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EMPLOYEE BENEFITS – THROUGH AN ESTATE PLANNER'S EYES

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BIOGRAPHY

STEVEN E. TRYTTEN, ESQ., CPA, MBA, is a nationally recognized authority on tax and estate planning, quoted in financial publications such as the Wall Street Journal, Forbes Magazine, Bloomberg Wealth Manager, Kiplinger's Retirement Report, and the Los Angeles Business Journal. He lectures across the country and has contributed numerous technical articles to publications for attorneys, CPAs, and other professionals.

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 serves as a Member of the ACTEC Employee Benefits Committee.

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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EMPLOYEE BENEFITS – THROUGH AN ESTATE PLANNER'S EYES

By Steven E. Trytten, Esq., CPA, MBA

I. Case Studies - Methodology.

All case studies reflect the current law with respect to income tax, transfer tax, and MRD Rules. The general income, estate, gift and generation-skipping tax rates, *etc.*, are calculated assuming that the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") sunsets and that pre-EGTRRA law continues. In particular, the dates of death in the case studies generally extend beyond the "sunset" date under EGTRRA, to avoid the moving targets that arise under EGTRRA that are more likely to produce misleading results.

A. How "Success" Is Defined In Financial Model – "After Tax Assets."

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 tax on excess retirement plan accumulations, which carried the stigma of a penalty). Minimizing taxes does not always produce the best outcome. What most clients really want is to maximize the net worth that remains after taxes have been paid ("After-Tax Assets"). If a client wants to preserve the maximum After-Tax Assets 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 the client's 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 an analysis for each distribution strategy that forecasts the gradual payout of a retirement plan over the entire deferral period (usually defined by the post-death life expectancy of the designated beneficiary) in a way that shows the total accumulation of after-tax net worth ("After-Tax Assets") at the end of the deferral period. The distribution strategy that produces the largest amount of After-Tax Assets wins!

"After-Tax Assets" 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, which is appropriate if the client's primary goal is to maximize the size of the Beneficiary's After Tax Assets. The point in time that is used for comparing After Tax Assets in most of the Case Studies is the end of the youngest beneficiary's deferral period. The After Tax Assets 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.

However, your author decided *not* to recognize capital gains tax on the beneficiary's non-retirement appreciated securities, on the theory that these securities would likely receive a cost basis "step up" at the beneficiary's death.

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

The results of each Case Study were generated with a financial model in Excel with separate spreadsheets corresponding to each planning scenario. In addition, an extra scenario runs in the background to measure how big the Beneficiary's After Tax Assets would have been had there not been a retirement plan at all. From a statistical point of view, this extra scenario serves as the "control" and provides a basis of comparison for the other scenarios.[1]

C. "After Tax Assets" Defined.

The results shown for each scenario are isolated to show *only the additional portion of the beneficiary's After Tax Assets that corresponds to the distributions received over the deferral period from the retirement plan ("Additional After Tax Assets")*. 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 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

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[1] The backup calculations for each scenario fill ten or more pages using a 6 point font. The backup calculations for a seven scenario Case Study fills eighty or more 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 or more pages.

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 retirement plan and lower turnover assets to remain outside.

The astute investor may also develop different asset allocation models for retirement and non-retirement investments. Although your author recognizes the value of different allocation models in the real world, for statistical purposes, your author's financial models assume the same asset allocation model for retirement and non-retirement investments. This avoids a statistical anomaly that could distort the results. For example, if a financial projection is run assuming that retirement assets are invested in higher yielding investments than non-retirement assets, it will be difficult to determine whether distribution strategies that produce the best results do so because of the benefit of tax-deferred compounding, or simply because money was left longer in the pot that is invested in higher yielding investments.

E. Level Yield Versus Market Fluctuations.

Most of the case studies in these materials assume level yields in each year of the deferral period. However, real life returns vary from year to year, and these variations can significantly alter overall long-term returns. This issue is addressed in depth in Sections V. and VII.

Section V. illustrates varying returns based on historical data, and the author gratefully acknowledges financial planner and software developer **Guerdon T. Ely** for his valuable contributions in preparing this Section.[2] Although the future is not likely to duplicate the past, these analyses are very helpful in gaining a general perspective as to how market fluctuations affect distribution planning.

A more ambitious approach to forecasting the future is illustrated by the Wealth Forecasting Analysis™ prepared specifically for inclusion in Section VII. of these materials by the well-known investment firm of **Bernstein**.[3] Bernstein's analysis is built upon their proprietary computer simulation software (Bernstein's Capital Markets Engine) that incorporates Bernstein's research and historical data. This engine runs a Monte Carlo simulation that models 10,000 different possible scenarios with interrelated variables for investment yields and inflation. The 10,000 outcomes are then compiled into summary charts that show a statistical breakdown of the range of possible outcomes. The preparation of this financial model represents a substantial commitment of resources on Bernstein's part, and your author gratefully acknowledges this effort.

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[2] Guerdon T. Ely is the founder of Ely Prudent Portfolios LLC, Chino, CA, and the creator and developer of two highly regarded software programs, MRD-Determinator and Pre-Determinator. For more information, visit: www.elyportfolios.com.

[3] Bernstein has published many valuable articles and financial analyses. To see these, or for more information about the Bernstein firm, visit: www.bernstein.com.

F. Investment Fees.

The financial model projects investment management fees, and allows them to be treated as either having been paid from inside the retirement plan, or paid from non-retirement assets. This issue is discussed in more detail in Section VI.

Bernstein's Wealth Forecasting Analysis™ in Section VII. not only illustrates market fluctuations are discussed above, but also illustrates several different scenarios comparing payment of investment management fees on retirement assets from the retirement plan as opposed to non-retirement assets.

G. 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.[4] 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.

H. 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.

[4] The "step up" is allowed under IRC § 1014.

II. Case Studies: Jones & Son – Basic Stretch-Out; Rogers & Daughter – High Net Worth.

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

A. Fact Pattern – Jones & Son—Basic Stretch-Out.

Mr. Jones visits his planner in the year 2008. He is 75 years old (born January 1, 1933), and is widowed with one child, age 34 (born January 1, 1974). 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	$ 1,500,000
Residence	$ 500,000

- All investments earn 8% annual return, consisting of 1.5% ordinary income and 6.5% growth. Portfolio turnover is 20% per year.
- Investments incur a 1% asset management fee, thus the "net" rate of return is 7%.
- Mr. Jones receives a $72,000 pension each year, $15,000 of social security (indexed for inflation), and has living expenses of $48,000 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 84 (December 31, 2017). Given the child's age (age 43 in the year of Mr. Jones's death), the potential period of deferral for the child will continue through the year 2057. Thus, this case study evaluates a fifty year deferral period, from 2008 – 2057, with potential deferral based on Uniform Lifetime Table factors derived from the IRA owner's life expectancy during the first ten years, and based on single life table factors derived from the child's life expectancy for the forty years remaining.
- Mr. Jones's child earns $50,000 per year (indexed) and has living expenses of $32,000 per year (indexed). When the child reaches age 65 he will receive social security benefits of $8,000 per year (in 2008 dollars, indexed for inflation).
- Income and estate tax laws are assumed to reflect what would happen if the provisions of EGTRRA sunset as scheduled, and no other changes to the tax law are enacted. The financial model includes provisions for alternative minimum tax, taxation of a portion of social security, Income with Respect to Decedent (I.R.D.), deduction, 3% phase-out ("haircut") of itemized deductions, limitations on charitable deductions, compressed rate brackets for trusts, *etc.* The IRD deduction will be utilized on the earliest dollars distributed, as discussed earlier.

• IRA distributions to trusts are taxed at the trust's level (and IRD deductions deducted at the trust's level) until the IRD deduction is fully utilized. Note that it may be necessary for the trust to accumulate (*i.e.*, not make any distributions) to accomplish this.

B. Planning Strategies Evaluated—Jones & Son—Basic Stretch-Out.

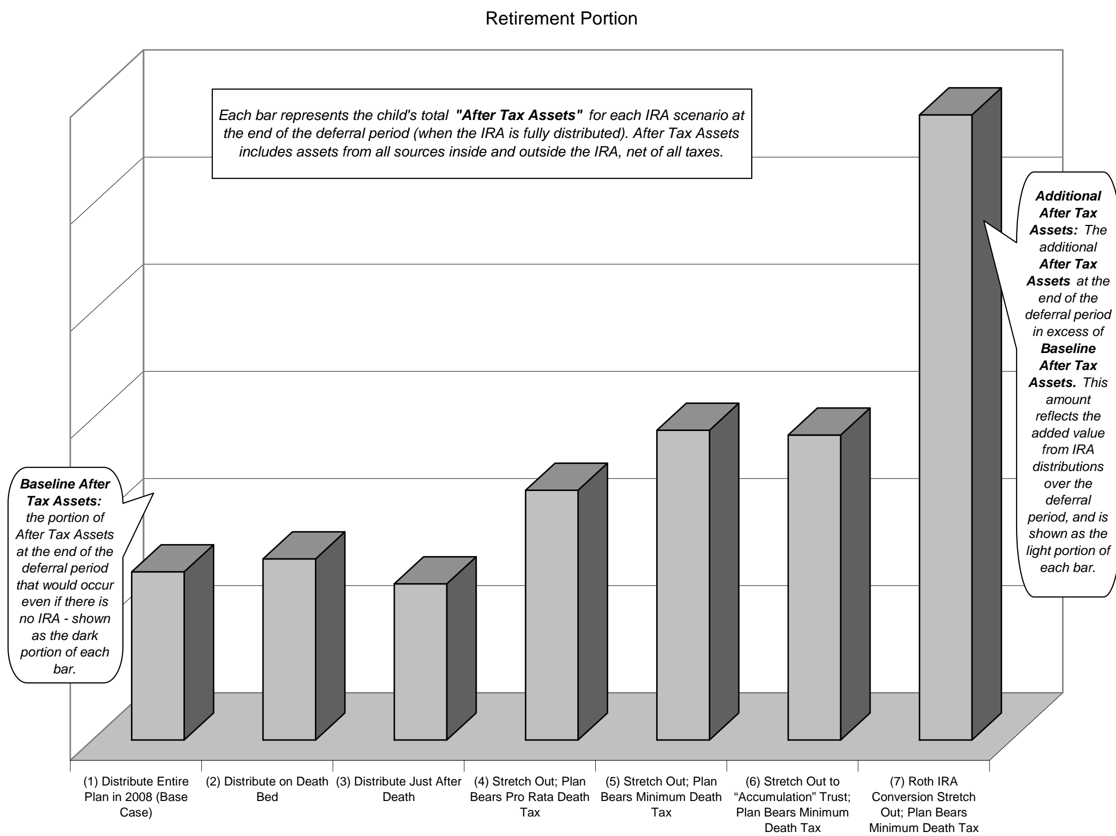
Strategy	Explanation
(1) Distribute Entire Plan in 2008	*For Comparison Purposes Only* - Mr. Jones takes full distribution of his IRA balance during the current year of 2008, which becomes the basis of comparison for the other strategies.
(2) Distribute on Death Bed	Mr. Jones takes minimum distributions until the year of his death, and takes full distribution of his IRA 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 IRA.
(4) Stretch Out; IRA Bears Pro Rata Death Tax	Mr. Jones takes minimum distributions during his life. After Mr. Jones's death, his child continues minimum distributions during the child's life. However, a IRA withdrawal is made shortly after Mr. Jones' death to pay the IRA's pro rata share of death taxes. The beneficiary (here the child) should pay the income tax on the IRA withdrawal from non-IRA assets, if possible.
(5) Stretch Out; IRA Bears Minimum Death Tax	Mr. Jones takes minimum distributions during his life. After Mr. Jones's death, his child continues minimum distributions during the child's life. Unlike Strategy (4), here death taxes are paid from non-IRA assets first, and are only apportioned to the IRA to the extent that other assets are insufficient to pay them.
(6) Stretch Out to "Accumulation" Trust; IRA Bears Minimum Death Tax	Same as Strategy (5), except that the IRA is designated to an "accumulation" trust that qualifies for stretch-out using the child's life expectancy, but accumulates IRA distributions and pays income tax inside the trust. This is not a "conduit" trust, and drafting this type of trust may require careful attention to special drafting issues covered later in these materials.
(7) Roth IRA Conversion Stretch Out; IRA Bears Minimum Death Tax	Same as Strategy (5), except that Mr. Jones converts the entire IRA to a Roth IRA in 2008, and pays all income taxes arising from the conversion from non-retirement assets. (The financial model assumes that Mr. Jones qualifies to make the Roth IRA conversion in 2008, even though the fact assumptions above suggest that Mr. Jones's "adjusted" AGI for 2008 will exceed the $100,000 ceiling requirement.)

C. MRD Divisors - Final regulations

Jones & Son: "Base Case"				
Calendar Year	*Distribution Year*	*Participant's Age*	*Beneficiary's Age*	*MRD Divisor*
2008	6	75	34	22.9
2009	7	76	35	22.0
2010	8	77	36	21.2
2011	9	78	37	20.3
2012	10	79	38	19.5
2013	11	80	39	18.7
2014	12	81	40	17.9
2015	13	82	41	17.1
2016	14	83	42	16.3
2017	15	84	43	15.5
2018	16		44	39.8
2019	17		45	38.8
2020	18		46	37.8
2021	19		47	36.8
2022	20		48	35.8
2023	21		49	34.8
2024	22		50	33.8
2025	23		51	32.8
2026	24		52	31.8
2027	25		53	30.8
2028	26		54	29.8
2029	27		55	28.8
2030	28		56	27.8
2031	29		57	26.8
2032	30		58	25.8
2033	31		59	24.8
2034	32		60	23.8
2035	33		61	22.8
2036	34		62	21.8
2037	35		63	20.8
2038	36		64	19.8
2039	37		65	18.8
2040	38		66	17.8
2041	39		67	16.8
2042	40		68	15.8
2043	41		69	14.8
2044	42		70	13.8
2045	43		71	12.8
2046	44		72	11.8
2047	45		73	10.8
2048	46		74	9.8
2049	47		75	8.8
2050	48		76	7.8
2051	49		77	6.8
2052	50		78	5.8
2053	51		79	4.8
2054	52		80	3.8
2055	53		81	2.8
2056	54		82	1.8
2057	55		83	1.0

D. Case Study Results – Jones & Son—Basic Stretch-Out.

Jones & Son: "Base Case"							
IRA Beginning Balance:	*$1,000,000*						
Deferral Period Begins:	*2008*	*Ends:*	*2057*	*# of Years:*	*50*		
IRA Owner Dies:	*2017*	*IRA Owner's Age at Death:*	*84*	*Child's Age, Year After Death:*	*44*		
IRA Distribution Strategy:	*(1) Distribute Entire Plan in 2008 (Base Case)*	*(2) Distribute on Death Bed*	*(3) Distribute Just After Death*	*(4) Stretch Out; Plan Bears Pro Rata Death Tax*	*(5) Stretch Out; Plan Bears Minimum Death Tax*	*(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax*	*(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax*
"Additional After Tax Assets" at End of Deferral Period for Each IRA Scenario (in Today's Dollars)	1,570,409	1,691,805	1,458,086	2,332,483	2,890,236	2,846,983	5,834,943
% Comparison of "Additional After Tax Assets"	100%	108%	93%	149%	184%	181%	372%



E. Fact Pattern – Rogers & Daughter—High Net Worth.

Ms. Rogers is a very successful business woman, with one daughter. She visits her planner in the year 2008. Her facts are the same as in the Jones & Son case study (*e.g.* she and her daughter are the same respective ages as Jones and his son), except as follows:

IRA	$ 5,000,000
Liquid Investments	$ 50,000,000
Residence	$ 10,000,000

- Ms. Rogers earns annual income of $1,000,000.
- Ms. Rogers' daughter earns annual income of $500,000.

F. Case Study Results – Rogers & Daughter—High Net Worth.

Rogers & Daughter: "Base Case"							
IRA Beginning Balance:	*$5,000,000*						
Deferral Period Begins:	*2008*	*Ends:*	*2057*	*# of Years:*	*50*		
IRA Owner Dies:	*2017*	*IRA Owner's Age at Death:*	*84*	*Child's Age, Year After Death:*	*44*		
IRA Distribution Strategy:	*(1) Distribute Entire Plan in 2008 (Base Case)*	*(2) Distribute on Death Bed*	*(3) Distribute Just After Death*	*(4) Stretch Out; Plan Bears Pro Rata Death Tax*	*(5) Stretch Out; Plan Bears Minimum Death Tax*	*(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax*	*(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax*
"Additional After Tax Assets" at End of Deferral Period for Each IRA Scenario (in Today's Dollars)	8,223,451	8,856,710	6,762,317	10,209,714	14,363,465	13,692,279	29,367,880
% Comparison of "Additional After Tax Assets"	100%	108%	82%	124%	175%	167%	357%

III. Sensitivity Analysis – Investment Yield.

How sensitive is the financial model to different investment yield assumptions? This Section illustrates four yield scenarios for the Jones and Rogers case studies, with all other facts the same as in the "Base Case" scenarios presented in Section II. The yield assumptions are as follows:

Yield Assumption	Ordinary Income	Growth	Less: Management Fee	Net Return
Low (fixed income only)	5.5%	0.0%	(0.25%)	5.25%
Low (balanced allocation)	3.0%	3.0%	(0.75%)	5.25%
Medium (balanced allocation with higher weight in equities, same as Section II.)	1.5%	6.5%	(1%)	7%
High (equities only)	1.0%	10.0%	(1%)	10%

The following tables combine the results from the above four yield scenarios for the Jones and Rogers case studies. As you will see, the model is very sensitive to investment yield in terms of the absolute dollar results under the various distribution strategies that allow deferral. However, the relative percentage outcomes of the various deferral distribution strategies are generally similar.

Jones & Son: Sensitivity Analysis - Yield

	IRA Beginning Balance:	*$1,000,000*						
	Deferral Period Begins:	*2008*	*Ends:*	*2057*	*# of Years:*	*50*		
	IRA Owner Dies:	*2017*	*IRA Owner's Age at Death:*	*84*	*Child's Age, Yr. After Death:*	*44*		
	IRA Distribution Strategy:	*(1) Distribute Entire Plan in 2008 (Base Case)*	*(2) Distribute on Death Bed*	*(3) Distribute Just After Death*	*(4) Stretch Out; Plan Bears Pro Rata Death Tax*	*(5) Stretch Out; Plan Bears Minimum Death Tax*	*(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax*	*(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax*
Low Yield (Fixed Income)	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	589,329	647,601	570,743	928,744	1,119,249	1,079,924	2,419,487
	% Comparison of "Additional After Tax Assets"	100%	110%	97%	158%	190%	183%	411%
Low Yield (Balanced)	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	696,029	742,420	653,940	1,005,660	1,215,564	1,238,195	2,454,256
	% Comparison of "Additional After Tax Assets"	100%	107%	94%	144%	175%	178%	353%
Medium Yield Balanced (Base Case)	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	1,570,409	1,691,805	1,458,086	2,332,483	2,890,236	2,846,983	5,834,943
	% Comparison of "Additional After Tax Assets"	100%	108%	93%	149%	184%	181%	372%
High Yield Equities	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	5,530,619	6,093,875	5,063,004	8,808,807	11,657,888	11,184,067	24,088,965
	% Comparison of "Additional After Tax Assets"	100%	110%	92%	159%	211%	202%	436%

Rogers & Daughter: Sensitivity Analysis - Yield

	IRA Beginning Balance:	*$5,000,000*						
	Deferral Period Begins:	*2008*	*Ends:*	*2057*	*# of Years:*	*50*		
	IRA Owner Dies:	*2017*	*IRA Owner's Age at Death:*	*84*	*Child's Age Yr. After Death:*	*44*		
	IRA Distribution Strategy:	*(1) Distribute Entire Plan in 2008 (Base Case)*	*(2) Distribute on Death Bed*	*(3) Distribute Just After Death*	*(4) Stretch Out; Plan Bears Pro Rata Death Tax*	*(5) Stretch Out; Plan Bears Minimum Death Tax*	*(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax*	*(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax*
Low Yield (Fixed Income)	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	2,526,484	2,744,539	2,125,370	3,151,587	4,453,399	5,338,831	12,065,469
	% Comparison of "Additional After Tax Assets"	100%	109%	84%	125%	176%	211%	478%
Low Yield (Balanced)	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	3,678,556	3,748,550	2,836,989	3,649,138	4,699,806	5,529,009	11,897,923
	% Comparison of "Additional After Tax Assets"	100%	102%	77%	99%	128%	150%	323%
Medium Yield Balanced (Base Case)	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	8,223,451	8,856,710	6,762,317	10,209,714	14,363,465	13,692,279	29,367,880
	% Comparison of "Additional After Tax Assets"	100%	108%	82%	124%	175%	167%	357%
High Yield Equities	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	28,558,465	31,490,104	23,371,815	38,772,679	57,472,385	54,734,800	123,443,798
	% Comparison of "Additional After Tax Assets"	100%	110%	82%	136%	201%	192%	432%

IV. Sensitivity Analysis – Portfolio Turnover.

How sensitive is the financial model to portfolio turnover? (Recall that turnover refers to the percentage of holdings in a portfolio that are bought or sold in a given year – thus a portfolio turnover of 20% suggests that an average of one-fifth of the portfolio is turned over in any given year.) The following table summarizes the results of six different portfolio turnover scenarios for the Jones and Rogers case studies, with all other facts the same as in the "Base Case" scenarios presented in Section II.

As you will see, portfolio turnover is an important variable, arguably as significant as investment yield when evaluating retirement distribution alternatives.

