as a beneficiary** under the plan.

Q&A-3 of Treas. Reg. 1.401(a)(9)-4 emphasizes again that only individuals may be "designated beneficiaries." A person who is not an individual, such as an estate or a charitable organization may not be a designated beneficiary. Indeed, if a person other than individual is designated as a beneficiary, then the employee will be treated as not having a beneficiary for purposes of IRC 401(a)(9), even if there are also individuals designated as beneficiaries.

Q&A-4 of Treas. Reg. 1.401(a)(9)-4 provides, in relevant part, that in order to be a designated beneficiary, an individual must be a beneficiary **as of the date of the employee's death**. Thus, generally, a designated beneficiary will be determined based on the beneficiaries designated as of the date of death and remain beneficiaries as of September 30 of the year following the calendar year of the date of death.

CONTINGENT BENEFICIARY VS. SUCCESSOR BENEFICIARY

The IRS then references the regulations that define a "contingent beneficiary" and a "successor beneficiary" and the very important significance of distinguishing between the two.

Q&A-7(b) of Treas. Reg. 1.401(a)(9)-5 provides, in essence, that if a beneficiary's entitlement to an employee's benefit after such employee's death is a "contingent right," then such "contingent beneficiary" is nevertheless considered to be a beneficiary for purposes of determining who, if anyone, is the designated beneficiary.

In contrast to a "contingent beneficiary," a "successor beneficiary" will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy. A "successor beneficiary" is defined as a person who only could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death. Q&A-7(c) of Treas. Reg. 1.401(a)(9)-5. (Note: It is the interest arising after the death of the employee's (designated) beneficiary, not after the death of the employee him or herself.)

TRUST REFORMATION AFFECTING THE TAX CONSEQUENCES

The IRS then states very definitively that a reformation of a trust instrument is not effective to change the tax consequences of a completed transaction. The IRS references Estate of La Meres v. Comm'r, 98 T.C. 294 (1992), where the trustees retroactively reformed a governing instrument solely for the purpose of qualifying the bequest for the estate tax charitable deduction. The Tax Court held that the retroactive reformation, undertaken solely for tax consequences, was not effective for federal tax purposes:

> This and other courts have generally disregarded the retroactive effect of State Court decrees for Federal tax purposes. (citations omitted)

The IRS then states that while it will look to local law in order to determine the nature of the interests provided under the trust document, it does not feel bound to give effect to a local court order which modifies the dispositive provisions of the document after respondent has acquired rights to tax revenues under its terms.

The IRS further states that it will treat a state court order as controlling with respect to a reformation if the reformation is specifically authorized by the Internal Revenue Code, such as under IRC section 2055(e)(3), which allows for the reformation of split-interest charitable trust in order for the charitable interest to qualify for the charitable deduction as authorized under that statute.

But the IRS then concludes that there is no applicable federal statute which authorizes, in this instance, the daughters' retroactive reformation of the Restated Trust. As a result, the IRS concludes, the subject modification of the Restated Trust will not be recognized for federal tax purposes:

> In this instance, the efforts undertaken to modify the terms of the Restated Trust will not be given retroactive effect for federal tax purposes and the designated beneficiary of IRA X must be determined under the terms of the Restated Trust as it existed **at the time of Taxpayer B (Dad's) death**.

The analysis then turns to the Bypass Trust created under the Restated Trust since it was named as the beneficiary of Dad's IRA.

The IRS states that, provided the Restated Trust meets the requirements for a "see through" trust as set forth in Q&A-5 of Treas. Reg. 1.401(a)(9)-4 (i.e. (1) the trust is valid under state law, (2) the trust is irrevocable on date of death, (3) the beneficiaries are "identifiable," and (4) relevant documentation has been timely provided to the plan administrator) it is then permissible to "look through" the trust in order to determine who, if anyone, is the designated beneficiary.

After doing its "look through" the IRS concludes that there was **no identifiable beneficiary of the IRA at the time of Dad's death**.

How did the IRS reach this conclusion?

