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The IRS Gets Its Swagger on When It Comes to IRA Beneficiary Trusts

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Vast amounts of wealth are held in individual retirement accounts, 401(k) plans and other retirement plans. The importance of proper estate planning for such retirement benefits was recently illustrated in private letter ruling 201021038. In this ruling, the Internal Revenue Service rejected a post-mortem reformation of a trust and concluded that the designated beneficiary of an IRA must be identifiable on the IRA owner's date of death.

There are many reasons that it may be advisable to fund trusts with retirement assets. For example, a trust can be used to optimize a decedent's exemption from Federal and New Jersey estate taxes. Under current law, beginning on January 1, 2011, the exemption from federal estate tax will be $1,000,000 and the exemption from New Jersey estate tax will be $675,000. A trust could be designated as the beneficiary of retirement benefits to use such exemptions. In addition, trusts can be helpful in protecting children or grandchildren who may have spendthrift tendencies.

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Paramount to planning with retirement benefits is "stretching" the mandatory distributions so that the income tax triggered by such distributions is deferred to the maximum extent. The key here is to qualify the trust as a "designated beneficiary" under the Internal Revenue Code.

In PLR 201021038, mother and father created a revocable trust that provided for the establishment of a testamentary trust upon the death of the first spouse. Some estate planners refer to this form of trust as a bypass trust. Upon the death of the first spouse, the bypass trust captures the deceased spouse's exemption from federal and state estate taxes. Mother died first. After her death, father designated the bypass trust as the beneficiary of his IRA. When father died all of the various testamentary trusts created by mother, including the bypass trust, were collapsed. The assets from the collapsed trusts were distributed to what the ruling referred to as "protective" trusts for each of their daughters.

The trusts for the daughters were what are generally referred to as "accumulation" trusts. The trustee of the respective protective trust had the discretion to distribute appropriate amounts of income and principal for the health care, maintenance, support and education of the respective daughter. There was no requirement for mandatory distributions to the respective daughter.

Also under the protective trusts, the daughters each had a broad power of appointment over the assets of her protective trust, which power extended to descendents of the daughters or to charities.

As a general rule, only individuals can meet the definition of a designated beneficiary under the code. If a person other than an individual is designated as a beneficiary, the IRA owner will be treated as having no designated beneficiary and accelerated income taxation shall result because the distributions cannot be paid out over the lifetime of the beneficiary. For example, if an estate is designated as an IRA beneficiary, accelerated distributions are mandated.

There is an exception for beneficiaries of a trust provided the following requirements under Section 1.401(a) (9)-4 of the IRC Regulations are satisfied: (1) the trust is valid under state law or would be but for the fact there is no corpus; (2) the trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee; (3) the beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable from the trust instrument and (4) relevant documentation has been timely provided to the plan administrator.

After their father died, the daughters realized that the protective trusts were flawed and they filed for a declaratory

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judgment in state court to reform the trusts so that they complied with the requirements under Reg. §1.401(a)(9)-4 to have the trusts meet the definition of a designated beneficiary. The state court, retroactive to father's death, granted a judgment reforming the protective trusts so that they were in compliance with the regulation.

In the ruling, the service rejected the order reforming the trusts issued by the State Court. Relying on *Estate of La Meres v. Commissioner,* 98 T.C. 294 (1992) the service concluded that the reformation of a trust instrument is not effective to change the tax consequences of a completed transaction. The service further provided that it will not treat a state court order as controlling with respect to a reformation unless the reformation is specifically authorized by the code. As an example, the service provided that Code Section 2055(e)(3) specifically allows for reformation of a charitable split-interest trust eligible for the charitable contribution. Since there is no applicable code authority which authorizes the retroactive reformation of the protective trusts, the reformation would not be given effect by the service for federal tax purposes.

Rejecting the reformation, the service concluded that there was no identifiable designated beneficiary of father's IRA on his date of death. The service noted in reaching its decision that the distribution of income and principal under the protective trusts was discretionary. This factor, combined with the daughters' overly broad power of appointment to distribute assets to their descendents or charities, only made it more compelling for the service to conclude father had not successfully designated a beneficiary of his IRA.

The consequence of this ruling is that distributions from father's IRA must be made more rapidly which accelerates the income taxation of the distributions. If the daughters had been successful obtaining a favorable ruling, the distributions could have been spread over a 30-year period, thereby deferring the income tax bite.

This may not be the final word on the issue. If in the future a taxpayer faces a meaningful tax liability, the service's position might be challenged. It remains to be seen if the tax court would reach the same conclusion as the Service. There are a few chinks in the Service's armor. In reaching its decision, it appears that the Service reversed its position on post-mortem reformation as previously set forth in PLRs 200235038 and 200620026. Also, Regulation Section 1.401(a)(9)-4 Q&A-4 permits potential beneficiaries (for purposes of determining who is a designated beneficiary) to be removed after the date of death of a taxpayer as long as it is done prior to September 30 of the calendar year following the calendar year of death of a taxpayer. The Service determined that this regulation was not applicable, concluding for the reasons set forth above that there was no clearly identifiable designated beneficiary at father's date of death. The Service stated that the regulation only permitted beneficiaries to be removed, not added.

In light of this ruling, estate planners should fly-speck retirement plan beneficiary designations and the terms of any beneficiary trust to be assured that such designations are in compliance with Code Section 401(a)(9) and the regulations thereunder. These rules are extremely technical and there is no margin for error. ■