The "no turnover" scenario is particularly interesting, because it suggests that continuing a retirement plan structure is less profitable than maintaining an after-tax investment portfolio for the true "buy and hold" investor. The financial model is very sensitive to portfolio turnover in the range of 0% to 10%, and much less sensitive to portfolio turnover assumptions over 20%.

Jones & Son: Sensitivity Analysis - Portfolio Turnover								
	IRA Beginning Balance:	*$1,000,000*						
	Deferral Period Begins:	*2008*	*Ends:*	*2057*	*# of Years:*	*50*		
	IRA Owner Dies:	*2017*	*IRA Owner's Age at Death:*	*84*	*Child's Age Yr. After Death:*	*44*		
	IRA Distribution Strategy:	*(1) Distribute Entire Plan in 2008 (Base Case)*	*(2) Distribute on Death Bed*	*(3) Distribute Just After Death*	*(4) Stretch Out; Plan Bears Pro Rata Death Tax*	*(5) Stretch Out; Plan Bears Minimum Death Tax*	*(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax*	*(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax*
0% Turnover	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**2,869,520**	**2,823,500**	**2,319,477**	**2,506,011**	**2,680,685**	**2,819,094**	**4,027,498**
	% Comparison of "Additional After Tax Assets"	**100%**	**98%**	**81%**	**87%**	**93%**	**98%**	**140%**
5% Turnover	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**2,086,067**	**2,132,351**	**1,798,286**	**2,625,919**	**3,037,046**	**2,954,354**	**5,460,981**
	% Comparison of "Additional After Tax Assets"	**100%**	**102%**	**86%**	**126%**	**146%**	**142%**	**262%**
10% Turnover	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,801,877**	**1,891,722**	**1,615,356**	**2,486,808**	**2,997,841**	**2,925,201**	**5,744,882**
	% Comparison of "Additional After Tax Assets"	**100%**	**105%**	**90%**	**138%**	**166%**	**162%**	**319%**
15% Turnover	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,658,212**	**1,767,337**	**1,517,998**	**2,391,618**	**2,937,047**	**2,882,689**	**5,815,801**
	% Comparison of "Additional After Tax Assets"	**100%**	**107%**	**92%**	**144%**	**177%**	**174%**	**351%**
20% Turnover	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,570,409**	**1,691,805**	**1,458,086**	**2,332,483**	**2,890,236**	**2,846,983**	**5,834,943**
	% Comparison of "Additional After Tax Assets"	**100%**	**108%**	**93%**	**149%**	**184%**	**181%**	**372%**
25% Turnover	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,510,732**	**1,641,235**	**1,417,626**	**2,292,745**	**2,856,003**	**2,818,705**	**5,837,429**
	% Comparison of "Additional After Tax Assets"	**100%**	**109%**	**94%**	**152%**	**189%**	**187%**	**386%**

Rogers & Daughter: Sensitivity Analysis - Portfolio Turnover								
	IRA Beginning Balance:	$5,000,000						
	Deferral Period Begins:	2008	Ends:	2057	# of Years:	50		
	IRA Owner Dies:	2017	IRA Owner's Age at Death:	84	Child's Age Yr. After Death:	44		
	IRA Distribution Strategy:	(1) Distribute Entire Plan in 2008 (Base Case)	(2) Distribute on Death Bed	(3) Distribute Just After Death	(4) Stretch Out; Plan Bears Pro Rata Death Tax	(5) Stretch Out; Plan Bears Minimum Death Tax	(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax	(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax
0% Turnover	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	14,740,091	14,824,910	11,003,085	12,219,220	13,952,545	13,720,945	21,385,573
	% Comparison of "Additional After Tax Assets"	100%	101%	75%	83%	95%	93%	145%
5% Turnover	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	10,927,257	11,257,788	8,496,753	11,991,315	16,194,736	14,259,510	29,776,201
	% Comparison of "Additional After Tax Assets"	100%	103%	78%	110%	148%	130%	272%
10% Turnover	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	9,463,357	10,042,436	7,654,286	11,135,514	15,351,873	14,189,620	30,224,354
	% Comparison of "Additional After Tax Assets"	100%	106%	81%	118%	162%	150%	319%
15% Turnover	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,698,881	9,308,883	7,104,934	10,564,150	14,743,740	13,914,047	29,721,450
	% Comparison of "Additional After Tax Assets"	100%	107%	82%	121%	169%	160%	342%
20% Turnover	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,223,451	8,856,710	6,762,317	10,209,714	14,363,465	13,692,279	29,367,880
	% Comparison of "Additional After Tax Assets"	100%	108%	82%	124%	175%	167%	357%
25% Turnover	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	7,897,770	8,557,329	6,534,758	9,975,687	14,112,332	13,526,739	29,121,508
	% Comparison of "Additional After Tax Assets"	100%	108%	83%	126%	179%	171%	369%

V. Sensitivity Analysis – Market Fluctuations In Yield.

Up until this Section, the financial model has assumed a level yield in each year of the deferral period, even on equity investments.

Financial planner and software developer **Guerdon T. Ely** of Ely Prudent Planning LLC[5] contributed additional coding to your author's financial model to allow a simulation of actual historical returns indicated by the Standard and Poor's "S&P 500" Index and the 5 Year Treasury Index for years 1927 through 2006. The S&P 500 Index had an average annual yield of 12.4% between 1927 and 2006, and the 5 Year Treasury Index averaged a 5.4% annual yield during the same period. A portfolio of 60% S&P 500 stocks and 40% five-year Treasury bonds would, theoretically, have averaged a 9.6% yield each year. If a 1% annual portfolio management fee applied, the portfolio's net average yield would have been 8.6%.

These enhancements illustrate the effect of varying returns based on historical data, and the author gratefully acknowledges **Guerdon T. Ely** for his valuable contributions in preparing this Section. Although the future is not likely to duplicate the past, these analyses are very helpful in gaining a general perspective on how market fluctuations affect distribution planning.

This Section illustrates four yield scenarios for the Jones and Rogers case studies, with all other facts the same as in the "Base Case" scenarios presented in Section II. The yield assumptions are as follows:

60% Equity/40% Fixed Income Portfolio in Varying Markets	**Ordinary Income***	**Growth**	**Less: Management Fee**	**"Average" Yield, Net of Fee**
Poor Market Period (1929-1978)	2.3%	Varies	(1%)	6.50%
Median Market Period (1938-1987)	2.8%	Varies	(1%)	8.67%
Level Yield	2.8%	6.8%	(1%)	8.6%
Good Market Period (1950-1999)	2.8%	Varies	(1%)	10.43%

** The ordinary income yields are your author's estimates of the "ordinary income" portion of the overall yield reported under the historical indexes, which aggregate dividends, interest and growth.*

The two tables below compile the results from the four yield scenarios for the Jones and Rogers case studies, and confirm that market fluctuations have a significant effect on average yield. Perhaps the most telling comparison is the difference in total yield between the "median market" and "level yield" scenarios, even though each reflects the same average annual yield.

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[5] Guerdon T. Ely is the founder of Ely Prudent Portfolios LLC, Chino, CA, and the creator and developer of two highly regarded software programs, MRD-Determinator and Pre-Determinator. For more information, visit: www.elyportfolios.com.

Jones & Son: Sensitivity Analysis - Market Fluctuations								
	IRA Beginning Balance:	$1,000,000						
	Deferral Period Begins:	2008	Ends:	2057	# of Years:	50		
	IRA Owner Dies:	2017	IRA Owner's Age at Death:	84	Child's Age Yr. After Death:	44		
	IRA Distribution Strategy:	(1) Distribute Entire Plan in 2008 (Base Case)	(2) Distribute on Death Bed	(3) Distribute Just After Death	(4) Stretch Out; Plan Bears Pro Rata Death Tax	(5) Stretch Out; Plan Bears Minimum Death Tax	(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax	(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax
Poor Market	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	919,754	937,680	875,367	1,333,827	1,550,027	1,542,248	3,075,006
	% Comparison of "Additional After Tax Assets"	100%	102%	95%	145%	169%	168%	334%
Median Market	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	2,435,048	2,526,996	2,248,270	3,790,356	4,682,798	4,533,870	10,070,467
	% Comparison of "Additional After Tax Assets"	100%	104%	92%	156%	192%	186%	414%
Median Market Level Yield	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	2,713,008	2,979,360	2,523,097	4,433,637	5,750,808	5,633,177	12,348,299
	% Comparison of "Additional After Tax Assets"	100%	110%	93%	163%	212%	208%	455%
Good Market	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	4,940,558	5,555,127	4,772,176	7,996,981	10,237,215	10,173,831	21,890,296
	% Comparison of "Additional After Tax Assets"	100%	112%	97%	162%	207%	206%	443%

Rogers & Daughter: Sensitivity Analysis - Market Fluctuations								
	IRA Beginning Balance:	$5,000,000						
	Deferral Period Begins:	2008	Ends:	2057	# of Years:	50		
	IRA Owner Dies:	2017	IRA Owner's Age at Death:	84	Child's Age Yr. After Death:	44		
	IRA Distribution Strategy:	(1) Distribute Entire Plan in 2008 (Base Case)	(2) Distribute on Death Bed	(3) Distribute Just After Death	(4) Stretch Out; Plan Bears Pro Rata Death Tax	(5) Stretch Out; Plan Bears Minimum Death Tax	(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax	(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax
Poor Market	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	4,539,617	4,633,399	3,830,509	5,586,420	7,556,528	7,198,598	15,217,912
	% Comparison of "Additional After Tax Assets"	100%	102%	84%	123%	166%	159%	335%
Median Market	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	12,312,290	12,602,806	9,884,144	16,045,077	23,312,886	22,005,180	50,372,325
	% Comparison of "Additional After Tax Assets"	100%	102%	80%	130%	189%	179%	409%
Median Market Level Yield	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	13,893,009	15,099,828	11,276,569	19,180,315	29,001,536	27,423,624	61,503,176
	% Comparison of "Additional After Tax Assets"	100%	109%	81%	138%	209%	197%	443%
Good Market	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	25,190,978	28,440,975	22,108,648	35,720,068	51,870,376	48,904,650	107,027,319
	% Comparison of "Additional After Tax Assets"	100%	113%	88%	142%	206%	194%	425%

VI. Sensitivity Analysis – Investment Fees.

How much difference does it make if investment management fees on retirement plan assets are paid from non-retirement plan assets?

Recurring administrative or overhead fees (such as Trustee's fees, annual management fees, so-called "wrap" fees, and the like) that arise with respect to the assets of an IRA may be paid by the individual IRA owner, without being considered an additional contribution to the IRA, and may be claimed by the individual as a miscellaneous itemized deduction.[6] Comparable rules apply to plans and plan sponsors, and a recent private letter ruling ruled favorably with respect to the individual owner of a Roth IRA.[7] This rule does not extend to specific expenses chargeable to plan assets, such as brokerage commissions,[8] but may extend to the entire management or "wrap" fee, even if transaction costs are bundled into the fee.[9]

Your author is concerned that investment management fees arising from Roth IRA assets may not be deductible, even if paid by the individual Roth IRA owner, since Code Section 265 bars a deduction for expenses relating to income that is "wholly exempt" from income tax. A Roth IRA may not necessarily be "wholly exempt" from income tax during the initial five-year period, but once the five-year period expires, the Roth IRA would appear to fall into the category of "wholly exempt." Your author's financial model assumes Roth IRA fees are not deductible.

Investment fees are miscellaneous itemized deductions, generally deductible only to the extent that they exceed 2% of the taxpayer's adjusted gross income for the year. The deduction is effectively negated if the taxpayer is in the Alternative Minimum Tax.

The following table compiles the results from eight investment fee scenarios for the Jones and Rogers case studies. The first scenario shows the results if investment fees are paid "ratably" (*i.e.*, the IRA pays its own investment fees out of IRA assets) throughout the deferral period. The second through seventh scenarios show different strategies that involve paying all investment fees from non-IRA assets at the start of the deferral period and continuing until a certain point in time, and then "switching" to paying the fees ratably from that point forward. The last scenario shows the outcome if investment fees are paid from non-IRA assets during the entire deferral period. Otherwise, the factual assumptions are the same for Jones and Rogers as in the "Base Case" scenarios presented in Section II. All of these tables were prepared using your author's financial model. (However, compare the financial modeling results prepared by **Bernstein** in the following section for another perspective on these issues.)

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[6] Rev. Rul. 84-146, 1984-2 C.B. 61; Priv. Ltr. Ruls. 1984-32-109, 1983-29-049, and 1988-30-061.

[7] Priv. Ltr. Rul. 2005-07-021, which did not address whether fees paid by the Roth IRA owner are deductible.

[8] Priv. Ltr. Rul. 1988-30-061.

[9] Priv. Ltr. Rul. 2005-07-021.

Jones & Son: Sensitivity Analysis - Investment Fees								
	IRA Beginning Balance:	$1,000,000						
	Deferral Period Begins:	2008	Ends:	2057	# of Years:	50		
	IRA Owner Dies:	2017	IRA Owner's Age at Death:	84	Child's Age Yr. After Death:	44		
	IRA Distribution Strategy:	(1) Distribute Entire Plan in 2008 (Base Case)	(2) Distribute on Death Bed	(3) Distribute Just After Death	(4) Stretch Out; Plan Bears Pro Rata Death Tax	(5) Stretch Out; Plan Bears Minimum Death Tax	(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax	(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax
Pay Investment Fees Ratably From IRA and Outside Assets (Base Case)	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	1,570,409	1,691,805	1,458,086	2,332,483	2,890,236	2,846,983	5,834,943
	% Comparison of "Additional After Tax Assets"	100%	108%	93%	149%	184%	181%	372%
Pay Fees From Outside Assets 1st Five Years Only	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	1,560,345	1,644,503	1,398,299	2,318,425	2,901,363	2,859,059	6,013,719
	% Comparison of "Additional After Tax Assets"	100%	105%	90%	149%	186%	183%	385%
Pay Fees From Outside Assets 1st Ten Years Only	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	1,560,345	1,602,258	1,338,434	2,307,103	2,916,960	2,876,439	6,333,504
	% Comparison of "Additional After Tax Assets"	100%	103%	86%	148%	187%	184%	406%
Pay Fees From Outside Assets 1st Fifteen Years Only	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	1,560,345	1,602,258	1,309,272	2,300,974	2,909,626	2,922,630	6,512,533
	% Comparison of "Additional After Tax Assets"	100%	103%	84%	147%	186%	187%	417%
Pay Fees From Outside Assets 1st Twenty Years Only	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	1,560,345	1,602,258	1,309,272	2,287,564	2,886,144	2,964,333	6,666,536
	% Comparison of "Additional After Tax Assets"	100%	103%	84%	147%	185%	190%	427%
Pay Fees From Outside Assets 1st Twenty-Five Years Only	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	1,560,345	1,602,258	1,309,272	2,265,210	2,849,632	2,997,021	6,788,161
	% Comparison of "Additional After Tax Assets"	100%	103%	84%	145%	183%	192%	435%
Pay Fees From Outside Assets 1st Thirty Years Only	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	1,560,345	1,602,258	1,309,272	2,236,244	2,804,039	3,001,233	6,876,199
	% Comparison of "Additional After Tax Assets"	100%	103%	84%	143%	180%	192%	441%
Pay Fees From Outside Assets Thrpoughout Deferral Period	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	1,560,345	1,602,258	1,309,272	2,137,751	2,646,286	2,842,117	6,978,497
	% Comparison of "Additional After Tax Assets"	100%	103%	84%	137%	170%	182%	447%

Rogers & Daughter: Sensitivity Analysis - Investment Fees								
	IRA Beginning Balance:	$5,000,000						
	Deferral Period Begins:	2008	Ends:	2057	# of Years:	50		
	IRA Owner Dies:	2017	IRA Owner's Age at Death:	84	Child's Age Yr. After Death:	44		
	IRA Distribution Strategy:	(1) Distribute Entire Plan in 2008 (Base Case)	(2) Distribute on Death Bed	(3) Distribute Just After Death	(4) Stretch Out; Plan Bears Pro Rata Death Tax	(5) Stretch Out; Plan Bears Minimum Death Tax	(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax	(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax
Pay Investment Fees Ratably From IRA and Outside Assets (Base Case)	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,223,451	8,856,710	6,762,317	10,209,714	14,363,465	13,692,279	29,367,880
	% Comparison of "Additional After Tax Assets"	100%	108%	82%	124%	175%	167%	357%
Pay Fees From Outside Assets 1st Five Years Only	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,214,736	8,610,020	6,413,083	10,032,301	14,409,022	13,707,926	30,283,960
	% Comparison of "Additional After Tax Assets"	100%	105%	78%	122%	175%	167%	369%
Pay Fees From Outside Assets 1st Ten Years Only	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,214,736	8,386,792	6,040,091	9,841,767	14,455,253	13,721,114	31,233,325
	% Comparison of "Additional After Tax Assets"	100%	102%	74%	120%	176%	167%	380%
Pay Fees From Outside Assets 1st Fifteen Years Only	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,214,736	8,386,792	5,961,141	9,795,750	14,428,139	13,838,450	32,149,724
	% Comparison of "Additional After Tax Assets"	100%	102%	73%	119%	176%	168%	391%
Pay Fees From Outside Assets 1st Twenty Years Only	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,214,736	8,386,792	5,961,141	9,745,326	14,319,780	13,756,740	32,915,918
	% Comparison of "Additional After Tax Assets"	100%	102%	73%	119%	174%	167%	401%
Pay Fees From Outside Assets 1st Twenty-Five Years Only	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,214,736	8,386,792	5,961,141	9,666,261	14,149,358	13,528,493	33,502,688
	% Comparison of "Additional After Tax Assets"	100%	102%	73%	118%	172%	165%	408%
Pay Fees From Outside Assets 1st Thirty Years Only	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,214,736	8,386,792	5,961,141	9,565,891	13,933,014	13,258,241	33,927,224
	% Comparison of "Additional After Tax Assets"	100%	102%	73%	116%	170%	161%	413%
Pay Fees From Outside Assets Thrpoughout Deferral Period	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,214,736	8,386,792	5,961,141	9,206,100	13,157,509	12,554,192	34,431,464
	% Comparison of "Additional After Tax Assets"	100%	102%	73%	112%	160%	153%	419%

Strategy for IRA Beneficiaries. Under current income tax laws, the individual beneficiary of an IRA may lose some or all of the benefit of miscellaneous itemized deductions over the years. Since the effect of paying these amounts with non-IRA assets is to increase the size of the IRA, this means that someday, distributions from the IRA will be larger, and will be fully taxable at ordinary rates. If these distributions will begin far enough into the future, paying the expenses with non-IRA assets makes sense. How far into the future is enough? The case studies suggest that the beneficiary should stop paying these expenses with non-IRA assets at roughly 10 to 15 years into the deferral period. Of course, these results will vary with each case.

Accumulation Trust as IRA Beneficiary. When an accumulation trust is named as IRA beneficiary and will be accumulating, there may be a greater benefit from paying investment fees from the trust's non-retirement assets, as shown in the case studies. This benefit occurs because the trust, as a separate taxpayer, has its own AGI floor that is lower than if all income is reported by the individual beneficiary. The trust is also not subject to the 3% haircut on itemized deductions under Code Section 68, and the trust has its own AMT exemption. Nevertheless, there is still a point in time when the payments being made by non-retirement trust assets should be reduced or eliminated. The "Jones & Son" case studies suggest that this point in time occurs at roughly 25 to 30 years into the deferral period. The "Rogers & Daughter" case study shows a more moderate benefit for the accumulating trust, which disappears at a point in time roughly 15 years into the deferral period. Results will vary from year to year, and from case to case.

Strategy for Roth IRA Beneficiaries. Since distributions from Roth IRAs will not be taxable when received, the best strategy for all Roth IRA beneficiaries is to pay all expenses from non-Roth IRA assets throughout the entire deferral period.

VII. "Monte Carlo" Analysis by Bernstein – Another Look At Volatility and Investment Fees for Jones & Son.

The following thirty-one page analysis is a Wealth Forecasting Analysis™ of the Jones & Son case study prepared specifically for inclusion in these materials by the well-known investment firm **Bernstein**.[10] Bernstein's analysis is built upon their proprietary computer simulation software (Bernstein's Capital Markets Engine) that incorporates Bernstein's research and historical data. This engine runs a Monte Carlo simulation that models 10,000 different possible scenarios with interrelated variables for investment yields and inflation. The 10,000 outcomes are then compiled into summary charts that show a statistical breakdown of the range of possible outcomes. The preparation of this financial model represents a substantial commitment of resources on Bernstein's part, and your author gratefully acknowledges this effort.

Bernstein's Wealth Forecasting Analysis™ not only illustrates market fluctuations, but also illustrates several different scenarios comparing payment of investment management fees on retirement assets from the retirement plan as opposed to from non-retirement assets.

Bernstein's findings, which appear on the twenty-fourth and twenty-fifth pages of the analysis (which has its own page numbers), are interesting and insightful.

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[10] Bernstein has published many valuable articles and financial analyses. To see these, or for more information about the Bernstein firm, visit: www.bernstein.com.

VIII. Sensitivity Analysis – Estate Taxes.

What impact do estate taxes have on the financial projections? Federal and state estate taxes have the obvious consequence of reducing the overall asset base for the beneficiary. Another factor is that the beneficiary's IRD deduction under IRC Section 691(c) is calculated based only on federal estate tax, and excludes state estate tax. (The IRD deduction is discussed in more detail in Section XXII.) The following table compiles the results for four estate tax scenarios for the Jones and Rogers case studies, with factual assumptions otherwise the same as the "Base Case" in Section II. The last two scenarios incorporate the carryover basis that is part of the EGTRRA rules for 2010, and assume that the $1 million election to "step up" cost basis is applied half to investment assets and half to the personal residence.