First, the IRS points out that the relevant terms of the Restated Trust, and specifically the terms of the Bypass and related trusts, <u>do not require or authorize either of the daughters under their respective Protective Trusts to receive all amounts that are distributed from the IRA</u>. The terms of the Restated Trust makes all distributions of either income or principal <u>subject to a standard, essentially the typical "ascertainable standard</u>."

Moreover, the relevant Restated Trust terms do not require that amounts distributed from the IRA, based on Catherine's life expectancy, be paid either to Catherine or Doreen <u>or any other natural person (human being)</u>. In essence there were no "conduit provisions" mandating that all IRA distributions be, in turn, distributed from the respective "Protective Trusts" to the daughters. The result? Such distributions from the IRA could be "accumulated" by the Trustee.

This, in turn, means that such accumulated IRA distributions could be the subject of the powers of appointment granted to the daughters. But these powers of appointment could be exercised not only in favor of individuals but also <u>charities</u>:

> Because the terms of the Restated Trust allow for the <u>accumulation of amounts distributed from the IRA X</u>, the remainder beneficiaries <u>must be considered beneficiaries of IRA X. Charitable organizations are clearly authorized to be potential/contingent beneficiaries</u> under the relevant provisions of the Restate Trust. However, <u>only individuals may be designated beneficiaries</u> for purposes of satisfying the requirements of Code section 401(a)(9) and related Income Tax Regulations. **As a result, Taxpayer B (Dad) is treated as having <u>no</u> beneficiary of his IRA** for purposes of section 401(a)(9) of the Code.

The IRS then repeats the rules for the proper timing for designating a beneficiary. First it is noted, as above, that "potential beneficiaries" may be eliminated after the death of an IRA owner and prior to September 30 of the year following the IRA owner's death for purposes of determining who is the “designated beneficiary.” But, in contrast, while “beneficiaries” may be eliminated, “beneficiaries” cannot be added during this period. Furthermore, a “designated beneficiary” must be in existence as of the IRA owner’s death.

> A designated beneficiary cannot be created after the date of death by means of a State Court Order even if said Order is valid under State Law.

The IRS concludes by emphasizing the importance of the terms of Restated Trust:

> In this case, due to the language of relevant terms of the controlling Restated Trust document there is no designated beneficiary for purposes of section 401(a)(9) analysis. Subsequent efforts to obtain a post-mortem judicial modification had the effect of **creating a designated beneficiary after the death of the taxpayer**. Said efforts will not be given effect for purposes of Code section 401(a)(9).

The IRS then provides its specific response to each of the ruling requests.

As to the first requested ruling, as noted above, the IRA will have to be distributed as if the IRA had no designated beneficiary. Why? Since entities ineligible to be treated as “designated beneficiaries” were, in fact, eligible to receive amounts from the IRA, then such entities (the charities) had to be considered as “contingent beneficiaries.” Thus, the IRA has to be treated as having no “designated beneficiary.”

As to the second ruling request, the IRS stated that no response could be provided because of the response to the first ruling request.

As to the third ruling request, Catherine cannot be treated as the “designated beneficiary” of the IRA simply because of the above described Court Order since said order created a “designated beneficiary” of IRA where none existed prior to the entry of the Court Order. Such “creation of a designated beneficiary after the death of the IRA owner” does not comply with the requirements of IRC 401(a)(9).

As to the fourth ruling request, it was noted that Dad had attained the “requiring beginning date” prior to his death. Consequently, the applicable required distribution period will be the remaining life expectancy of Dad in accordance with the relevant regulations.

CONCLUSION:

This Ruling presents an excellent list of typical provisions of a Family Revocable Trust that must be considered, and potentially revised, before such a trust should be designated as a beneficiary of an IRA. An amendment that assumes that by simply stating the intent of the grantors to achieve the "stretch" such results will be achieved is just not recognizing the trust terms that have to be addressed. Moreover, the Ruling underscores how those powers of appointment, typically inserted to provide flexibility, will likely eviscerate all the benefits that could have been realized by the proper designation of beneficiaries. Indeed, the Ruling may appropriately guide advisors away from naming the Family Revocable Trust as the IRA beneficiary and toward using what is often referred to as the Standalone IRA Trust.