As you will see, estate taxes have a significant effect on the overall wealth transferred to the beneficiary, but do not significantly change the relative performance of the various distribution strategies, with one exception. The benefits of the Roth IRA conversion are moderated somewhat in a "no estate tax" environment, although it is still the most favorable strategy.

Rogers & Daughter: Sensitivity Analysis - Estate Taxes								
	IRA Beginning Balance:	***$5,000,000***						
	Deferral Period Begins:	***2008***	*Ends:*	***2057***	*# of Years:*	***50***		
	IRA Owner Dies:	***2017***	*IRA Owner's Age at Death:*	***84***	*Child's Age Yr. After Death:*	***44***		
	IRA Distribution Strategy:	*(1) Distribute Entire Plan in 2008 (Base Case)*	*(2) Distribute on Death Bed*	*(3) Distribute Just After Death*	*(4) Stretch Out; Plan Bears Pro Rata Death Tax*	*(5) Stretch Out; Plan Bears Minimum Death Tax*	*(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax*	*(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax*
Pre-EGTRRA Estate Tax, Federal and State (Base Case)	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**8,223,451**	**8,856,710**	**6,762,317**	**10,209,714**	**14,363,465**	**13,692,279**	**29,367,880**
	% Comparison of "Additional After Tax Assets"	**100%**	**108%**	**82%**	**124%**	**175%**	**167%**	**357%**
Estate Tax Reform Based on EGTRRA 2009 Rules, Plus State "Sponge Tax" Based on 2001 Rules	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**8,442,753**	**9,092,899**	**7,047,662**	**10,718,341**	**14,656,480**	**13,980,996**	**29,643,454**
	% Comparison of "Additional After Tax Assets"	**100%**	**108%**	**83%**	**127%**	**174%**	**166%**	**351%**
Estate Tax Repeal Based on EGTRRA 2010 Rules, Plus State "Sponge Tax" Based on 2001 Rules	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**14,408,990**	**16,134,532**	**14,801,155**	**22,375,275**	**23,452,235**	**22,622,778**	**38,735,585**
	% Comparison of "Additional After Tax Assets"	**100%**	**112%**	**103%**	**155%**	**163%**	**157%**	**269%**
Estate Tax Repeal Based on EGTRRA 2010 Rules, No State Estate Tax	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**17,333,535**	**19,283,535**	**19,681,091**	**28,038,008**	**28,038,008**	**27,211,438**	**42,263,202**
	% Comparison of "Additional After Tax Assets"	**100%**	**111%**	**114%**	**162%**	**162%**	**157%**	**244%**

Jones & Son: Sensitivity Analysis - Estate Taxes								
	IRA Beginning Balance:	$1,000,000						
	Deferral Period Begins:	2008	Ends: 2057		# of Years: 50			
	IRA Owner Dies:	2017	IRA Owner's Age at Death: 84		Child's Age Yr. After Death: 44			
	IRA Distribution Strategy:	(1) Distribute Entire Plan in 2008 (Base Case)	(2) Distribute on Death Bed	(3) Distribute Just After Death	(4) Stretch Out; Plan Bears Pro Rata Death Tax	(5) Stretch Out; Plan Bears Minimum Death Tax	(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax	(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax
Pre-EGTRRA Estate Tax, Federal and State (Base Case)	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	1,570,409	1,691,805	1,458,086	2,332,483	2,890,236	2,846,983	5,834,943
	% Comparison of "Additional After Tax Assets"	100%	108%	93%	149%	184%	181%	372%
Estate Tax Reform Based on EGTRRA 2009 Rules, Plus State "Sponge Tax" Based on 2001 Rules	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	2,533,613	2,666,336	2,399,032	3,637,511	3,852,318	3,755,675	6,811,266
	% Comparison of "Additional After Tax Assets"	100%	105%	95%	144%	152%	148%	269%
Estate Tax Repeal Based on EGTRRA 2010 Rules, Plus State "Sponge Tax" Based on 2001 Rules	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	2,973,833	3,344,711	3,183,106	4,844,785	4,938,603	4,815,960	7,914,556
	% Comparison of "Additional After Tax Assets"	100%	112%	107%	163%	166%	162%	266%
Estate Tax Repeal Based on EGTRRA 2010 Rules, No State Estate Tax	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	3,339,103	3,738,796	3,799,294	5,535,257	5,535,257	5,413,225	8,371,856
	% Comparison of "Additional After Tax Assets"	100%	112%	114%	166%	166%	162%	251%

IX. Sensitivity Analysis – Income Taxes.

What impact do income taxes have on the financial projections? The income tax rules are complex. The Alternative Minimum Tax has a significant impact. An increase in income tax rates would also produce a significant impact. The following table compiles the results of ten scenarios isolating different income tax rules for the Jones and Rogers case studies. Except as mentioned, the factual assumptions are the same as the "Base Case" in Section II.

The 2% floor on itemized deductions, combined with AMT, wipes out a large amount of deduction for investment management fees. The scenario that assumes that the 2% floor and AMT are repealed and pays investment fees from non-IRA assets produces a more favorable result than when the fees are paid ratably, which confirms the problem discussed in Section VI. about losing deductions too close in time to the ultimate distribution of IRA funds. The second scenario shows the importance of the IRD deduction under IRC Section 691(c). (The IRD deduction is discussed in more detail in Section XXII.)

The "repeal of AMT" scenario is particularly interesting. This scenario shows a lower dollar value for several distribution strategies than in the "Base Case." How is it possible that eliminating the AMT tax could do anything but increase the dollar value? Remember, the dollar values shown are the "incremental" values attributable to the retirement plan distributions over the deferral period, over the "baseline" value that would result if there was no retirement plan at all. Eliminating the AMT substantially increases the "baseline value," and highlights that the ordinary income from retirement plan distributions was actually helping mitigate AMT on the "baseline" assets. With AMT repealed, the tax effect of the retirement plan distributions is actually higher, relative to the "baseline" value.

Jones & Son: Sensitivity Analysis - Income Taxes								
	IRA Beginning Balance:	*$1,000,000*						
	Deferral Period Begins:	*2008*	*Ends:*	*2057*	*# of Years:*	*50*		
	IRA Owner Dies:	*2017*	*IRA Owner's Age at Death:*	*84*	*Child's Age Yr. After Death:*	*44*		
	IRA Distribution Strategy:	***(1) Distribute Entire Plan in 2008 (Base Case)***	***(2) Distribute on Death Bed***	***(3) Distribute Just After Death***	***(4) Stretch Out; Plan Bears Pro Rata Death Tax***	***(5) Stretch Out; Plan Bears Minimum Death Tax***	***(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax***	***(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax***
Current Income Tax Law, Assuming EGTRRA Sunsets (Base Case)	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,570,409**	**1,691,805**	**1,458,086**	**2,332,483**	**2,890,236**	**2,846,983**	**5,834,943**
	% Comparison of "Additional After Tax Assets"	**100%**	**108%**	**93%**	**149%**	**184%**	**181%**	**372%**
Base Case, Except I.R.D. Deduction Repealed	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,570,409**	**1,691,805**	**685,848**	**1,801,721**	**2,488,727**	**2,430,419**	**5,834,943**
	% Comparison of "Additional After Tax Assets"	**100%**	**108%**	**44%**	**115%**	**158%**	**155%**	**372%**
Base Case, Except Income Tax Rates on Ord. Inc. and Cap. Gn. (but not AMT) Increase by 5%	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,439,252**	**1,572,783**	**1,315,819**	**2,244,890**	**2,744,112**	**2,499,089**	**5,597,210**
	% Comparison of "Additional After Tax Assets"	**100%**	**109%**	**91%**	**156%**	**191%**	**174%**	**389%**
Base Case, Except Income Tax Rates on Ord. Inc. and Cap. Gn. (but not AMT) Increase by 10%	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,253,695**	**1,336,754**	**1,076,682**	**1,787,962**	**2,190,244**	**2,117,443**	**5,562,878**
	% Comparison of "Additional After Tax Assets"	**100%**	**107%**	**86%**	**143%**	**175%**	**169%**	**444%**
Base Case, Except Income Tax Rates on Ord. Inc. and Cap. Gn. (but not AMT) Increase by 15%	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,003,401**	**1,078,262**	**835,698**	**1,527,408**	**1,909,652**	**1,853,519**	**5,728,459**
	% Comparison of "Additional After Tax Assets"	**100%**	**107%**	**83%**	**152%**	**190%**	**185%**	**571%**
Base Case, Except AMT Repealed	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,889,765**	**1,969,574**	**1,683,397**	**2,384,697**	**2,791,897**	**2,704,638**	**5,508,983**
	% Comparison of "Additional After Tax Assets"	**100%**	**104%**	**89%**	**126%**	**148%**	**143%**	**292%**
Base Case, Except AMT Repealed and Rates Increase by 5%	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,547,453**	**1,630,292**	**1,355,988**	**2,070,864**	**2,480,238**	**2,398,298**	**5,534,544**
	% Comparison of "Additional After Tax Assets"	**100%**	**105%**	**88%**	**134%**	**160%**	**155%**	**358%**
Base Case, Except AMT Repealed and Rates Increase by 10%	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,253,695**	**1,336,754**	**1,076,682**	**1,787,962**	**2,190,244**	**2,117,443**	**5,562,878**
	% Comparison of "Additional After Tax Assets"	**100%**	**107%**	**86%**	**143%**	**175%**	**169%**	**444%**
Base Case, Except AMT and 2% Floor Repealed	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,934,303**	**2,026,333**	**1,732,892**	**2,454,532**	**2,863,601**	**2,768,705**	**5,498,618**
	% Comparison of "Additional After Tax Assets"	**100%**	**105%**	**90%**	**127%**	**148%**	**143%**	**284%**
Base Case, Except AMT and 2% Floor Repealed, and Investment Fees Paid From Non-IRA Assets For Entire Period	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,932,411**	**1,994,107**	**1,649,685**	**2,469,028**	**2,927,089**	**2,892,651**	**7,087,730**
	% Comparison of "Additional After Tax Assets"	**100%**	**103%**	**85%**	**128%**	**151%**	**150%**	**367%**

Rogers & Daughter: Sensitivity Analysis - Income Taxes								
	IRA Beginning Balance:	*$1,000,000*						
	Deferral Period Begins:	*2008*	*Ends:*	*2057*	*# of Years:*	*50*		
	IRA Owner Dies:	*2017*	*IRA Owner's Age at Death:*	*84*	*Child's Age Yr. After Death:*	*44*		
	IRA Distribution Strategy:	*(1) Distribute Entire Plan in 2008 (Base Case)*	*(2) Distribute on Death Bed*	*(3) Distribute Just After Death*	*(4) Stretch Out; Plan Bears Pro Rata Death Tax*	*(5) Stretch Out; Plan Bears Minimum Death Tax*	*(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax*	*(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax*
Current Income Tax Law, Assuming EGTRRA Sunsets (Base Case)	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,523,396**	**1,505,895**	**1,059,379**	**1,703,992**	**2,376,687**	**2,386,701**	**5,374,325**
	% Comparison of "Additional After Tax Assets"	**100%**	**99%**	**70%**	**112%**	**156%**	**157%**	**353%**
Base Case, Except I.R.D. Deduction Repealed	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**8,223,451**	**8,856,710**	**3,306,953**	**7,554,774**	**12,645,633**	**11,838,924**	**29,367,880**
	% Comparison of "Additional After Tax Assets"	**100%**	**108%**	**40%**	**92%**	**154%**	**144%**	**357%**
Base Case, Except Income Tax Rates on Ord. Inc. and Cap. Gn. (but not AMT) Increase by 5%	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**7,374,856**	**7,548,758**	**5,239,768**	**7,514,926**	**10,002,357**	**11,172,864**	**28,207,987**
	% Comparison of "Additional After Tax Assets"	**100%**	**102%**	**71%**	**102%**	**136%**	**151%**	**382%**
Base Case, Except Income Tax Rates on Ord. Inc. and Cap. Gn. (but not AMT) Increase by 10%	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**6,090,410**	**6,188,262**	**3,941,842**	**5,708,997**	**8,055,195**	**9,587,768**	**28,660,607**
	% Comparison of "Additional After Tax Assets"	**100%**	**102%**	**65%**	**94%**	**132%**	**157%**	**471%**
Base Case, Except Income Tax Rates on Ord. Inc. and Cap. Gn. (but not AMT) Increase by 15%	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**4,877,292**	**4,958,430**	**2,815,223**	**4,512,274**	**6,716,866**	**8,280,119**	**28,872,621**
	% Comparison of "Additional After Tax Assets"	**100%**	**102%**	**58%**	**93%**	**138%**	**170%**	**592%**
Base Case, Except AMT Repealed	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**9,182,552**	**9,239,117**	**6,809,936**	**8,541,938**	**10,995,898**	**12,505,532**	**28,167,605**
	% Comparison of "Additional After Tax Assets"	**100%**	**101%**	**74%**	**93%**	**120%**	**136%**	**307%**
Base Case, Except AMT Repealed and Rates Increase by 5%	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**7,517,600**	**7,602,819**	**5,260,685**	**7,041,624**	**9,473,719**	**10,987,468**	**28,431,289**
	% Comparison of "Additional After Tax Assets"	**100%**	**101%**	**70%**	**94%**	**126%**	**146%**	**378%**
Base Case, Except AMT Repealed and Rates Increase by 10%	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**6,090,410**	**6,188,262**	**3,941,842**	**5,708,997**	**8,055,195**	**9,587,768**	**28,660,607**
	% Comparison of "Additional After Tax Assets"	**100%**	**102%**	**65%**	**94%**	**132%**	**157%**	**471%**
Base Case, Except AMT and 2% Floor Repealed	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**9,507,596**	**9,558,650**	**7,173,388**	**8,866,581**	**11,290,763**	**12,755,398**	**28,071,766**
	% Comparison of "Additional After Tax Assets"	**100%**	**101%**	**75%**	**93%**	**119%**	**134%**	**295%**
Base Case, Except AMT and 2% Floor Repealed, and Investment Fees Paid From Non-IRA Assets For Entire Period	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**9,498,227**	**9,470,017**	**6,749,086**	**8,848,517**	**11,867,234**	**13,462,706**	**37,928,785**
	% Comparison of "Additional After Tax Assets"	**100%**	**100%**	**71%**	**93%**	**125%**	**142%**	**399%**

X. Sensitivity Analysis – Participant's Mortality.

What impact does the Participant's mortality have on the financial projections? The following scenarios correspond to the Jones and Rogers case studies, with factual assumptions otherwise the same as the "Base Case" in Section II.

The following charts confirm that an "early" death results in more overall deferral for taxable IRA accounts, and that a "late" death results in more overall deferral for Roth IRA accounts, which makes sense since no lifetime distributions are required from a Roth IRA.

Jones & Son: Sensitivity Analysis - Participant's Mortality								
	IRA Beginning Balance:	*$1,000,000*						
	Deferral Period Begins:	*2008*	*Ends:*	*2057*	*# of Years:*	*50*		
	IRA Owner Dies:	*Varies*	*IRA Owner's Age at Death:*	*Varies*	*Child's Age Yr. After Death:*	*Varies*		
	IRA Distribution Strategy:	*(1) Distribute Entire Plan in 2008 (Base Case)*	*(2) Distribute on Death Bed*	*(3) Distribute Just After Death*	*(4) Stretch Out; Plan Bears Pro Rata Death Tax*	*(5) Stretch Out; Plan Bears Minimum Death Tax*	*(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax*	*(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax*
Participant Dies in 2011	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,592,409**	**1,530,437**	**1,251,995**	**2,651,425**	**3,366,362**	**3,361,208**	**5,797,514**
	% Comparison of "Additional After Tax Assets"	**100%**	**96%**	**79%**	**167%**	**211%**	**211%**	**364%**
Participant Dies in 2014	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,567,407**	**1,589,439**	**1,338,883**	**2,455,771**	**3,105,295**	**3,077,384**	**5,802,250**
	% Comparison of "Additional After Tax Assets"	**100%**	**101%**	**85%**	**157%**	**198%**	**196%**	**370%**
Participant Dies in 2017 (Base Case)	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,570,409**	**1,691,805**	**1,458,086**	**2,332,483**	**2,890,236**	**2,846,983**	**5,834,943**
	% Comparison of "Additional After Tax Assets"	**100%**	**108%**	**93%**	**149%**	**184%**	**181%**	**372%**
Participant Dies in 2020	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,583,862**	**1,807,303**	**1,598,989**	**2,267,106**	**2,724,230**	**2,670,075**	**5,880,040**
	% Comparison of "Additional After Tax Assets"	**100%**	**114%**	**101%**	**143%**	**172%**	**169%**	**371%**
Participant Dies in 2023	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,645,604**	**1,978,417**	**1,794,247**	**2,309,323**	**2,679,105**	**2,618,454**	**6,407,312**
	% Comparison of "Additional After Tax Assets"	**100%**	**120%**	**109%**	**140%**	**163%**	**159%**	**389%**
Participant Dies in 2026	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	**1,652,055**	**2,078,922**	**1,929,012**	**2,291,851**	**2,556,930**	**2,507,754**	**6,687,617**
	% Comparison of "Additional After Tax Assets"	**100%**	**126%**	**117%**	**139%**	**155%**	**152%**	**405%**

Rogers & Daughter: Sensitivity Analysis - Participant's Mortality								
	IRA Beginning Balance:	$5,000,000						
	Deferral Period Begins:	2008	Ends:	2057	# of Years:	50		
	IRA Owner Dies:	Varies	IRA Owner's Age at Death:	Varies	Child's Age Yr. After Death:	Varies		
	IRA Distribution Strategy:	(1) Distribute Entire Plan in 2008 (Base Case)	(2) Distribute on Death Bed	(3) Distribute Just After Death	(4) Stretch Out; Plan Bears Pro Rata Death Tax	(5) Stretch Out; Plan Bears Minimum Death Tax	(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax	(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax
Participant Dies in 2011	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,021,188	7,587,350	4,950,247	9,991,176	16,193,333	15,378,448	28,853,522
	% Comparison of "Additional After Tax Assets"	100%	95%	62%	125%	202%	192%	360%
Participant Dies in 2014	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,162,520	8,242,963	5,863,932	10,087,856	15,244,716	14,496,061	29,117,496
	% Comparison of "Additional After Tax Assets"	100%	101%	72%	124%	187%	178%	357%
Participant Dies in 2017 (Base Case)	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,223,451	8,856,710	6,762,317	10,209,714	14,363,465	13,692,279	29,367,880
	% Comparison of "Additional After Tax Assets"	100%	108%	82%	124%	175%	167%	357%
Participant Dies in 2020	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,249,658	9,429,016	7,639,406	10,370,436	13,588,283	13,004,946	29,641,881
	% Comparison of "Additional After Tax Assets"	100%	114%	93%	126%	165%	158%	359%
Participant Dies in 2023	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,538,132	10,289,904	8,770,940	10,941,015	13,400,579	12,875,465	31,089,514
	% Comparison of "Additional After Tax Assets"	100%	121%	103%	128%	157%	151%	364%
Participant Dies in 2026	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,542,558	10,779,287	9,593,179	11,166,197	12,825,967	12,402,483	31,313,519
	% Comparison of "Additional After Tax Assets"	100%	126%	112%	131%	150%	145%	367%

XI. Sensitivity Analysis – Beneficiary's Age.

What impact does the Beneficiary's age have on the financial projections? The following scenarios correspond to the Jones and Rogers Case Studies, with factual assumptions otherwise the same as the "Base Case" in Section II., including the assumption that the Beneficiary is not a "Skip Person" for Generation Skipping Transfer (GST) Tax purposes with respect to the IRA Owner.

The following chart confirms that there is a substantial increase in the value of deferral for a younger beneficiary, for both IRA and Roth IRA strategies.

Jones & Son: Sensitivity Analysis - Beneficiary's Age								
	IRA Beginning Balance:	*$1,000,000*						
	Deferral Period Begins:	*2008*	*Ends:*	*Varies With Age of Beneficiary*	*# of Years:*	*Varies With Age of Beneficiary*		
	IRA Owner Dies:	*2017*	*IRA Owner's Age at Death:*	*84*	*Child's Age Yr. After Death:*	*Varies With Age of Beneficiary*		
	IRA Distribution Strategy:	*(1) Distribute Entire Plan in 2008 (Base Case)*	*(2) Distribute on Death Bed*	*(3) Distribute Just After Death*	*(4) Stretch Out; Plan Bears Pro Rata Death Tax*	*(5) Stretch Out; Plan Bears Minimum Death Tax*	*(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax*	*(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax*
Beneficiary is Age 63 at IRA Owner's Death	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	867,369	934,261	805,002	1,049,607	1,194,606	1,171,338	2,098,436
	% Comparison of "Additional After Tax Assets"	100%	108%	93%	121%	138%	135%	242%
Beneficiary is Age 53 at IRA Owner's Death	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	1,165,450	1,255,523	1,082,104	1,561,589	1,853,061	1,823,005	3,518,857
	% Comparison of "Additional After Tax Assets"	100%	108%	93%	134%	159%	156%	302%
Beneficiary is Age 43 at IRA Owner's Death (Base Case)	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	1,570,409	1,691,805	1,458,086	2,332,483	2,890,236	2,846,983	5,834,943
	% Comparison of "Additional After Tax Assets"	100%	108%	93%	149%	184%	181%	372%
Beneficiary is Age 33 at IRA Owner's Death	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	2,186,994	2,356,005	2,030,615	3,634,160	4,683,416	4,613,967	9,928,876
	% Comparison of "Additional After Tax Assets"	100%	108%	93%	166%	214%	211%	454%
Beneficiary is Age 23 at IRA Owner's Death	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	3,044,797	3,280,100	2,827,082	5,689,491	7,583,870	7,481,948	16,713,931
	% Comparison of "Additional After Tax Assets"	100%	108%	93%	187%	249%	246%	549%
Beneficiary is Age 13 at IRA Owner's Death	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	4,101,079	4,418,011	3,807,835	8,637,478	11,852,464	11,720,100	26,952,787
	% Comparison of "Additional After Tax Assets"	100%	108%	93%	211%	289%	286%	657%
Beneficiary is Age 3 at IRA Owner's Death	*"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)*	5,709,642	6,150,885	5,301,379	13,634,903	19,191,061	19,003,245	44,761,585
	% Comparison of "Additional After Tax Assets"	100%	108%	93%	239%	336%	333%	784%

Rogers & Daughter: Sensitivity Analysis - Beneficiary's Age								
	IRA Beginning Balance:	$5,000,000						
	Deferral Period Begins:	2008	Ends:	Varies With Age of Beneficiary	# of Years:	Varies With Age of Beneficiary		
	IRA Owner Dies:	2017	IRA Owner's Age at Death:	84	Child's Age Yr. After Death:	Varies With Age of Beneficiary		
	IRA Distribution Strategy:	(1) Distribute Entire Plan in 2008 (Base Case)	(2) Distribute on Death Bed	(3) Distribute Just After Death	(4) Stretch Out; Plan Bears Pro Rata Death Tax	(5) Stretch Out; Plan Bears Minimum Death Tax	(6) Stretch Out to "Accumulation" Trust; Plan Bears Minimum Death Tax	(7) Roth IRA Conversion Stretch Out; Plan Bears Minimum Death Tax
Beneficiary is Age 63 at IRA Owner's Death	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	4,532,257	4,881,269	3,726,741	4,764,182	6,024,978	5,582,718	10,531,327
	% Comparison of "Additional After Tax Assets"	100%	108%	82%	105%	133%	123%	232%
Beneficiary is Age 53 at IRA Owner's Death	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	6,105,344	6,575,495	5,020,531	6,942,423	9,266,424	8,743,956	17,763,317
	% Comparison of "Additional After Tax Assets"	100%	108%	82%	114%	152%	143%	291%
Beneficiary is Age 43 at IRA Owner's Death (Base Case)	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	8,223,451	8,856,710	6,762,317	10,209,714	14,363,465	13,692,279	29,367,880
	% Comparison of "Additional After Tax Assets"	100%	108%	82%	124%	175%	167%	357%
Beneficiary is Age 33 at IRA Owner's Death	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	11,448,940	12,330,581	9,414,707	15,685,721	23,222,353	22,298,016	49,869,791
	% Comparison of "Additional After Tax Assets"	100%	108%	82%	137%	203%	195%	436%
Beneficiary is Age 23 at IRA Owner's Death	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	15,939,551	17,166,999	13,107,433	24,238,112	37,594,653	36,305,811	83,858,465
	% Comparison of "Additional After Tax Assets"	100%	108%	82%	152%	236%	228%	526%
Beneficiary is Age 13 at IRA Owner's Death	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	21,469,197	23,122,463	17,654,579	36,357,817	58,780,563	57,086,274	135,056,626
	% Comparison of "Additional After Tax Assets"	100%	108%	82%	169%	274%	266%	629%
Beneficiary is Age 3 at IRA Owner's Death	"Additional After Tax Assets" at End of Deferral Period (in Today's Dollars)	29,890,047	32,191,773	24,579,224	56,747,380	95,287,961	92,878,262	224,261,689
	% Comparison of "Additional After Tax Assets"	100%	108%	82%	190%	319%	311%	750%

XII. Conversion of IRA to Roth IRA.

A. Fully Taxable.

A taxpayer who qualifies may convert all or any portion of an IRA to a Roth IRA. The tax law refers to such a conversion as a "rollover", but it is fully taxable.[11]

B. Roth IRA Conversion Eligibility Requirements.

For taxable years prior to 2010, a Roth IRA conversion is allowable only when the taxpayer who is the IRA owner or plan participant satisfies, for the year of conversion, both (i) the adjusted gross income (AGI) limitation and (ii) the filing status requirement.[12]

1. AGI Requirement.

The taxpayer's modified AGI must be $100,000 or less[13] for the taxable year to which the conversion relates.[14] The $100,000 limit is applied 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.[15]

AGI is calculated consistent with IRC Section 219(g)(3),[16] except that (i) income created by a Roth IRA conversion is not counted;[17] (ii) deductions for standard IRAs or other retirement plans are ignored;[18] and (iii) beginning in years after 2004, income from "lifetime" minimum distributions is ignored.[19] Note that a beneficiary receiving minimum distributions after the death of the Participant is not allowed to exclude the distribution income from AGI.

2. Filing Status Requirement.

A taxpayer's filing status must not be married filing separately (except that if two spouses live apart for the entire year and file separately,[20] they are treated under this rule as if they were single).[21]

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[11] IRC § 408A(d)(3)(A)(i).

[12] IRC § 408A(c)(3)(B).

[13] IRC § 408A(c)(3)(B)(i).

[14] IRC § 408A(c)(3)(B) was revised by the 1998 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.

[15] IRC § 408A(c)(3)(D).

[16] IRC § 408A(c)(3)(A) flush language.

[17] IRC § 408A(c)(3)(C)(i).

[18] Ibid., as amended by 1998 Act § 6005(b)(1).

[19] IRC § 408A(c)(3)(C)(i)(II), added by 1998 Act § 7004(a), effective for taxable years beginning after December 31, 2004.

[20] IRC § 408A(c)(3)(B)(ii).

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.[22]

D. Two-Year Spread for 2010 Conversions.

If the conversion occurs in 2010, the income is spread over two years, unless the taxpayer elects to report all of the income in 2010.[23] The election to report all of the income in 2010 becomes irrevocable on the taxpayer's tax return due date (including extensions).[24] There is no provision for a partial election, and no special provision for years after 2010, so taxpayers making conversions in 2011 and later will recognize the entire amount of conversion income in the tax year of conversion. The two-year spread replaces a similar provision allowing a four year spread for conversions which occurred in 1998. A taxpayer who does not make this election at the time of filing her return and subsequently wants to accelerate income inclusion could arguably make the election later, if the statute is to be read literally.[25]

E. Roth IRA Conversions from Non-IRA Plans.

The Pension Protection Act of 2006[26] ("PPA") was enacted on August 17, 2006. 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,[27] effective for transfers occurring after December 31, 2007.[28] Such a transfer is taxable to the same extent as if there were no qualified rollover, but the pre-59-½ penalty under IRC Section 72(t) does not apply.[29] The term "eligible retirement plan" currently refers to any plan that is:

(i) an individual retirement account described in IRC Section 408(a);

(ii) an individual retirement annuity described in IRC Section 408(b) (other than an endowment contract);

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

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[21] IRC § 408A(c)(3)(D).

[22] IRC § 408A(c)(3)(B), as amended by Tax Increase Prevention Act §512(a)(1).

[23] IRC § 408A(d)(3)(A)(iii), as amended by the Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222, § 512(b)(1)

[24] IRC §§ 408A(d)(3)(A) (flush language following subsection (iii)) and (d)(6)(7).

[25] Compare the language of IRC § 408A(d)(3)(A) (" . . . may not be changed after the due date . . .) to the language of IRC § 408A(d)(3)(E)(ii)(II) (" . . . may not be *made or* changed after the due date . . . *[emphasis added]*).

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

[27] IRC § 408A(d)(3).

[28] 2006 Pension Act §824(c).

[29] IRC § 408A(d)(3)(A).

(iv) an annuity plan described in IRC Section 403(a);

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

(vi) an annuity contract described in IRC Section 403(b).[30]

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 IRC Section 408A(d)(6), which refers only to individual retirement plans (*i.e.*, individual 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.

F. Roth IRA Remorse.

What happens if a taxpayer makes a conversion to a Roth IRA with the belief that she is qualified, and subsequently discovers that she is not qualified? Prior to the 1998 Act, it appeared that the taxpayer would still report the entire IRA distribution as income and would not be allowed to put the funds back into her Traditional IRA. Fortunately, the 1998 Act provides relief as follows.

A taxpayer may recharacterize a contribution from a Roth IRA to an IRA (or vice versa) by making an election and transferring the funds in a trustee-to-trustee transfer that includes any earnings thereon and is completed by the due date of the taxpayer's income tax return (including extensions).[31] The election is made by providing notice to the trustee of each IRA of the recharacterization.[32] Note that this provision does not protect taxpayers who do not discover that they are disqualified until after the due date (*e.g.*, upon examination).

Soon after enactment of the 1998 Act, the U.S. stock market corrected substantially, with major indexes falling approximately 20%. Almost immediately, some commentators pointed out that a literal reading of these provisions allows a taxpayer who converted an IRA to a Roth IRA prior to drop in value of the IRA assets to "undo" the conversion, setting the stage to reconvert at lower asset values.

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[30] IRC § 402(c)(8)(B).

[31] IRC §§ 408A(d)(6) and (7); Reg. § 1.408A-5 A-1(b)

[32] Reg. § 1.408A-5 A-6.

It did not take the IRS long to respond to this notion. Notice 98-50[33] supplemented the proposed regulations released in September, 1998 with interim rules governing "reconversions." These rules were ultimately incorporated in the final regulations.[34] In summary, the interim rules allow one "reconversion." A Participant may continue making more reconversions if she chooses, but the amount included in her income is based on the amount of the first reconversion.[35] The interim rules took effect November 1, 1998, which suggests that multiple reconversions prior to that date will be recognized.

[33] 1998-44 I.R.B., October 20, 1998.

[34] Reg. § 1.408A-5 A-9.

[35] The interim rules are difficult to summarize, and are broken down into rules that govern the period November 1, 1998 - December 31, 1998, and calendar 1999.

XIII. The "Trusteed" IRA.

The scope of this section is limited to the establishment of individual retirement accounts ("IRAs") under IRC Section 408(a), and Roth IRAs under IRC Section 408A. This section excludes individual retirement annuities under IRC Section 408(b), and does not address any other type of retirement account. For readability, references in this Section to an "IRA" are generally intended to refer to IRAs, Roth IRAs, or both.

A. Custodial and Trusteed IRAs.

There are general requirements under I.R.C. Sections 408 and 408A for establishing a valid IRA or Roth IRA, including the requirement that the account be either a custodial account or a trust.

The overwhelming majority of IRA accounts are custodial accounts. Most financial institutions offer only the custodial account option, perhaps because the account can be offered for a more competitive cost due to the limited scope of responsibility for the financial institution.

1. Trusteed IRAs to Accomplish Investment Objectives – the "Short-Form Trust IRA."

IRA accounts can hold a wide, but not unlimited, range of investments, including marketable securities, other stocks or bonds, real estate, and interests in partnerships or LLCs. Of course, certain assets require that careful attention be paid to UBTI and prohibited transaction rules, as discussed in Section XIV.

Most financial institutions follow a policy of further limiting the scope of permissible investments to cash, certificates of deposit, money market funds, and marketable securities, and will normally not hold real estate, closely-held stock, or interests in partnerships or LLCs.

A client who desires to invest his or her IRA account in something more adventurous than marketable securities will probably need a "trusteed" IRA. Specialized banks, trust companies, and other financial institutions will agree to serve as a trustee and to invest in a wider range of assets. The trustee fee charged for doing so is likely to be somewhat more than the typical custodial fee charged by a financial institution, but may be less than the full trustee fee a trust company might charge to serve as trustee of an irrevocable trust holding similar assets. The account statements, tax reporting, and the underlying account agreement and death beneficiary paperwork may be surprisingly similar to those associated with standard custodial accounts. Your author loosely refers to this type of "trusteed IRA" as a "Short-Form Trust IRA."

2. Trusteed IRAs to Accomplish Estate Planning Objectives – the "Full Trust IRA."

Generally, most custodial IRA and Roth IRA accounts (and most "Short-Form Trust IRAs") provide a standard death beneficiary designation form that contemplates that the account will pass at the owner's death either to individual beneficiaries, or to trusts for individual beneficiaries arising under other documents. This standard death beneficiary designation form is not always suitable for including more complex estate planning provisions.

For certain clients, there may be estate planning advantages if the IRA account is an integrated trust that not only provides the terms and conditions of the IRA account but also includes certain sophisticated provisions that are often helpful in outside documents such as Wills and trusts. Your author refers to this type of IRA as a "Full Trust IRA."

For example, a "Full Trust IRA" could not only provide all of the normal terms and conditions during the owner's lifetime, but it could also provide that at the owner's death the account shall continue, operating as both an inherited IRA account and a QTIP Marital Trust qualifying for the marital deduction election for estate tax under IRC Section 2056(b)(7), all integrated in one trust document. This arrangement is significantly different than when a standard custodial IRA is designated to a QTIP Marital Trust, because distributions are made directly from the "Full Trust IRA" to the surviving spouse. With a standard custodial IRA, IRA distributions are made from one entity (the inherited custodial IRA) to another (the irrevocable QTIP trust arising under a non-IRA trust document) that is a separate taxpayer, and the spouse then receives distributions from the QTIP trust (that may or may not be the same amount as the IRA distributions). The balance of this Section explores the trade-offs of these two approaches.

The documentation needed to establish a "Full Trust IRA" is significantly different than the documentation used to establish a typical custodial IRA or a "Short-Form Trust IRA" that is being established only to accomplish investment objectives. At one end of the spectrum, the financial institution may provide a "Full Trust IRA" document of modest length with certain blanks to be filled in or boxes to be checked. At the other end of the spectrum, the client's attorney may custom draft the entire document, subject to the financial institution's approval, resulting in a lengthy document comparable in scope to a sophisticated irrevocable trust.

The "Full Trust IRA" is not widely used, perhaps because it is not as well known and as well understood, and perhaps because there are a select few financial institutions that accommodate this type of account.

B. The Differences Between Custodial and Trusteed IRA.

Your author acknowledges Edwin P. Morrow III of Key Private Bank in Ohio for his thoughtful and comprehensive article, "Contrasting Conduit Trusts, Accumulation Trusts and Trusteed IRAs."[36] This article was helpful to your author in developing this Section.

1. Income Tax Rules at IRA Level.

For income tax purposes, there is no difference between a custodial and a trusteed IRA. In fact, IRC Section 408(a) defines an IRA as a trust that meets certain requirements, and Section 408(h) provides that a custodial account that otherwise meets those requirements shall be treated as a trust.

However, the Trusteed IRA may produce significantly different tax results compared to the outside trust that is designated to receive a custodial IRA, as explained below.

[36] CCH Journal of Retirement Planning, May-June 2007, p. 31.

2. Bank as Trustee.

Any IRA, whether custodial or trusteed, must have as its custodian or trustee a bank, credit union, savings and loan, or other corporation subject to banking regulation.[37] Thus, a Trusteed IRA may not have the IRA Owner, members of his or her family, or other individuals as trustees.

3. MRD Rules.

For MRD Rule purposes, there is no difference between a custodial and a trusteed IRA. In particular, the rules regarding MRDs for trusts will apply to either a custodial IRA designated to a trust, or to a Trusteed IRA that continues as a trust.

4. Applicable State Law.

The applicable laws of most states governing general principles of property ownership and legal remedies are more developed with respect to trusts than custodial accounts, and may provide greater certainty.

Federal laws (*e.g.* ERISA or REA) do not normally preempt state law with respect to IRA accounts. Labor Department Reg. Section 2510.3-2(d) excepts Individual Retirement Accounts and Individual Retirement Annuities described in IRC Sections 408(a) or (b) provided that:[38]

a. No contributions are made by the employer or an employee association;

b. Participation is completely voluntary for employees or members;

c. The employer's involvement does not extend beyond publicizing program to employees or members and collecting contributions through payroll deductions; and

d. The employer receives no consideration other than reasonable compensation for services actually rendered in connection with payroll deductions.

By the way, regardless of whether an IRA is a trust, there may be conflict of law issues to consider in determining which state's laws apply when the IRA document refers to the financial institution's home state and the IRA owner lives in another state.

5. Income Tax Treatment of Distributions to Beneficiary.

Distributions from the IRA or Roth IRA are generally taxable to the individual beneficiary according to normal principles – IRA distributions are likely to be fully taxable and Roth IRA distributions are not taxable if they are "qualified" distributions.

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[37] IRC § 408(a)(2); Regs. § 1-408(2)(b)(2).

[38] The Estate Planning, Probate and Trust section of the California State Bar formed a task force to file an amicus curiae brief in the *Boggs v. Boggs* case. Members of this task force have expressed concern that *Boggs* can be interpreted as supporting the preemption of state community property law as it applies to an IRA upon the death of a married participant, notwithstanding that the IRA is excepted from ERISA. The author does not share this view.

The individual beneficiary may claim any allowable IRD deductions associated with distributions.

6. Tax Reporting.

Tax reporting is likely to be less burdensome with the "Full Trust IRA" than when a custodial IRA or "Short-Form Trust IRA" is designated to an outside trust, because all activity is occurring in one trust entity that is an IRA, which is not required to file an income tax return except in unusual circumstances (UBTI is reported by the IRA).

The IRA prepares a 1099-R either way showing the amounts of distributions made to the trust or individual, as the case may be.

7. Accumulations Not Possible With Trusteed IRA.

Every IRA must make MRDs. A custodial IRA that is designated to an outside trust can make MRDs to the trust, which may distribute or accumulate the MRD amounts, net of expenses.

By definition, a Trusteed IRA cannot accumulate MRDs, and must distribute them in full (not "net" of expenses). Thus, if an accumulation trust is intended (*e.g.* a special needs, discretionary, or dynasty trust), the Trusteed IRA will need to provide for distributions to an accumulation trust that is either established outside the Trusteed IRA, or that arises independently pursuant to the provisions of the Trusteed IRA document. Your author suggests that in most cases when an accumulation trust is needed, it will be less confusing to use a separate, outside document to establish the accumulation trust.

8. Income Tax Treatment of Trust Fees and Expenses.

The "Full Trust IRA" may be at a disadvantage compared to the outside trust where fees are concerned, since the minimum distribution requirement is based on the asset value of the trust, without reduction for any trustee, investment, or other fees that will be payable from the IRA during the year.

With an outside trust, the minimum distribution may then be applied to pay trust level expenses, with the "net" amount then distributed to the beneficiary. The remaining balance in the IRA at the end of the year is higher, and the minimum distribution and amount of tax paid by the beneficiary is lower.

9. Amount of Fees.

During the IRA owner's lifetime, the financial institution is likely to charge a higher fee for serving as trustee of a "Full Trust IRA" than would be charged on a custodial IRA account. However, the combined trustee and investment management fees may not be as different if the underlying investments of the IRA (and perhaps other investments of the IRA owner) are also managed by the financial institution.

Upon the IRA owner's death, the financial institution's fee to serve as trustee of a "Full Trust IRA" is likely to be comparable to the fees that would be paid to a trustee under an outside trust designated as beneficiary of a custodial IRA. Again, combined trustee and investment management fees for the "Full Trust IRA" may be higher or lower than if a custodial IRA is designated to an outside trust, depending on

whether the financial institution also manages investments in the IRA or other related accounts.

10. Accountings.

Trust accountings will be due either way, but may be less complex with the Trusteed IRA since all activity is integrated in one trust entity.

In particular, a trust that is required to distribute income (*e.g.* a QTIP marital trust) does not have to coordinate the distribution of IRA "inside income" with the trust's other income.

11. QTIP Marital Trusts.

In fact, for QTIP marital trusts the Trusteed IRA avoids a point of interpretation under Revenue Ruling 2006-26 (and its predecessors 2000-2 and 89-89), in that any fees or expenses are paid from IRA income with the result that the "net income" of the IRA is distributed to the surviving spouse. With the custodial IRA designated to a marital trust, a literal reading of these rulings suggests that the spouse must be entitled to all of the income earned inside the IRA, leaving unanswered the question of where fees and costs are paid from.

However, this point of interpretation is of little help when MRDs exceed net income, which is to be expected as the surviving spouse's age approaches his or her mid-sixties and the life expectancy factors used to calculate MRDs produce MRD amounts that begin to exceed the net income produced by conventional investment portfolios. In fact, as discussed above, the MRDs must be distributed in full, with any trust costs and fees paid from the balance of the IRA.

An even more important consideration is the depletion of the IRA that will occur if the surviving spouse lives into his or her nineties, when MRDs begin to get very large. This could defeat the fundamental purpose of preserving assets for remainder beneficiaries, which may be the reason the client formed a QTIP marital trust in the first place. Thus, your author suggests that the Trusteed IRA is rarely the right choice for a QTIP marital trust.

12. Greater Flexibility in Drafting Dispositive Provisions.

It is usually more difficult to incorporate dispositive provisions into a death beneficiary designation than a full-featured trust instrument. Aside from syntax issues ("the IRA Owner hereby designates as his primary beneficiary . . ." versus "the trust shall be allocated and distributed . . ."), other drafting tools are available such as references to defined terms or terminology lawyers often use in drafting, such as "per stirpes" or "by right of representation," or references to classes without necessarily naming each member or assigning a percentage.

A full-featured trust instrument can include complex provisions such as:

a. A no contest clause;

b. Complex "tiers" or "tranches" of gifts, with varying ademption provisions;

c. Specific tax apportionment instructions, such as "free of death tax;"

d. A trust protector, independent trustee, and related clauses that allow removal and replacement of trustee, *etc.*

e. The ability to include complex estate planning provisions may in many cases be the best reason to use the "Full Trust IRA" approach.

13. Pecuniary Gifts.

In theory, pecuniary gifts to individual recipients should produce the same income tax outcome regardless of whether the gift is provided under a trusteed IRA or under an outside trust designated as the death beneficiary of an IRA, with the individual ultimately reporting the distribution in income and no additional trust-level income tax.

However, pecuniary gifts to charities can be problematical if they are provided in an outside trust, as illustrated by General Counsel memorandum 2006-44-020. This problem can be avoided if the pecuniary gift is provided under a trusteed IRA.

14. Setting Up IRA After IRA Owner's Death.

Most practitioners at one time or another have had to grapple with a financial institution serving as custodian during an IRA Owner's lifetime that is uncomfortable setting up the inherited IRA accounts for one or more trusts designated as beneficiary. The Trusteed IRA avoids these difficulties.

15. In-Kind Transfers of Inherited IRAs At Termination of Trust.

Assume a trust provides income to A for life, and then the balance is to be distributed outright to B's children in equal shares at A's death. If the trust is the designated beneficiary of a custodial IRA, it is sometimes challenging for the trustee to obtain the custodian's cooperation in assigning the IRA balance at A's death in the form of continuing IRAs for each individual remainder beneficiary. One would hope that the trustee of a Trusteed IRA would be comfortable cooperating in this regard.

16. Disability.

Many death beneficiary designations provide alternate provisions on the death of a beneficiary but do not address the consequences if the beneficiary is or becomes disabled. The Trusteed IRA can accommodate more complex drafting to address disability or other unusual circumstances.

17. Coordination of Provisions With Other Estate Planning Documents.

It is essential to coordinate appropriate provisions with other estate planning documents, regardless of whether a custodial IRA or Trusteed IRA is in place. These provisions should, for example, address apportionment of taxes, administration expenses and claims.

18. Coordination of Assets and Distributions With Other Trusts.

A Trusteed IRA, by its nature, segregates IRA assets from other assets. It will distribute, at a minimum, its MRD each year whether the beneficiary needs or wants it, or not. But if additional distributions are needed, there may be advantages or disadvantages to making these distributions from either the IRA or other assets. Other trusts may or may not have the same Trustee, and the documents should provide some guidance as to which trusts should be making additional distributions.

Similarly, if the MRD distributions are sufficient for a beneficiary's needs, the other trusts holding other assets will probably work best if the trustee has discretion to accumulate.

19. Inadvertent Errors.

A Trusteed IRA can be changed or amended only with the signatures of the client and the Trustee, which may reduce the risk of errors such as:

a. a custodial IRA with a "good" death beneficiary designation is transferred from one institution to another, and the death beneficiary designation is overlooked or changed;

b. a custodial IRA is distributed immediately by an investment advisor before other advisors can assist with setting up an inherited IRA;

c. a trust with carefully crafted provisions (*e.g.* a conduit provision) is amended, altered, or changed by the client or another advisor.

XIV. Limitations on Transactions and Permissible Investments.

Questions often arise as to when and how cash or property held in a retirement account can be applied to invest in unique investments or participate in transactions with potentially related parties. This section reviews the various limitations that apply. The scope of this section is limited to IRA and Roth IRA accounts, as a full treatment of these issues for other types of qualified plans would require more analysis than is possible within the scope of this outline.

A. The High Net Worth Investor.

The high net worth family often has access to investment opportunities that are unavailable to others. They have enough assets to meet investment minimums for the best investment managers. They can commit $5 to $10 million to a specific alternative investment without throwing their overall investment diversification out of balance. In fact, for many high net worth investors, the most distinguishing characteristic of their investment portfolio is the nature and amount of alternative investments, usually structured as partnerships.

Alternative investments generally require a contribution commitment, but the funds are not contributed all at once. The client needs to be ready to make commitments when asked. If the investment is successful, it will make cash distributions to the investor over time, but it is difficult to predict when these will occur. In the meantime, the client does not want a substantial portion of the portfolio to remain in cash. As a result, the high net worth client is not as liquid as one might think. When a cash need arises, the client may need to liquidate marketable securities, which may trigger capital gains tax.

High net worth clients sometimes ask whether other pools of assets can participate in these alternative investments, such as the family foundation, charitable remainder trust, or the IRA or retirement plan.

The rules for qualified retirement plans can be complex and are best negotiated with the help of an experienced ERISA attorney.

This section provides a brief review of rules that might apply to IRA or Roth IRA accounts, although these rules are also complicated.

B. Wash Sale Rule Extended to IRAs and Roth IRAs.

Revenue Ruling 2008-5 now applies the so-called “wash sale rule” by aggregating personal investment trades with trades occurring in a person’s IRA or Roth IRA. IRC Section 1091(a) imposes a “wash sale rule” on any investor who sustains a loss from the sale or other disposition of marketable securities, providing that the loss is disallowed if the investor acquires substantially identical securities within thirty days. Revenue Ruling 2008-5 disallows an individual investor’s loss when his IRA or Roth IRA acquires substantially identical securities within thirty days.

C. Unrelated Business Taxable Income (“UBTI”).

Tax exempt entities must pay tax on unrelated business taxable income (“UBTI” which is often pronounced “YOU-bit”). Retirement plans and IRAs are tax exempt entities for purposes of the UBTI rules.

UBTI consists of income arising an “unrelated business” that is “regularly carried on” by the tax exempt entity.

Issue of whether a business is “related” may not always be obvious, but for IRAs any trade or business is “unrelated.”

Debt-financed income is also UBTI, which includes earnings of investments subject to margin loans, and real estate subject to loans.

Note that many “alternative investments” are structured as partnerships and occasionally involve margin borrowing, which will result in some UBTI. Many of these investments offer “on-shore” and “off-shore” versions, that require careful review both as to which version to select for investment, and as to the income tax elections and reporting that may be required with an “off-shore” investment.

Real estate rent is not UBTI, unless it is determined based on a percentage of the tenant’s profits.

Items that would normally not be UBTI will be considered as UBTI if they reduce the business income of an entity that is more than 50% controlled by the IRA.

What are the consequences of UBTI in an IRA? The IRA must file an income tax return using Form 990-T reporting and paying income tax at ordinary rates on “adjusted” UBTI, and may have estimated tax requirements with associated penalties. There may be no tax if “adjusted” UBTI is $1,000 or less, and expenses specifically related to UBTI may be allowed as an offset in determining “adjusted” UBTI.

The IRA’s status as an IRA is not jeopardized by the UBTI, but the tax on the UBTI is a cost that could otherwise be avoided. In the case of an IRA, the UBTI will be taxed a second time when it is distributed to the beneficiary. In the case of a Roth IRA it will not, but no tax would have been due but for the UBTI rules. So, either way, any tax paid should be viewed as equivalent to a penalty, and should be considered as part of the overall economic analysis before proceeding with an investment that might produce UBTI.

D. Prohibited Transaction Rules.

The prohibited transaction rules are a complex subject that could justify a stand alone presentation. To summarize:

IRAs are prohibited from entering into certain transactions with “disqualified persons” (“DQPs”) consisting of:

a. The IRA Owner;

b. His or her spouse;

c. His or her ancestors;

d. His or her descendants;

e. Spouses of his or her descendants;

f. The trustee or custodian of the IRA; or

g. Any entity 50% or more owned by IRA Owner collectively by the above (IRC 4975(e)(2) does not include family members, but IRC 4975(e)(4) and (5) call for attribution using rules from IRC Section 267).

If the IRA Owner or his beneficiary engages in a prohibited transaction, the IRA ceases to be an IRA and the individual is taxed as if the entire account had been distributed on the first day of the taxable year (including 10% pre-59-1/2 penalty if applicable).

If a prohibited transaction occurs other than one engaged in by the IRA Owner or his beneficiary, an excise tax is due under 4975.

Here are some of the most worrisome prohibited transactions (full analysis would be beyond the scope of this outline) – regardless of whether IRA is "harmed":

h. Sale, exchange or lease between IRA and DQP;

i. Lending of money or extension of credit;

j. Furnishing of goods, services, or facilities;

k. Direct or indirect transfer to or use by a DQP of the income or assets of the IRA;

l. If IRA Owner benefits from transaction, it may be a prohibited transaction even if not with a DQP (*e.g.* IRA owner is minority shareholder in a business);

m. Exemptions for contributions, distributions, certain routine transactions with financial institutions, *e.g.* IRA balance counts toward total assets with institution, minimum balance, fees, *etc.*; or

n. A transaction that creates a conflict of interest for the IRA fiduciary.

E. Family Limited Partnerships.

Can an IRA invest in a family limited partnership? If so, the potential tax benefits may be valuable, both in terms of reduced income tax and reduced transfer tax that may result from valuation discounts.

The Labor Department issued a favorable ruling eight years ago, DOL Opinion 2000-01A. The fact pattern was unusual. The family seeking the ruling had existing investments with an investment manager through a family partnership that satisfied the manager's minimum capital requirement. One family member had formed a new IRA with $500,000 that did not satisfy the manager's minimum capital requirements on its own, and could not be invested with the manager unless it was allowed to join the existing family partnership. The partnership was not a DQP, at least not prior to entry of IRA, due to ownership by individuals outside the scope of "family" for IRC 4975. The individual IRA owner was the sole general partner of the limited partnership.

The Labor Department ruled that the family partnership was not a DQP, and that IRA's proposed investment in the family partnership was not a prohibited transaction, in these specific facts.

This ruling addressed the issue of whether a "direct" prohibited transaction would occur, but did not address whether the proposed transaction violated other rules,

such as prohibition of use of IRA assets by a DQP, or rules prohibiting an IRA owner from dealing with IRA assets in his own interest, or placing fiduciary in conflict of interest. Also, the ruling does not address future transactions with the partnership now that IRA is a partner.

This type of planning is aggressive, and not for the faint of heart. For most clients, your author suggests the best course is to avoid mixing retirement plans and family partnerships or other entities. One aspect of the tax risk of investing IRA funds in a family limited partnership that is particularly disturbing is that the potential penalty exposure if the transaction is subsequently determined to be a prohibited transaction could continue for many years.

If an IRA will be investing in a family limited partnership, the risks may be reduced somewhat if the partnership is owned by more than 50% non-DQPs after it is established.

Even if an IRA can invest in a family limited partnership, there are other trade-offs. MRDs will be determined each year based on the value of IRA assets, which means that the partnership will need to be valued each year. The appraisal costs may be significant. Partnership assets could be distributed in kind; in fact, if the partnership is the only asset of the IRA, that may avoid the need for an appraisal since the percentage could be calculated without reference to the value. (However, this assumes the same discount methodology for the MRD portion as the IRA's entire portion.)

Funds for each year's MRD may need to come from the limited partnership. If so, they may need to be part of a pro rata distribution to all partners. Of course, other partners may recontribute.

XV. Case Study: Mr. Jones – Stretch-Out With Separate Accounts.

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

A. Fact Pattern.

The fact pattern is similar to as Mr. Jones (discussed earlier)[39], except here Mr. Jones has three children, child A, child B, and child C. This case study compares the outcomes for the three children using a few different age assumptions, with and without "separate account" treatment under the minimum required distribution rules. Mr. Jones's estate consists of:

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

B. Planning Strategies Evaluated.

Scenario	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) Ages 48, 42, and 36 - Stretch Out Over Oldest Life	The three children are ages 48, 42, and 36 in the calendar year following Mr. Jones' death (he dies at age 82). Mr. Jones takes minimum distributions until the year of his death, and the IRA is divided equally among the three children who continue to take only minimum distributions over the oldest child's life expectancy (age 48).
(3) Ages 48, 42, and 36 - "Separate Accounts"	Same as (2), except "separate accounts" are recognized for minimum required distribution purposes, thus each of the three children uses his or her own life expectancy.
(4) Ages 58, 52, and 46 - Stretch Out Over Oldest Life	Same as (2), *i.e.* over oldest life expectancy, except the three children are ten years older.
(5) Ages 58, 52, and 46 - "Separate Accounts"	Same as (3), *i.e.* separate accounts, except the three children are ten years older.
(6) Ages 48, 46, and 43 - Stretch Out Over Oldest Life	Same as (2), *i.e.* over oldest life expectancy, except the three children are closer in age (five years between oldest and youngest).

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[39] This case study is not identical, having been run five years ago with slightly different fact assumptions, including a higher investment return of 10%. Your author has not updated this case study yet, but believes that it is a valid illustration of the issues relating to separate account treatment.

(7) Ages 48, 46, and 43 - "Separate accounts" Same as (3), *i.e.* separate accounts, except the three children are closer in age (five years between oldest and youngest).

C. Case Study Results.

Mr. Jones - Stretch Out Using Separate Shares							
Retirement Plan in Yr 2003:	$ 1,000,000						
Deferral Period Ends:	2068						
Distribution Strategy:	(1) Distribute in 2003	(2) Ages 48, 42, and 36 - Stretch Out Over Oldest Life	(3) Ages 48, 42, and 36 - "Separate Shares"	(4) Ages 58, 52, and 46 - Stretch Out Over Oldest Life	(5) Ages 58, 52, and 46 - "Separate Shares"	(6) Ages 48, 46, and 43 - Stretch Out Over Oldest Life	(7) Ages 48, 46, and 43 - "Separate Shares"
Value of Retirement Plan Assets At End of Deferral Period:	32,669,896	67,291,671	73,408,688	58,627,618	64,647,652	67,291,671	69,936,002
Value of Retirement Plan Assets At End of Deferral Period (In Today's Dollars):	12,412,378	25,566,340	27,890,398	22,274,579	24,561,790	25,566,340	26,571,010
% Comparison:	100%	206%	225%	179%	198%	206%	214%

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

A. Fact Pattern.

Mr. Gramps's situation is similar to 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,[40] 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 IRD deduction will be utilized on the earliest dollars distributed, as discussed earlier.

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.

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[40] This case study is not identical, having been run five years ago with slightly different fact assumptions, including a higher investment return of 10%. Your author has not updated this case study yet, but believes that it is a valid illustration of the issues relating to multi-generational planning with retirement assets.

(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 Mr. Gramps directs investment assets to grandchild in amount of then-indexed GST exemption ($1,360,000).

(5) Stretch-Out; $1.36M IRA to GC — Same, except Mr. Gramps designates portion of IRA to grandchild equal to the then-indexed GST exemption; other assets pass to his child. Both child and grandchild take MRDs.

(6) Stretch-Out; Entire IRA to GC (incurs GST tax) — Same, except Mr. Gramps designates the entire IRA to his grandchild, and pays GST tax at death; other assets pass to his child.

(7) Stretch-Out; $1.36M Roth IRA to GC — Same as scenario (5) except that Mr. 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 Mr. Gramps completes a conversion of his entire retirement plan to a Roth IRA in the year 2003 (paying income tax from non-IRA assets).

C. 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%

XVII. 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.[41] Now the Participant can ignore the RBD, as long as he or she makes 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 "Determination Date," and has heard others call it the "Applicable Date" or the "Designation Date").[42] 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.[43])

Clients considering the disclaimer approach should remember that a qualified disclaimer of an inheritance must be made within nine months of death.[44] This deadline will generally occur earlier than the "Determination Date."

***Example 1**: Paul the participant dies on January 1, 2008. He designated his only child Donna Beth as primary beneficiary and Donna Beth's three children as next alternates in equal shares. Donna Beth has until October 1, 2009 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 accounts are in place by December 31, 2009).*

Does it matter whether Paul had actually mentioned Donna Beth's three children on his death beneficiary designation? Yes, it is essential that her children be designated as

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[41] 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.

[42] Reg. § 1.401(a)(9)-4, A 4.

[43] IRC § 2518.

[44] IRC § 2518.

alternates, and that the designation direct how their shares are determined (equal shares in this example). If Paul had only designated Donna Beth, her 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.[45] 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 Determination 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 Determination Date she will continue to be recognized as the designated beneficiary regardless of whether alternate beneficiaries were designated.[46] 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 Determination Date, her life expectancy continues to control and the designation of the revocable trust does not affect the life expectancy used to calculate MRDs.*

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 Determination Date.

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[45] Reg. § 1.401(a)(9)-4, A 4(a).

[46] Reg. § 1.401(a)(9)-4, A 4(c).

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 "Determination 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 "Determination 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 account 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 databases. Also, some financial institutions take the position that a designation is not effective until it has been "accepted" by the institution. 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 Reference to Specific 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.

XVIII. "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. SAMPLE FORM: 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 accounts in the following manner:

> One equal account shall be established for each of the IRA Owner's two children, namely Ruth Smith Johnson and Sue Smith. The following table provides pertinent information about the Owner's children:

Name	Relationship	Social Security Number	Birth Date
RUTH SMITH JOHNSON	Daughter	111-11-1111	January 1, 1960
SUE SMITH	Daughter	222-22-2222	January 1, 1966

> ***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.*

If any child does not survive the IRA Owner, said deceased child's account shall be further divided into separate accounts for each of 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 accounts so established.

Each separate account created for a child or more remote descendant of the IRA Owner who, at the time of the IRA Owner's death, has attained twenty-one (21) years of age and is not "disabled" (as defined below), shall be designated to such individual, outright and free of trust.

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 IX, and "separate account" treatment is not assured for multiple subtrusts, as discussed in Section XII.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, 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 separate account, if any, for a person who at the time of the IRA Owner's death, has not attained twenty-one (21) years of age or is "disabled," 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, 2008.

[IF NO SUBTRUSTS] Each separate account, if any, for a person who at the time of the IRA Owner's death, has not attained twenty-one (21) years of age and is not otherwise "disabled" shall be held by the person's legal guardian as custodian until the person attains twenty-one (21) years of age under the Uniform Transfers to Minors Act or if there is no such legal guardian, the custodian shall be the then serving Trustee of the CINDY SMITH REVOCABLE TRUST established June 22, 2008. Each separate account, 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, 2008.

[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 to the extent that all or any portion of the IRA does not pass under her primary designation, it shall instead be designated to the Trustee of the CINDY SMITH REVOCABLE TRUST established June 22, 2008.

Further Death Beneficiary Designations. The IRA Owner requests that the documents and terms governing the IRA (including the terms of this Death Beneficiary Designation) be construed to the greatest extent possible to allow any individual beneficiary to make further death beneficiary designations after the IRA Owner's death that direct how said individual beneficiary's interest in the IRA would pass at the individual beneficiary's death.

Transfer by Fiduciary. The IRA Owner requests that the documents and terms governing the IRA (including the terms of this Death Beneficiary Designation) be construed to the greatest extent possible to allow the fiduciary of any estate or trust holding an interest in the IRA to "transfer" part or all of said

interest to any one or more beneficiaries of said trust or estate for any reason (including by way of example and not limitation the partial or complete distribution of said trust or estate). "Transfer" refers to the transfer of ownership and authority over said interest without actually causing taxable distributions from the IRA, *e.g.* such as the transfers 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 most likely scenario at Ms. Smith's death is that both children will survive and take their separate accounts free of trust. However, Ms. Smith's Will and revocable Trust, if applicable, will need to be ready in case part of her IRA passes to the Trust for a disabled or minor beneficiary. 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.

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

10.6 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.

10.7 Trust for Minor or Disabled Beneficiary. If a beneficiary entitled to distribution of all or part of a trust is under age Twenty-One (21) 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, 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-One (21) 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 10.7. If the beneficiary dies before the distribution of such interest, the Trustee shall distribute such interest to such beneficiary's estate.

Notwithstanding the foregoing, to the extent the Trustee receives distributions from a Stretch-Out Retirement Account as to which the beneficiary is the Stretch-Out Beneficiary (as these terms are defined in Sections 12.16, and 12.17), 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 properly allocable to distributions received or to the balance remaining in said Stretch-Out Retirement Account), for as long as the beneficiary shall live or until the earlier termination of his or her trust.

For so long as the beneficiary is the Stretch-Out Beneficiary of a Stretch-Out Retirement Account, certain individuals acting as Trustee are prohibited from withdrawing "Excess Distributions" from said Stretch-Out Retirement Account, and said power shall be reserved to others acting jointly as Trustee who are not prohibited from so acting or, if none, to the Independent Trustee:

(**a**) **Disclaimant.** Any individual serving as Trustee who made a qualified disclaimer with respect to said interest in said Stretch-Out Retirement Account.

(b) Individual With Obligation of Support. Any individual serving as Trustee who owes a legal obligation of support to the beneficiary.

For purposes of this Section, the term "Excess Distributions" refers, with respect to an interest in a Stretch-Out Retirement Account, to any distribution 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; (iii) comply with the legal obligation to pay income, estate, inheritance, generation-skipping transfer tax, or other taxes properly chargeable to distributions received from or the balance remaining in said Stretch-Out Retirement Account; and (iv) provide for payment of trust expenses properly allocable to distributions received from or the balance remaining in said Stretch-Out Retirement Account.

Author's Note: Certain terms used in the above clauses should be included in the definitions section of the revocable trust and coordinated with the death beneficiary designation and other documents:

12.3 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 statement of the disabled person's regularly attending physician 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.

12.8 Minimum Distribution Rules. The term "Minimum Distribution Rules" refers to the rules of IRC Section 401(a)(9).

12.10 Retirement Account. The term "Retirement Account" refers to a Tax-Advantaged Account that is subject to the Minimum Distribution Rules.

12.16 Stretch-Out Retirement Account. The term "Stretch-Out Retirement Account" refers, with respect to a trust hereunder, to an interest in a Retirement Account that satisfies the following conditions: (i) the interest in the Retirement Account (or a successor Retirement Account, *e.g.* an inherited IRA that receives a rollover from a qualified retirement plan) became part of the trust by reason of the Settlor's death (or the death of another, depending on the context); and (ii) the provisions governing the Retirement Account permit the Trustee of the trust to take distributions following the year of death of the balance of the interest over the life expectancy of a trust beneficiary (or the oldest member of a group of individuals determined under the Minimum Distribution Rules to which a trust beneficiary belongs), assuming said trust otherwise qualifies to do so under the Minimum Distribution Rules.

12.17 Stretch-Out Retirement Beneficiary. The term "Stretch-Out Retirement Beneficiary" refers, with respect to a trust hereunder that owns an interest in a "Stretch-Out Retirement Account," to the trust beneficiary whose life expectancy is or will be used in determining the timing and amount of post-death distributions (or whose life expectancy would have been so used if he or she was the oldest member of the group of individuals determined under the Minimum Distribution Rules to which he or she belongs).

12.12 Tax-Advantaged Account. The term "Tax-Advantaged Account" refers to any plan, contract, or other arrangement (other than a life insurance contract) that is allowed under the Internal Revenue Code to accumulate any part of its income in a tax-advantaged manner (*e.g.*, income tax-deferred or income tax free) for the benefit of an owner, beneficiary, or successor, and includes, by way of example and not limitation, a qualified or non-qualified annuity, a deferred compensation plan, or a retirement or individual retirement account arrangement established under IRC Section 401, 403, 408, 408A, or 457. A plan account or arrangement that is otherwise a "Tax-Advantaged Account" and that owns one or more life insurance contracts among its assets is a "Tax-Advantaged Account." A plan, contract, or other arrangement that is reasonably believed to qualify for tax-advantaged treatment under the Internal Revenue Code is a "Tax-Advantaged Account" even if it is subsequently determined it did not so qualify.

XIX. Trusts as Beneficiaries Under the MRD Rules.

The MRD Rules effectively impose two steps of analysis to determine the post-death MRDs of a trust that has been designated as death beneficiary of a retirement plan account:

Step 1 - Does Trust Meet Threshold Requirements to Qualify as a DB Trust. If the trust satisfies certain threshold requirements, it is referred to in these materials as a "DB Trust" and MRDs will be calculated as if certain trust beneficiaries had been designated individually. These trust beneficiaries are referred to in these materials as the "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."[47] This effectively excludes charities, business entities, estates, and trusts,[48] but an exception is allowed for any trust that meets the following threshold requirements:[49]

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.[50]

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.[51] 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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[47] "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.

[48] Reg. § 1.401(a)(9)-4, A 3.

[49] Reg. § 1.401(a)(9)-4, A 5.

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

[51] Reg. § 1.401(a)(9)-4, A 1.

4. Documentation Provided to Plan Administrator.

Participant's Lifetime. It is generally not necessary to determine whether a trust is a DB Trust during the Participant's lifetime, and thus it is generally not necessary for a trust to satisfy the threshold documentation requirement prior to the Participant's death. However, there is one scenario, that admittedly does not arise often, in which these issues arise and documentation is required. This scenario arises 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 designating the Spouse individually. When this situation arises, a documentation requirement applies. To satisfy this requirement, the Participant must provide the plan administrator with either:[52]

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 IRC 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:[53]

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 Determination 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 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

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[52] Reg. § 1.401(a)(9)-4, A 6(a).

[53] Reg. § 1.401(a)(9)-4, A 6(b).

after the Determination Date of September 30).[54] ***The consequence of failing to meet this deadline is that the trust will not meet the threshold requirements to be a DB Trust in any year of post-death distributions.***

Relief for Missed Documentation Deadline. This threshold documentation requirement has been required under each version of the proposed and final regulations. The final regulations that were promulgated on April, 2002[55] 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.[56] This grace period was available regardless of how long ago the failure to submit documentation occurred. However, since the final regulations are not generally considered to apply to years prior to 2002, it is unclear what benefit, if any, this grace period provided in determining MRDs for pre-2002 years.

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 IRC Section 401(a)(9) if MRDs were too small only because the plan administrator relied on trust documentation.[57] 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.[58]

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.[59]

5. Drafting Suggestion - Documentation Requirement.

Since the consequence of failing to comply with the documentation requirement is that the trust is precluded from qualifying as a DB Trust, and since there is no known remedial procedure that can be followed if documentation is not submitted by the prescribed due date, your author suggests including language in each trust instrument that reminds the trustee of the documentation requirement. For a sample clause, see XIX.B.7.

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,[60] 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

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[54] Id.

[55] The final regulations are published in the Fed. Reg. Vol. 67, No. 74, p. 18834 (4/17/2002); they were released for publication in T.D. 8987 (4/16/2002), which begins with a "Statement of Information" that provides background and explanation of provisions; the IRS also released Notice 2002-27 on the same day (4/16/2002) to finalize the rules for reporting of MRD amounts by IRA custodians.

[56] Reg. § 1.401(a)(9)-1, A 2(c).

[57] Reg. § 1.401(a)(9)-4, A 6(c)(1).

[58] Reg. § 1.401(a)(9)-4, A 6(c)(2).

[59] Reg. § 1.408-8, A 1(b).

[60] Reg. § 1.401(a)(9)-4, A 5(a).

possible. The second step is to identify the member of the "pool" of DB Trust Beneficiaries who has the shortest life expectancy, consistent with the rules that apply to multiple DBs under the MRD Rules.[61]

1. One Trust Viewed as Multiple Trusts - "Separate Account" Treatment.

As discussed earlier, if a retirement plan asset is passing directly or in trust for several individuals (*e.g.* the plan owner's children), all of the individuals must calculate MRDs using the life expectancy of the oldest individual in the group, unless the plan by its terms provides "separate accounts" for each individual, in which case each individual may use his or her own life expectancy for his or her account.[62] The final regulations provide that "separate account" treatment is not allowed with respect to multiple beneficiaries of a DB Trust.[63] Thus, minimum distributions for the entire DB Trust must be calculated based on the DB Trust Beneficiary with the shortest life expectancy.

The IRS issued a group of private rulings in April, 2003 that denied separate account treatment with respect to an IRA being distributed to three different subtrusts arising under a common trust instrument.[64] The rulings did not provide as much factual background as the author would have preferred, but 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 your author still believes would qualify for separate account treatment:

"The IRA shall be divided into three equal separate accounts 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 separate accounts 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.

Your author's faith in this analysis was reinforced by Priv. Ltr. Rul. 2005-37-044, which analyzed an IRA death beneficiary designation similar to the above providing that the IRA was to be divided into nine shares for nine subtrusts arising under a common trust instrument. The IRS ruled that each subtrust was allowed to use the life expectancy of its respective primary beneficiary to calculate MRDs.

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[61] Reg. § 1.401(a)(9)-5, A 7.

[62] Reg. § 1.401(a)(9)-8, A-2(a)(2).

[63] Reg. § 1.401(a)(9)-4, A 5(c).

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

Other private letter rulings issued in recent years have denied separate account treatment when the death beneficiary language names the so-called "parent" trust without specifically calling for the plan interest to be divided into shares that are each designated to subtrusts.[65]

Of course, private letter rulings cannot be cited as authority by any taxpayer other than the taxpayer who obtained the ruling. What planning options are available for those clients who are determined to accomplish separate account treatment for multiple subtrusts and are not comfortable relying on Priv. Ltr. Rul. 2005-37-044?

- *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 2003 rulings discussing the requirement under Reg. 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 these rulings were created post-death by the Trustee pursuant to the trust instrument). Your author is not so sure that this is what the IRS was getting at in these sections of the ruling, but setting up the subtrusts early certainly will not 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 IRS truly intends never to allow separate account treatment when an entire plan interest 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 account treatment. This interpretation was advanced by Marjorie Hoffman, principal draftsperson of the regulations, in an informal conversation with your author during the summer of 2004. To overcome this point of view, one might need to implement a more extreme approach of drafting multiple trust instruments, one for each of 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 makes sense to fund each trust or subtrust during the plan owner's lifetime as part of the effort.

- *Create Separate Accounts Now.* A Participant may be able to circumvent this whole problem by dividing the plan into separate accounts during life. This approach may ring strangely familiar, since this type of approach was necessary to obtain separate account treatment under the 1987 proposed regulations, and was used commonly until the issuance of new proposed regulations in 2001. 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.

How much is at stake if "separate account" treatment is lost? If the difference in the ages of the various DB Trust Beneficiaries is only a few years (*e.g.* the traditional family with all of the children still living) the economic hit is not as much as one might think, as illustrated in the "Jones - Separate Account" case study in

[65] Priv. Ltr. Rul. 2004-32-027 through 029; Priv. Ltr. Rul. 2006-08-032.

Section XV. However, if there is a wide difference in age, the economic cost of losing "separate account" 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 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.[66]

[66] 2001 Prop. Reg. § 1.405(a)(9)-5, A 7(c).

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.[67] To illustrate, consider the following example, which describes a type of trust commonly requested by clients:

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.*[68]*) 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 Determination 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 Determination 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 Determination Date, are they 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 Determination 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.[69]

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[67] Reg. § 1.401(a)(9)-5, A 7(c).

[68] IRC § 691(a)(2).

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

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 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 Determination 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 Determination 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 Determination 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 Determination 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 Determination 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. Treasury's Rationale On Trust Requirements.

Why are the rules for trusts so difficult? Based on several informal conversations with Marjorie Hoffman, principal draftsperson of the proposed and final regulations, your author understands that Treasury is very 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 will 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 that of a "mere potential successor."

It is interesting, however, that by extending special treatment to “conduit trusts” (discussed in detail in Section XX.) the Treasury is willing to ignore accumulation for the possible benefit of older successor beneficiaries if the accumulation is 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.

7. General Drafting Suggestions for Trusts.

The IRS has hinted that the Participant’s estate might be viewed as a DB Trust Beneficiary if the DB Trust requires or allows plan assets to be applied to satisfy general debts, expenses, and tax obligations arising at the Participant’s death.[70] Proactive drafting can go a long way to reduce the risk of this attack, but special care is always advisable when coordinating a special rule for plan assets with general language apportioning debts, expenses, and taxes (as illustrated by the form below).

The simplest drafting approach would be to simply forbid the trustee from applying plan assets to pay general debts, expenses, and tax obligations. However, your author is concerned that this approach is too broad and could lead to administrative difficulties and economic distortions among beneficiaries.

Another simple drafting approach that is less likely to result in administrative difficulties or economic distortions is to limit the trustee’s power to apply plan assets to pay general debts, expenses, and tax obligations to those that are properly chargeable to the plan assets. One would think that the IRS would recognize the logic that this is not the same as including the estate as a DB Trust Beneficiary, but experience tells us that neither the IRS nor the MRD Rules can be counted on to produce the most logical result. However, the IRS has left a clue as to what it would accept in the post-mortem rules that allow certain post-mortem planning to eliminate certain beneficiaries by a Determination Date of September 30 of the calendar year following the year of death[71] (these rules are discussed in detail elsewhere in these materials).

Accordingly, your author suggests a more complicated drafting approach that incorporates the post-mortem planning rules by requiring amounts that are properly chargeable to plan assets to be paid prior to the September 30 “Determination Date” provided in the regulations. Of course, it may not be possible to determine all such amounts with certainty by the Determination Date, and the clause will need to provide guidance on how these amounts are to be handled. The following clause illustrates this type of approach. The sample form uses a defined term, “Stretch-Out Retirement Account,” to narrow its application to those retirement plan interests that have the potential to provide stretched out distributions – a benefit that might be lost if the estate were included as a DB Trust Beneficiary. The sample form also addresses how “outside” assets are to be addressed (*e.g.*, annuity arrangements, which can present difficult tax apportionment issues when not properly addressed in the governing documents). The bold headings referring to “September 30” may be helpful in alerting the casual reader of the instrument of an unexpected deadline for determining and paying debts, expenses, and taxes.

9.3 “Stretch-Out Retirement Accounts” Passing Under Trust Instrument. The Trustee shall not apply Stretch-Out Retirement Account assets passing under any trust hereunder to pay any portion

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

[71] Reg. § 1.401(a)(9)-4, A-4(a).

of a debt of the Settlor, expense of administration, or Death Tax arising by reason of the Settlor's death, except as follows:

(a) Payment Prior to September 30 Determination Date. If the Trustee determines, prior to the Determination Date, that all or any portion of a debt of the Settlor, expense of administration, or Death Tax is properly chargeable by reason of the Settlor's death to a beneficiary's interest in a Stretch-Out Retirement Account passing under any trust hereunder, the Trustee shall pay said amount prior to the Determination Date by applying the following assets in any combination the Trustee determines in its sole discretion (and such payment shall be credited against the amount chargeable to said Stretch-Out Retirement Account interest): (i) assets from said Stretch-Out Retirement Account interest; (ii) assets the beneficiary offers to provide for this purpose; or (iii) assets the Trustee selects for this purpose (other than assets qualifying for the charitable or marital deductions from federal estate tax in the Settlor's estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion. The Settlor requests, but does not require, that the Trustee apply assets other than Stretch-Out Retirement Account assets to pay said amount when doing so reduces the need to take a distribution from the Stretch-Out Retirement Account earlier than would otherwise be necessary, thus enhancing the beneficiary's ability to benefit from income tax deferred compounding.

(b) Amounts Determined On or After September 30 Determination Date. If the Trustee determines, on or after the Determination Date, that all or any portion of a debt of the Settlor, expense of administration, or any Death Tax would be properly chargeable by reason of the Settlor's death, but for the operation of this Section 9.3(b), to a beneficiary's interest in one or more Stretch-Out Retirement Account interests passing under any trust hereunder, the Trustee shall pay said amount by first applying the following assets in any combination the Trustee determines in its sole discretion: (i) assets the beneficiary offers to provide for this purpose; or (ii) assets the Trustee selects for this purpose (other than Stretch-Out Retirement Account assets or assets qualifying for the charitable or marital deductions from federal estate tax in the Settlor's estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion; and the Trustee shall apply assets from said Stretch-Out Retirement Account interests to pay said amount only to the extent that said other assets are insufficient to do so.

9.4 Tax-Advantaged Accounts or Other Assets Passing Outside Trust. If the Trustee determines that all or any portion of a debt of the Settlor, expense of administration, or Death Tax is properly chargeable, by reason of the Settlor's death, to a beneficiary's interest in property not passing under any trust hereunder (including by way of example and not limitation a Tax-Advantaged Account), the Trustee may in its sole discretion pay (or not pay) all or part of said amount by applying any combination the Trustee determines in its sole discretion of the following assets (and any such payment shall be credited against the amount chargeable to said interest in property not passing under any trust hereunder): (i) assets the beneficiary offers to provide for this purpose; or (ii) assets the Trustee selects for this purpose (other than assets qualifying for the charitable or marital deductions from federal estate tax in the Settlor's estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion. The Settlor requests, but does not require, that the Trustee apply assets other than Tax-Advantaged Account assets to pay said amount when doing so reduces the need to take a distribution from a Tax-Advantaged Account earlier than would otherwise be necessary, thus enhancing the beneficiary's ability to benefit from income tax deferred compounding. The Trustee's powers provided under this Section 9.4 are in addition to, and not in place of, other powers provided the Trustee under this or other instruments, or under applicable law.

11. Powers and Administrative Provisions. (The following clause is suggested for inclusion in the "boilerplate" of most trusts. However, some of the sample trusts illustrated in these

materials address specific retirement plan related issues in the body of the dispositive language, which may require some adjustment to provisions that would otherwise appear in the "boilerplate" section.)

11.15 Trust as Beneficiary of Retirement Account. The Settlor intends that each trust hereunder that owns an interest in a Retirement Account enjoy the longest possible deferral period under the Minimum Distribution Rules. Accordingly, the following shall apply:

(a) The Trustee of a trust so designated shall, within the time limit prescribed under the Minimum Distribution Rules, deliver documentation required under said rules to the respective administrators and custodians of each Retirement Account.

(b) For purposes of this instrument, when the Trustee is directed to "distribute" an interest in a Retirement Account to an individual or another trust, the Trustee is to assign all of the Trustee's interests in and powers over said Retirement Account interest (*e.g.*, to direct investments and withdrawals) to said individual or to the trustee of said other trust, and such direction shall not be interpreted as requiring the Trustee to arrange for the assets held in the Retirement Account to be withdrawn from said Retirement Account. The Settlor specifically intends that any such "distribution" of a Retirement Account shall be handled in a manner that results in zero, or the minimum possible amount of income tax payable by either the trust, said individual, or said other trust.

(c) The administrators, custodians, or other fiduciaries of the respective Retirement Accounts 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 11.15.

12. Definitions. (The following are selected definitions relating to retirement plan issues. The term "Stretch-Out Retirement Beneficiary" will be important in drafting the conduit trust provisions discussed further below.)

12.5 Determination Date. The term "Determination Date" refers, with respect to the death of the Settlor (or the death of another, if the context specifically indicates) the thirtieth day of September of the calendar year following the calendar year of said Settlor or other individual, or such other date as may be provided under Treasury Regulation Section 1.401(a)(9)-4 for determining post-death designated beneficiaries under the Minimum Distribution Rules.

12.8 Minimum Distribution Rules. The term "Minimum Distribution Rules" refers to the rules of IRC Section 401(a)(9).

12.10 Retirement Account. The term "Retirement Account" refers to a Tax-Advantaged Account that is subject to the Minimum Distribution Rules. [correct formatting on 12.16]

12.16 Stretch-Out Retirement Account. The term "Stretch-Out Retirement Account" refers, with respect to a trust hereunder, to an interest in a Retirement Account that satisfies the following conditions: (i) the interest in the Retirement Account (or a successor Retirement Account, *e.g.* an inherited IRA that receives a rollover from a qualified retirement plan) became part of the trust by reason of the Settlor's death (or the death of another, depending on the context); and (ii) the provisions governing the Retirement Account permit the Trustee of the trust to take distributions following the year of death of the balance of the interest over the life expectancy of a trust beneficiary (or the oldest member of a group of individuals determined under the Minimum Distribution Rules to which a trust beneficiary belongs), assuming said trust otherwise qualifies to do so under the Minimum Distribution Rules.

12.17 Stretch-Out Retirement Beneficiary. The term "Stretch-Out Retirement Beneficiary" refers, with respect to a trust hereunder that owns an interest in a "Stretch-Out Retirement Account," to the trust beneficiary whose life expectancy is or will be used in determining the timing and amount of post-

death distributions (or whose life expectancy would have been so used if he or she was the oldest member of the group of individuals determined under the Minimum Distribution Rules to which he or she belongs).

12.12 Tax-Advantaged Account. The term "Tax-Advantaged Account" refers to any plan, contract, or other arrangement (other than a life insurance contract) that is allowed under the Internal Revenue Code to accumulate any part of its income in a tax-advantaged manner (*e.g.*, income tax-deferred or income tax free) for the benefit of an owner, beneficiary, or successor, and includes, by way of example and not limitation, a qualified or non-qualified annuity, a deferred compensation plan, or a retirement or individual retirement account arrangement established under IRC Sections 401, 403, 408, 408A, or 457. A plan account or arrangement that is otherwise a "Tax-Advantaged Account" and that owns one or more life insurance contracts among its assets is a "Tax-Advantaged Account." A plan, contract, or other arrangement that is reasonably believed to qualify for tax-advantaged treatment under the Internal Revenue Code is a "Tax-Advantaged Account" even if it is subsequently determined it did not so qualify.

8. Terminology – "Spouse" or "Issue."

Special issues may arise if recipients are described using terms such as "spouse" or "issue," as follows:

a. If an interest is provided for a person's "Spouse" with no name or further qualification, there is no way of knowing with certainty who that Spouse will be and what his or age will be. Thus, if the "spouse" will be included among the DB Trust Beneficiaries of a trust (other than a conduit trust, as discussed below), the trust is likely to be treated as not having an identifiable life expectancy.

b. If interests are provided for a person's issue or descendants with no further qualification, a similar question arises. Since it may be possible in many jurisdictions to adopt a person of any age, will this cause the trust to be treated as not having an identifiable life expectancy? Two private letter rulings that addressed trusts providing for a person and then the person's descendants ruled that the trusts qualified to use the person's life expectancy, without raising this question about adoption.[72] Nevertheless, the safest approach may be to draft the trust instrument in a way that limits the scope of adoptees who are considered to be descendants when doing so reflects limitations the client would have desired regardless of the MRD Rule implications.

9. Permissible Appointees Under A Power of Appointment.

If Paul's trust in Example 5 provides each beneficiary a testamentary 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 have been promulgated with respect to trusts that included powers of appointment without analyzing this issue.

A group of private letter rulings were issued in August, 2002 analyzing trusts as IRA beneficiaries under the final regulations.[73] 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 child's subtrust was recognized as having the oldest child's life expectancy under

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[72] Priv. Ltr. Rul. 1999-03-050; Priv. Ltr. Rul. 1999-18-065.

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

the final regulations, even though it was not a conduit trust. Each child's subtrust provided distributions to the child of income, and of principal subject to an ascertainable standard. Each child's subtrust also provided the child with a testamentary 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 IRS ruled that the oldest DB Trust beneficiary of each subtrust was decedent's oldest child. The rulings do not identify the takers in default if the power of appointment is not exercised with respect to any of the subtrusts, and does not analyze whether those takers in default should be included in the pool of DB Trust Beneficiaries for each subtrust. Further, although the rulings mention the limited class of permissible appointees under the power of appointment in each subtrust, the rulings *do not* analyze whether the permissible appointees are treated as DB Trust Beneficiaries of any of the subtrusts. Your author cautions that the reasoning in these rulings is incomplete, and that it is unwise to rely on them.

Majority View – Permissible Appointees Are Included in Pool of DB Beneficiaries. Most commentators who have addressed this issue conclude that the permissible appointees under a power of appointment (testamentary or otherwise) are potentially includible among the pool of DB Trust Beneficiaries.[74] This view is consistent with the Treasury's concern that a trust should not be allowed to take MRDs based on one trust beneficiary's life expectancy if it is possible to accumulate them and ultimately distribute them to another, older trust beneficiary.

Conduit Trusts. As discussed in Section XX., a "conduit trust" is allowed to disregard any DB Trust Beneficiaries other than the primary beneficiary who will be receiving conduit distributions. Thus, a testamentary power of appointment may be included in the conduit trust without limitation without risk of jeopardizing the conduit trust's ability to use the primary beneficiary's life expectancy for MRD purposes.

Non-Conduit Trusts. Whenever a power of appointment (testamentary or otherwise) is included in a non-conduit trust, the safest course is to assume that all of the permissible appointees under the power of appointment will be included among the pool of DB Trust Beneficiaries. The inclusion of permissible appointees among the pool of DB Trust Beneficiaries can cause problems, as follows.

If the scope of permissible appointees is not limited in some way, the class of permissible appointees may either include a specific recipient with little or no life expectancy, or may be so broad that it is difficult or impossible to determine which recipient has the shortest life expectancy.

Limiting the permissible appointees to those who are not older than the "target" DB Trust Beneficiary is one possible solution, but could open up other problems in interpreting and administering the trust, and could potentially distort the economic outcome among the various beneficiaries and recipients. These problems may be partially mitigated if separate trusts are used for retirement and non-retirement assets and the age limitation is only imposed on the trust holding retirement assets.

If a trust holds both retirement and non-retirement assets and an age limitation is to be applied to only the retirement assets, the age limitation must be drafted to apply to both the assets in the retirement plan, and any assets that have been distributed

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[74] See, for example, Natalie Choate, *Life and Death Planning for Retirement Benefits*, 6th ed. (2006), Ataxplan Publications, Section 6.3.09; or Marcia Chadwick Holt, *Estate Planning for Retirement*, 1st ed. (2007), Bradford Publishing Company, Section 9.8.

from the retirement plan and accumulated in the trust. It may be helpful to direct the trustee to account separately for accumulations of retirement and non-retirement assets.

Some standard clauses granting powers of appointment include charities as permissible appointees. Charities are not recognized under the MRD Rules as having a life expectancy, and the trust will be treated as having no life expectancy if a charity is included among the DB Trust Beneficiaries.

Similarly, if the power of appointment is intended to function as a "general" power of appointment within the meaning of IRC Section 2041 (a common drafting technique with respect to certain marital trusts and trusts that are not anticipated to receive an allocation of generation-skipping transfer tax exemption), a standard clause will normally include one or more of the power holder's creditors, estate, or creditors of the power holder's estate. If any of these are included among the pool of DB Trust Beneficiaries, the trust will be treated as having no life expectancy. (Is it even possible to draft a general power of appointment in a non-conduit trust that will not cause the trust to be treated as having no life expectancy? Yes it is.)

This type of problem can also arise if a power of appointment allows an appointment in further trust. The regulations provide that if another trust is a beneficiary of the trust, the other trust's beneficiaries must also be considered in determining the qualification of the trust.[75] Thus, the power of appointment should either prohibit appointments in further trust altogether, or should limit permissible trust recipients to trusts that will not jeopardize the primary trust's qualification under the MRD Rules (*e.g.*, conduit trusts or other trusts that have no life expectancy older than the "target" life expectancy).

The regulations generally require that a trust must meet certain threshold requirements in order for the trust to be treated as having the life expectancy of a beneficiary.[76] These requirements must normally be satisfied on the Determination Date (the September 30 of the calendar year following the year of the plan owner's death). Specifically, the trust must then be a valid trust, must be irrevocable, and must provide certain documentation to the plan administrator no later than the October 31 of the calendar year following the death of the plan owner.[77] Must these requirements be met for purposes of determining the beneficiaries of a trust that is a permissible appointee under a power of appointment? Your author is not aware of any authority that addresses this question, but doubts that these requirements apply. If they did, it would rarely be possible for any trust to be recognized as having a life expectancy if it might someday pass to another trust.

As discussed in Section XIX.B.8., if the permissible appointees under a power of appointment include a person's "spouse" with no further qualification, there is no way of knowing who that spouse will be and what his or her age will be, and the trust is likely to be treated as not having an identifiable life expectancy.

Similarly, as discussed in Section XIX.B.8., if the permissible appointees under a power of appointment include a person's issue or descendants with no further qualification, there is a theoretical possibility that the class could include an adopted

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[75] Reg. § 1.401(a)(9)-4, A-5(d).

[76] Reg. § 1.401(a)(9)-4, A 5.

[77] Reg. § 1.401(a)(9)-4, A 6(b).

person of any age, and the trust is likely to be treated as not having an identifiable life expectancy.

Some trust instruments authorize a trust protector or independent trustee to modify powers of appointment. Any such power should be limited so that it cannot be used to add permissible appointees to a power of appointment over retirement assets (including accumulations).

The existence of a power of appointment may interfere with certain planning techniques that attempt to extend the conduit trust concept beyond the fact pattern of Example 2 of the conduit trust regulation.[78]

Minority View – Permissible Appointees Not Included in Pool of DB Beneficiaries. Although your author recommends that practitioners follow the majority view outlined above, it could be argued that a power of appointment is better viewed as an enhancement of the interest provided to the DB Trust Beneficiary who holds the power of appointment, and should not be viewed as creating beneficial interests in the permissible appointees prior to an effective exercise of the power, and that consequently a person should not be considered a DB Trust Beneficiary solely because the person 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 IRC Section 1361, stating:[79]

> *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.*

10. Creditors.

If the provisions of a trust are such that the creditors of a beneficiary could attach all or a portion of the trust, must these potential creditors be included in the pool of DB Trust Beneficiaries? Your author is not aware of any authority that has addressed this issue. The conduit trust distribution approach, which is specifically blessed in the regulations, could lead to attachment by creditors of the amounts that must be distributed under the conduit clause under the laws of many states. One could argue that this potential creditor problem must not be an issue under the MRD rules for trusts since the regulations have specifically approved the conduit trust without any discussion of creditor issues. Your author warns, however, that the MRD rules were generally written by employee benefits specialists, and that there are numerous estate planning concepts that have not been adequately developed in these rules. Thus, it would be wise to draft any trust that is not a conduit trust in a way that will not result in exposure of the trust to creditors.

11. Summary of Various Approaches to Drafting Trusts.

a. When retirement plan interests are to be designated to one or more trusts, and the trusts are to qualify for "stretched-out" MRDs, there are several types of trusts that may or may not be appropriate in any given situation, as well as a

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

[79] 1997-2 C.B. 304.

number of other related issues. The next Section discusses the "conduit trust," which is the type of trust your author considers to be the "default" approach that can be used except when there is a specific reason to use another approach.

XX. The Conduit Trust.

Conduit Trust as "Default Alternative." As will be discussed in this and the next several sections, there are several alternatives for structuring trusts that will be designated as the beneficiary of retirement plan assets. Your author suggests that the "conduit trust" discussed in this section is the default choice, as it is less complicated than most of the other alternatives, it does not limit the drafting of powers of appointment or provisions for remainder beneficiaries, and it offers a "safe harbor" under the regulations. Of course, there will be certain cases in which the conduit trust alternative must be ruled out (*e.g.*, a special needs trust that cannot mandate conduit distributions), and there will be certain clients with more ambitious planning objectives who will appreciate a review of the pros and cons of other alternatives (*e.g.* a dynasty trust).

Safe Harbor. The regulations specifically provide that when a trust requires all distributions taken from the plan during the primary beneficiary's lifetime to be distributed to the primary beneficiary, rather than accumulated in the trust, the primary beneficiary of the trust is recognized as the sole DB Trust Beneficiary.[80] Although the term "conduit trust" does not appear in the regulations, it has been universally adopted as a name for this type of 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.

A. Pros and Cons of the Conduit Trust.

When a client is designating a retirement plan interest for an individual heir, and is considering a conduit trust structure, the following advantages and disadvantages should be considered:

- Of the various types of trusts that could be drafted to hold a retirement plan interest for the benefit of an individual heir and to accomplish "stretch-out" minimum distributions over the individual heir's life expectancy, the "conduit trust" is probably the least complex to draft and most certain to comply with MRD Rules.

- Multiple conduit trusts may qualify for the separate account rule so long as the death beneficiary designation directs the division of the plan into separate accounts.

- The primary disadvantage of the conduit trust is that the amounts of all distributions from the retirement plan (MRDs plus any other distributions) to the trust must then be distributed from the trust to the individual, regardless of whether he or she wants to receive them, subject to possible planning alternatives discussed in this section.

- However, the actual MRDs for a young individual will be very small. For example, an individual who turns five years old in the year following the plan owner's death would receive a distribution of 1/78th (approximately 1.25%) of his or her account that year (or even less, depending on planning alternatives discussed in this section).

- The trust instrument may authorize the trustee to make conduit distributions to the minor individual's custodian acting under applicable state law *(e.g.* the Uniform Transfers to Minors Act).

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

- Distributions can also be directed to the legal guardian for the young individual, or the trustee may be given the discretion to do so, effectively allowing the trustee to apply distributions for the individual's needs.

- Will a trust comply with the MRD conduit requirements if it allows the trustee to apply distributions directly in payment of an individual's needs, without the participation of the individual's legal guardian? Your author is unaware of any guidance on this issue in the MRD Rule context, but there is favorable authority in the context of the marital deduction for estate tax. A marital deduction is allowed under IRC Section 2056(b)(5) and (7) with respect to certain interests in property passing to a spouse if certain requirements are satisfied, including the requirement that the surviving spouse shall receive the right to all income from the interest for the balance of his or her life.[81] Treasury Regulations provide that a trustee's power to apply income for the benefit of the spouse is a permissible administrative power that will not disqualify the marital deduction, provided that the overall terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers.[82]

- If a person with an obligation to support the individual may be serving as trustee, the trust should be drafted to avoid providing that person with discretionary powers that would cause tax problems. In particular, the Trustee's power to take distributions from the retirement plan may need to be limited (as illustrated in the sample conduit trust form below).

- The funds that actually reach the young beneficiary may be less than the amounts of distributions from the retirement plan to the trust, due to the payment of legitimate trust expenses, such as trustee's fees, tax return preparation or other expenses, and possibly investment management fees of the retirement plan to the extent the trustee chooses not to arrange payment of these fees from inside the retirement plan.

- Paying the plan's investment management fees from non-retirement assets may or may not provide a better overall financial outcome, as discussed in Sections VI and VII.

- Financial institutions often do not understand trusts or other concepts that deviate from their standard death beneficiary designation form. As a general rule, any time that retirement plans are designated to trusts, allowance should be made for additional paperwork and coordination with the financial institution to get the trust's inherited account set up properly.

- A conduit trust may provide for a termination while the primary beneficiary is still living, *e.g.* at a specified age. However, upon termination the primary beneficiary must receive complete control over the balance in the retirement plan without any other contingencies. As discussed next, it is not always easy for a trustee to "assign" the balance in a retirement plan to the individual primary beneficiary. A conduit trust that provides for a terminating event should allow the trustee the flexibility to keep the trust going after the terminating event in case there are difficulties assigning the retirement plan interest. Along those lines, it may be advisable to include a power of appointment to ensure the primary beneficiary has dispositive control over a retirement plan interest that must continue in trust.

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[81] IRC § 2056(b)(5).

[82] Reg. § 20.2056(b)-5(f)(4).

- A trust's interest in a qualified retirement plan may not necessarily be assignable to the trust's beneficiary due to anti-alienation requirements of ERISA and the plan document. IRAs are not subject to these anti-alienation requirements, but some financial institutions resist the notion that a trust can transfer its interest in an IRA to an individual beneficiary without causing a taxable distribution at the time the trust terminates, or at such time as the trustee may choose to distribute the IRA interest. Of course, if one financial institution does not understand, the trustee has the power to move the inherited IRA to another financial institution.

B. Case Study: Jane Reynolds.

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. She would like for her children to benefit from "stretched-out" distributions, but would otherwise like to keep her estate plan as simple as possible. Based on these requirements, she decides to provide conduit trusts for each child.

C. Drafting Considerations.

As discussed above, 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.

Drafting a good conduit clause requires more time and thought than one might initially expect. Here is a sampling of some of the 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, and your author recommends this approach for Jane Reynolds. The "stand-alone" approach may be worthwhile for certain clients who want the planning that has been done for retirement assets to stand out in the form of a separate document. This may be helpful to fiduciaries, beneficiaries, and advisors who may be juggling many different issues during a death administration.

- *"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 it is probably not necessary to do so with a conduit trust. One set of "double-duty" subtrusts will work just fine for Jane Reynolds. Note that the subtrusts must be drafted to include language coordinating 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. It can be particularly confusing when the clause is referring in some contexts to distributions from the plan, and in other contexts to distributions from the trust. Your author has attempted

to draft a clause that makes clear distinction between the beneficiary of the plan versus the beneficiary of the trust.

- *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, the term "Stretch-Out Retirement Account" is defined to effectively exclude from the scope of the conduit clause any plan that cannot pay out over the beneficiary's life expectancy (or the oldest life of a group of individuals that includes the beneficiary).

- *Separate Accounts.* The language allowing for a group of individuals is intended to apply the conduit provision in a situation when the trust is one of several conduit trusts that, for some reason, do not qualify for "separate account" treatment under the MRD Rules and must use the life expectancy of the oldest conduit trust beneficiary.

- *Chicken and Egg.* Your author added a phrase to address the "chicken and egg" relationship between the sentence that defines "Stretch-Out Retirement Account" and the conduit distribution clause (*i.e.*, the conduit distribution clause does not apply unless the plan satisfies the definition of "Stretch-Out Retirement Account," and the trust might not satisfy the definition unless the beneficiary is the only DB Trust Beneficiary).

- *Only Applies to Primary Beneficiaries*. 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. Thus, the definitions of "Stretch-Out Retirement Account" and "Stretch-Out Beneficiary" are incorporated into the conduit clause in a way to limit the scope of the conduit clause to only the primary beneficiary

- *Designation of Trust that Subdivides*. Your author chose to define Stretch-Out Retirement Accounts using the phrase "became part of the trust by reason of the Settlor's death (or the death of another, depending on the context)" rather than language such as "a trust that was designated" to clarify that the conduit clause applies even if a revocable trust is designated and immediately subdivides into conduit trusts.

- *Early Termination.* 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, for reasons discussed above. 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.

- *Tax Apportionment Provisions; Payment of Taxes and Expenses*. Tax apportionment provisions in the client's estate plan should be reviewed carefully. If possible, avoid subjecting retirement plan assets to apportionment as the plan may "melt

down" if distributions are needed to pay tax. However, in certain 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, but opted to leave all of the language together to provide the clearest guidance to trust officers and other advisors. For further discussion of payment of death taxes, including a "pay by September 30" requirement, see Section XIX.B.7.

- *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, to avoid placing what is effectively a general power of appointment into the hands of a tax-sensitive trustee. Three possible tax-sensitive trustees are addressed: (i) an individual who has made a disclaimer; (ii) an individual subject to a legal obligation to support the beneficiary; and (iii) the beneficiary. 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, this clause restricts the trustee's authority only as long as the conduit provision is in effect. 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).

- *MRDs in Year of Participant/Owner's Death*. The language discussed above that defines a "Stretch-Out Retirement Account" as a plan that allows distributions based on the life expectancy of the primary beneficiary needs to drafted in a way that there is no confusion if, in the year of the plan owner's death, a minimum distribution remains to be made that is calculated using the so-called life expectancy of the deceased plan owner, and not the primary beneficiary.

D. 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 Settlor 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 a child or more remote descendant of the Settlor (each child or more remote descendant is sometimes referred to as the "Beneficiary" of his or her trust) 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 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 Account 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 "conduit distributions" made or anticipated under Section 2.6.2.

2.6.2 "Conduit Distributions" From Stretch-Out Retirement Accounts. To the extent the Trustee receives distributions from a Stretch-Out Retirement Account as to which the Beneficiary is the Stretch-Out Retirement Beneficiary (as these terms are defined in Sections 12.16 and 12.17), 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 properly allocable to distributions received or to the balance remaining in said Stretch-Out Retirement Account), for as long as the Beneficiary shall live or until the earlier termination of his or her trust.

2.6.3 Limitations on Trustee's Power to Take Distributions. For so long as the Beneficiary is the Stretch-Out Retirement Beneficiary of a Stretch-Out Retirement Account, the following individuals, while serving a*s Trustee*, are prohibited from withdrawing "Excess Distributions" from said Stretch-Out Retirement Account, and said power shall be reserved to others acting jointly as Trustee who are not prohibited from so acting or, if none, to the Independent Trustee:

(a) Disclaimant. Any individual who made a qualified disclaimer of any interest in said Stretch-Out Retirement Account as to which the Beneficiary is the Stretch-Out Retirement Beneficiary.

(b) Individual With Obligation of Support. Any individual who owes a legal obligation of support to the Beneficiary.

(c) Beneficiary. The Beneficiary.

For purposes of this Section, the term "Excess Distributions" refers, with respect to an interest in a Stretch-Out Retirement Account, to any distribution 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; (iii) comply with the legal obligation to pay income, estate, inheritance, generation-skipping transfer tax, or other taxes properly chargeable to distributions received from or the balance remaining in said Stretch-Out Retirement Account; and (iv) provide for payment of trust expenses properly allocable to distributions received from or the balance remaining in said Stretch-Out Retirement Account.

2.6.4 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 outright and free of trust. 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. The Trustee may postpone the termination of the trust with respect to any IRA, Roth IRA, or other Retirement Account if doing so will postpone the requirement of a distribution of funds out of said account or otherwise produce a better tax outcome for the Beneficiary, and shall continue to administer said account hereunder as if the Beneficiary had not yet attained Thirty-Five (35) years of age.

2.6.5 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.

2.6.6 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:

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 2.6.7.

2.6.7 Alternate Heirs. If disposition be made under this Section 2.6.7, the Trustee shall distribute the affected trust estate to ________________________________.

Author's Note: The following clause is suggested for inclusion in the "boilerplate" of most trusts.

11.15 Trust as Beneficiary of Retirement Account. The Settlor intends that each trust hereunder that owns an interest in a Retirement Account enjoy the longest possible deferral period under the Minimum Distribution Rules. Accordingly, the following shall apply:

(a) The Trustee of a trust so designated shall, within the time limit prescribed under the Minimum Distribution Rules, deliver documentation required under said rules to the respective administrators and custodians of each Retirement Account.

(b) For purposes of this instrument, when the Trustee is directed to "distribute" an interest in a Retirement Account to an individual or another trust, the Trustee is to arrange for the individual or trustee to hold the various powers over said Retirement Account interest (*e.g.*, to direct investments and withdrawals) that would otherwise be held by the Trustee, and such direction shall not be interpreted as requiring a "taxable distribution" from the Retirement Account for income tax purposes.

(c) The administrators, custodians, or other fiduciaries of the respective Retirement Accounts 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 11.15.

12. Definitions. (The following are selected definitions relating to retirement plan issues.)

12.8 Minimum Distribution Rules. The term "Minimum Distribution Rules" refers to the rules of IRC Section 401(a)(9).

12.10 Retirement Account. The term "Retirement Account" refers to a Tax-Advantaged Account that is subject to the Minimum Distribution Rules.

12.16 Stretch-Out Retirement Account. The term "Stretch-Out Retirement Account" refers, with respect to a trust hereunder, to an interest in a Retirement Account that satisfies the following conditions: (i) the interest in the Retirement Account (or a successor Retirement Account, *e.g.* an inherited IRA that receives a rollover from a qualified retirement plan) became part of the trust by reason of the Settlor's death (or the death of another, depending on the context); and (ii) the provisions governing the Retirement Account permit the Trustee of the trust to take distributions following the year of death of the post-death balance of the interest over the life expectancy of a trust beneficiary (or the oldest member of a group of individuals determined under the Minimum Distribution Rules to which a trust beneficiary belongs), assuming said trust otherwise qualifies to do so under the Minimum Distribution Rules.

12.17 Stretch-Out Retirement Beneficiary. The term "Stretch-Out Retirement Beneficiary" refers, with respect to a trust hereunder that owns an interest in a "Stretch-Out Retirement Account," to the trust beneficiary whose life expectancy is or will be used in determining the timing and amount of post-death distributions (or whose life expectancy would have been so used if he or she was the oldest member of the group of individuals determined under the Minimum Distribution Rules to which he or she belongs).

12.18 Tax-Advantaged Account. The term "Tax-Advantaged Account" refers to any plan, contract, or other arrangement (other than a life insurance contract) that is allowed under the Internal Revenue Code to accumulate any part of its income in a tax-advantaged manner (*e.g.*, income tax-deferred or income tax free) for the benefit of an owner, beneficiary, or successor, and includes, by way of example and not limitation, a qualified or non-qualified annuity, a deferred compensation plan, or a retirement or individual retirement account arrangement established under IRC Sections 401, 403, 408, 408A, or 457. A plan account or arrangement that is otherwise a "Tax-Advantaged Account" and that owns one or more life insurance contracts among its assets is a "Tax-Advantaged Account." A plan, contract, or other arrangement that is reasonably believed to qualify for tax-advantaged treatment under the Internal Revenue Code is a "Tax-Advantaged Account" even if it is subsequently determined it did not so qualify.

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

RETIREMENT PLAN DEATH BENEFICIARY DESIGNATION

Person Making Designation (hereafter, "Owner")	JANE REYNOLDS
Owner's Social Security Number:	555-55-5555
Owner's Birth Date:	November 1, 1966
Plan Description (*e.g.*, 401(k), IRA, Roth IRA) (hereafter, "Retirement Plan")	IRA
Name of Plan Administrator, Trustee or Custodian	

(hereafter, "Administrator") All American Financial
Retirement Plan Account Number
(hereafter, "Retirement Plan Account") 7-7777777-77

1. Primary Death Beneficiary. The Owner hereby designates, as her primary designation, that the above-referenced IRA (the "Retirement Plan Account") be divided into separate accounts in the following manner:

One equal account shall be established for each of the Owner's two (2) children, namely, CHRISTINE REYNOLDS and CYNTHIA REYNOLDS. The following table provides pertinent information about the Owner's children:

Name	Relationship	Social Security Number	Birth Date
CHRISTINE REYNOLDS	Daughter	222-22-2222	October 3, 1994
CYNTHIA REYNOLDS	Daughter	333-33-3333	February 8, 1998

If any child does not survive the IRA Owner, said deceased child's account shall be further divided into separate accounts for each of 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 accounts so established.

Each separate account created for a child or more remote descendant of the Owner who has attained Thirty-Five (35) years of age and is not "disabled" shall be designated outright and free of trust to said individual.

Each separate account created for a child or more remote descendant of the Owner who has not attained Thirty-Five (35) years of age or who is "disabled" shall be designated to the Trustee of the [name of subtrust] established for the benefit of said child or descendant under the Jane Reynolds Revocable Trust established January 2, 2008, as amended from time to time during the Owner's lifetime (hereafter, the "Revocable Trust").

If there is no [name of subtrust] provided under the Revocable Trust for any one or more of said children or descendants: (i) if at the time of the Owner's death he or she has attained twenty-one (21) years of age and is not "disabled," his or her separate account shall be designated to him or her outright and free of trust; (ii) if at the time of the Owner's death he or she has not attained twenty-one (21) years of age and is not otherwise "disabled," his or her separate account shall be designated to him or her free of trust and held for him or her by his or her legal guardian as custodian under the Uniform Transfers to Minors Act until the child or descendant attains twenty-one (21) years of age or, if there is no such legal guardian, the custodian shall be the then serving Trustee of the Revocable Trust; or (iii) if at the time of the Owner's death he or she is "disabled," his or her separate account shall be designated to the Trustee of the Revocable Trust to hold for his or her benefit.

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.

Further Death Beneficiary Designations. The Owner requests that the documents and terms governing the IRA (including the terms of this Death Beneficiary Designation) be construed to the greatest extent possible to allow any individual beneficiary to make further death beneficiary designations after the

IRA Owner's death that direct how said individual beneficiary's interest in the IRA would pass at the individual beneficiary's death.

Transfer by Fiduciary. The Owner requests that the documents and terms governing the IRA (including the terms of this Death Beneficiary Designation) be construed to the greatest extent possible to allow the fiduciary of any estate or trust holding an interest in the IRA to "transfer" part or all of said interest to any one or more beneficiaries of said trust or estate for any reason (including by way of example and not limitation the partial or complete distribution of said trust or estate). "Transfer" refers to the transfer of ownership and authority over said interest without actually causing taxable distributions from the IRA, *e.g.* such as the transfers 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 Owner under a durable power of attorney; (ii) an agent acting for an individual entitled to an interest hereunder following the Owner's death; or (iii) the trustee or executor of a trust or estate entitled to an interest hereunder following Owner's death.

Executed and accepted on this date of January 2, 2008.

____
JANE REYNOLDS - OWNER

[Notary attestation optional, but suggested]

XXI. How a DB Trust Can Save Income Tax.

From a tax planning point of view, it is widely believed that income taxes will be higher if a trust is designated than if an individual is designated. This belief arises from the low exemptions and compressed income tax brackets that apply to trusts. However, if the individual beneficiary is already in the top income tax bracket, the use of a trust will not necessarily increase the income tax rate.

In fact, a trust may save income taxes. Although trusts have compressed income tax brackets, they are not subject to the "3% of AGI haircut" of itemized deductions under IRC Section 68. If the beneficiary is already in the top income tax bracket, the designation of a trust may result in taxation of retirement plan distributions at the trust level, where the IRD deduction can be fully utilized without any reduction under the 3% "haircut." Further, the individual will have a lower AGI and may get better mileage out of his or her other deductions.

The benefits of avoiding the 3% "haircut" are harder to predict after enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, which schedules a "phase out" of the 3% "haircut" during the years 2006 through 2009 and repeal in 2010. However, these phase-out provisions are scheduled to "sunset" in 2011, which would bring the 3% "haircut" back into law.

Another increasingly significant variable is the alternative minimum tax,[83] which is a factor in determining the income tax for trusts and individuals.

Your author suggests that an accumulation trust that allows income to either be accumulated or distributed provides valuable flexibility, as the trustee and beneficiary can maintain income tax projections and determine what portion, if any, of income to distribute each year to accomplish the lowest overall income taxes.

For an accumulating strategy to be effective, most or all of the IRD and IRD deduction should stay with the trust during the period of time that the IRD deduction is being utilized. One way to accomplish this is for the trust to accumulate during this period and not distribute. This will not always be practical, and if distributions must be taken, some benefit may still be obtained by bunching distributions in one year or borrowing from the trust.

Probably the best approach is to provide two subtrusts for each individual under this type of plan - one is solely for the plan distributions, and the other holds any other assets. This way, the other trust can make distributions while the DB Trust accumulates.

[83] IRC §§ 55 *et seq.*

XXII. IRD Deduction - A Shave and a Haircut.

A distribution from a deceased Participant's retirement plan is included in the recipient's gross income as Income in Respect of a Decedent ("I.R.D.").[84] The recipient of IRD may claim an income tax deduction (the "IRD deduction") for the incremental federal estate tax paid on the IRD[85] In theory, the IRD deduction should fully offset the burden of double taxation under the income and estate taxes. In practice, however, there are two reasons why the IRD deduction may only provide partial relief, compared to the outcome that would occur if the income tax had been paid prior to death:

One reason the IRD deduction may fall short is that state death taxes are "shaved" from the calculation.[86]

Another reason the IRD deduction may not provide full relief has to do with the "3% haircut" that reduces itemized deductions under IRC Section 68.[87] The receipt of IRD increases "adjusted gross income" ("AGI"), which may negate part of the IRD deduction corresponding to the distribution, other itemized deductions, or both.

Fortunately, the IRD deduction is not a "miscellaneous itemized deduction" subject to the 2% of AGI "floor" under IRC Section 67, and thus is not a preference item for the alternative minimum tax.

If a Participant is on her death bed and expects her designated beneficiary to take full distribution of the retirement plan soon after her death, it may be more tax efficient to recognize as much income tax as possible prior to death, either by taking full distribution or, if the Participant qualifies, by engineering a Roth IRA conversion.

The IRD deduction is calculated based on the estate tax value of the retirement plan. Although there is no direct authority on this point, most practitioners claim the deduction on the first dollars coming out of the plan. For example, if the date of death value of the retirement plan is $1,000,000 and the incremental federal estate tax attributable to the retirement plan is $400,000, common practice is to deduct 40 cents on the dollar on the first 1,000,000 dollars distributed. It is not unusual for the IRD deduction to be utilized fully within the first ten to fifteen years of distributions.

The IRD deduction that is allowed to the recipient of IRD is the same, regardless of whether any estate tax is actually apportioned to the recipient. Conversely, if the estate tax is apportioned to others, they are not entitled to the IRD deduction, and your author is unaware of any state law that would allow any reimbursement of the benefits of the IRD deduction to others who actually paid the estate tax.

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[84] IRC § 691(a)(1).

[85] IRC § 691(c).

[86] IRC § 691(c)(2)(A). The Economic Growth and Tax Relief Reconciliation Act of 2001 schedules a "phase out" of the credit for state death taxes during the years 2002-2004 and repeal thereafter. However, these provisions are scheduled to "sunset" in 2011, which would bring the state death tax credit back into law.

[87] A taxpayer's itemized deductions receive a "haircut" if the taxpayer's adjusted gross income ("AGI") exceeds the "applicable amount," which is $100,000 ($50,000 if married filing separate) indexed for inflation since 1991. The "haircut" results in a reduction of itemized deductions by 3% of the portion of AGI that exceeds the applicable amount, but in no event more than 80% of the itemized deductions. IRC § 68. The Economic Growth and Tax Relief Reconciliation Act of 2001 schedules a "phase out" of the 3% "haircut" during the years 2006 through 2009 and repeal in 2010. However, these provisions are scheduled to "sunset" in 2011, which would bring the 3% "haircut" back into law.

An interesting private letter ruling was issued in 2003 that addresses some of the mechanics of calculating the IRD deduction when a surviving spouse receives IRD assets.[88] In particular, the ruling highlights the different calculations required, depending on whether the IRD is a "specific gift" to the surviving spouse. If the IRD is a "specific gift," the hypothetical estate tax that is part of the calculation is calculated using a hypothetical marital deduction that is reduced dollar-for-dollar for the IRD that was specifically gifted. If the IRD is not a "specific gift," the hypothetical marital deduction is reduced on a pro rata basis, producing a larger IRD deduction.[89] Your author interprets "specific gift" as including the situation in which a retirement plan is designated specifically to the spouse. This difference in calculation methods suggests that in certain situations, careful attention to the structure of a married couple's estate plan may make the difference between a larger or smaller IRD deduction. Any increase that can be obtained is truly "found money," since the increased deduction does not change any of the other taxes involved.

Another interesting point explained in the ruling is that the recipients of the IRD assets at the survivor's death may be entitled to two IRD deductions corresponding to the respective estate taxes paid in each spouse's estate.

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[88] Priv. Ltr. Rul. 2003-16-008.

[89] Compare to Rev. Rul. 67-242, or Kincaid v. Commissioner, 85 T.C. 25 (1985).

XXIII. 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.[90]

The QTIP Marital Trusts and Bypass Trusts commonly used at the first spouse's death are subject to the same rules discussed in Section XIX. 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 Determination 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.

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.[91] 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.

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[90] IRC §§ 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).

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

XXIV. 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.[92]

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.[93] The financial model measures the "After-Tax Assets" 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 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

[92] IRC §§ 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).

[93] 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."

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 IRD 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. nor 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.

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."[94]

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.[95] 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" 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").[96] 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

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

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

[96] Reg. § 1.401(a)(9)-5, A-5(b).

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.

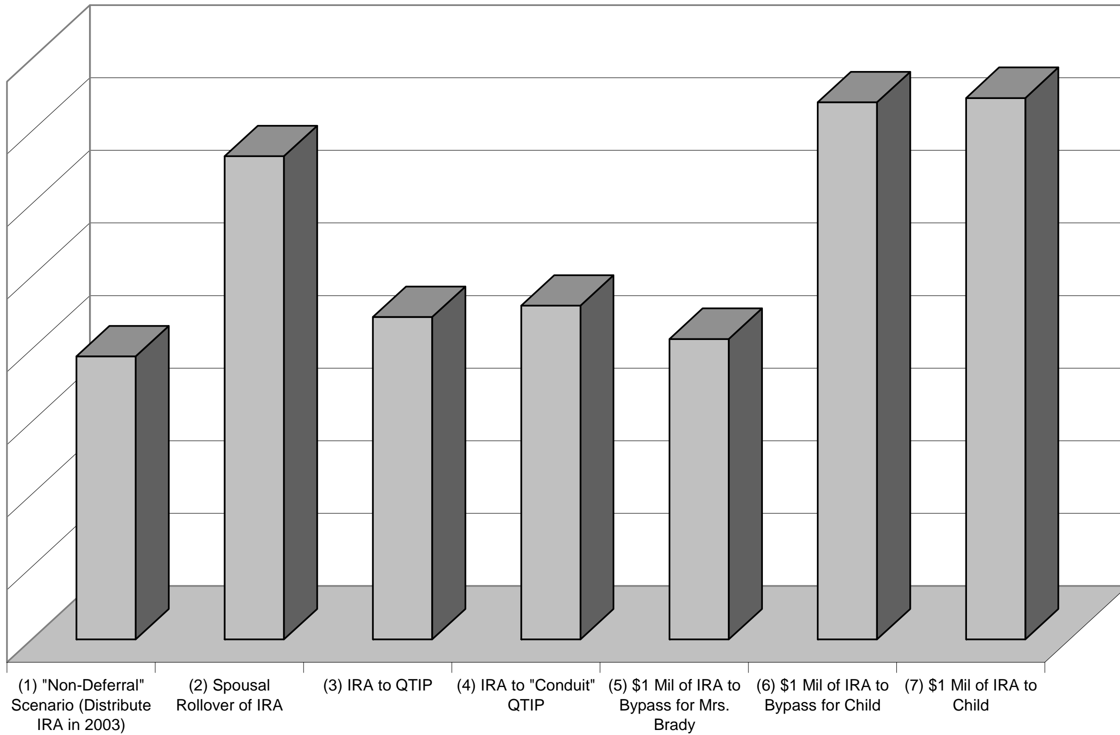
Minimum Distribution Divisors. The following table shows the MRD divisors that apply to these various scenarios:

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

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 "After-Tax Assets" 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.

MRD Divisors: 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
Value of Excess After Tax Assets At End of Deferral Period:	8,579,917	14,649,926	9,774,117	10,120,369	9,111,088	16,284,335	16,416,865
Value of Excess After Tax Assets At End of Deferral Period (In Today's Dollars):	3,897,471	6,654,803	4,439,942	4,597,229	4,138,758	7,397,241	7,457,444
% Comparison:	100%	171%	114%	118%	106%	190%	191%



What the Results Tell Us. As might be expected, the spousal rollover in Scenario 2 produces the largest "After-Tax Assets," reflecting the maximum deferral available to the Brady family. The benefit of maximum deferral allows the retirement plan distributions to build "After Tax Assets" that are 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 "After-Tax Assets" 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 "After-Tax Assets" 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 "After-Tax Assets" 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, 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 IRC 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 "After Tax Assets" 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 "After-Tax Assets" 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.

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

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

In Revenue Ruling 2006-26,[97] 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.[98]

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

In Revenue Ruling 2000-2,[99] 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 IRC Section 2056(b)(7) in order to qualify as QTIP property. Rev. Rul. 89-89, 1989-2 C.B. 231.[100] 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 IRC 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 IRC 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.

Generally, in order for a bequest of property to qualify for the QTIP election under IRC Section 2056(b)(7), the surviving spouse of the decedent must be entitled to

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

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

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

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

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 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 IRC Section 68.

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.[101] 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 to income to the extent necessary to obtain the marital deduction,[102] which is not terribly helpful since the estate tax marital deduction definition of income depends on state law, here completely undefined.

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 XIX.

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

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

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.[103]

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 assets and other assets).[104] 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.[105]

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 IRC Sections 2511 and 2512 is only the portion that corresponds to the remainder, since the survivor retains the income portion. However, IRC 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 IRC 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.

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[103] 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.]

[104] IRC § 2514(e).

[105] Reg. § 25.2511-2.

(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;[106] plus

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

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.

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 IRC 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 IRC Section 2033 if the power has not lapsed; or

(b) under IRC Section 2036(a) if the power has lapsed, because of the survivor's retained income interest.[107]

Property that is includible under more than one section is only counted once.[108] 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.[109]

A properly drafted QTIP trust is not includible in the survivor's estate under any section of the Internal Revenue Code other than IRC Section 2044, which requires

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[106] IRC § 678(a).

[107] IRC §§ 678(b) and 677(a).

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

[109] IRC § 2652(a)(3)(B); Reg. § 26.2652-2(a).

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 IRC 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 IRC Section 2044 is ignored.

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

IRC Section 2207A allows the survivor's estate to recover estate taxes paid by the estate on QTIP trust property included under IRC 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 diminish the recovery right? No. The only requirement under the statute is that the property be includible under IRC Section 2044.[110]

However, if the property can also be included under IRC Section 2036(a), a right of recovery also exists under IRC 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.[111] 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,

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110 IRC § 2207A(a)(1).

111 IRC § 2207A(a)(2).

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 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 XXIX.E.) 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.

XXVI. Rollovers By Surviving Spouse.

A. Terminology.

"Rollover" is used as a noun or a verb to describe moving funds from one of the Participant's Plans to another of the Participant's Plans.

If the benefit of a plan is payable to a deceased Participant's Surviving Spouse, the transfer to an IRA belonging to the Surviving Spouse may also be called a "Rollover" or "Spousal Rollover," but this description is incomplete. To complete the description, it should be clarified whether the Surviving Spouse made an election to treat the new IRA as his or her own.[112]

If an IRA is payable to a deceased IRA Owner's Surviving Spouse, a "Rollover" may not even occur if the Surviving Spouse leaves the IRA Account alone, but the Surviving Spouse still has the option to elect to treat the IRA as his or her own.

B. Two Different Tax Benefits.

First, the non-recognition of income tax is an important tax benefit associated with any "Rollover" that is often taken for granted.[113] In this context, no time limit is imposed on the Surviving Spouse.

Second, the "fresh start" under the MRD Rules becomes available when a Surviving Spouse elects to treat an IRA as his or her own.[114] There is no time limit imposed on the Surviving Spouse in this context, either.[115] (A "fresh start" under the MRD Rules allows the Surviving Spouse to take lifetime distributions based on the joint life expectancies in the Uniform Lifetime Table, and also allows the Surviving Spouse to name the children or other young beneficiaries as death beneficiary, setting up the potential for a long "stretched out" deferral period.)

C. How the Surviving Spouse Elects to Treat IRA as His or Her Own.

The election to "treat as his or her own" is available with respect to IRAs, either those owned by the deceased Participant or those set up by the Surviving Spouse to receive Rollovers from the deceased Participant's IRAs or other plans.

To be eligible to make the election with respect to an IRA, the Surviving Spouse must be the sole beneficiary. This election is *not* satisfied if a trust is designated, even if the Surviving Spouse is the sole beneficiary of the trust.[116] If an IRA is designated to multiple beneficiaries, it should be possible to divide the IRA into multiple IRAs so that one of the IRAs satisfies the "sole beneficiary" requirement.

The Surviving Spouse makes the election to treat an IRA as his or her own by redesignating the IRA account to be in the Spouse's name as owner, rather than as

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[112] Reg. § 1.408-8, A 5.

[113] IRC § 402(c).

[114] Reg. § 1.408-8, A 5.

[115] Reg. § 1.408-8, A 5(a).

[116] Id.

beneficiary.[117] Further, the Surviving Spouse is "deemed" to have made the election if either (i) post-death MRDs that would be due absent an election are not taken on a timely basis; or (ii) any amount is contributed to the IRA that is subject to lifetime MRDs in the hands of the Spouse.[118]

The drafters of the regulations have made it as easy as possible for a Surviving Spouse to receive the benefits of the election. Thus, if a Surviving Spouse does not want to make this election, special care will be required to avoid inadvertently making the election.

D. Timing of Minimum Distributions.

If a Participant dies prior to his RBD, no MRD is required for the calendar year of Participant's death.[119]

If a Participant dies on or after his RBD, a "lifetime" MRD is required for the year of death. Any portion of MRDs not taken while Participant was living are due by December 31 of the year of death.[120]

As a general rule, if there is a rollover of assets from one plan to another, the "distributing" plan must keep at least the MRD for the year of the rollover, and the "receiving" plan does not begin MRDs until the following year.[121] (Remember, a Rollover is not the same thing as the Surviving Spouse's election to treat an IRA as his or her own.) The final regulations include an exception to the general rule with respect to IRAs. If both plans are IRAs, the "distributing" IRA may distribute the entire plan balance to the "receiving" IRA. The "distributing" IRA still has an MRD requirement, but since MRDs from IRAs can be aggregated, the final regulations allow the MRD to be paid from other IRAs.[122]

For years following the year of Participant's death, when the Surviving Spouse elects to treat an IRA as his or her own, the Spouse may begin calculating MRDs as the IRA Owner in the year of election (*i.e.*, using the Uniform Lifetime Table) - he or she does not need to wait until the beginning of the next year.[123] However, if a non-IRA plan holds assets that are designated to the Surviving Spouse, MRDs must continue to be calculated using the "post-death" rules that apply through the year of the rollover into the Spouse's IRA, and the MRDs will not be based on the Uniform Lifetime Table until the following year.[124]

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[117] Reg. § 1.408-8, A 5(b).

[118] Id.

[119] Reg. § 1.401(a)(9)-3.

[120] Reg. § 1.401(a)(9)-5, A 5.

[121] Reg. § 1.401(a)(9)-7, A 1 through A 4.

[122] Reg. § 1.408-8, A 4; A 7 through A9.

[123] Reg. § 1.408-8, A 5.

[124] Reg. § 401(a)(9)-7, A 1 through A 4.

E. Salvaging the Rollover Election When Estate or Trust Designated.

The I.R.S. has been extremely generous in a number of private letter rulings that allowed the Surviving Spouse to elect to treat an IRA as his or her own even though the estate or trust had been designated. The I.R.S. position is that if the surviving spouse has the powers, either individually, as a fiduciary, or in combination, to unilaterally cause the retirement plan to be allocated to the Survivor's Trust and then distributed out to the survivor, the survivor may then complete the rollover and election. Here are some sample forms to assist a trustee in this process:

STEP-BY-STEP INSTRUCTIONS FOR TRUSTEE

1. Contact the manager of the office of the financial institution that is handling the IRA. Identify yourself as Trustee of the Mark and Margo Married Family Revocable Trust, and explain that the trust was designated as the IRA beneficiary. Also explain that the trust authorizes you to make complete distribution of the IRA to you in your individual capacity as the sole beneficiary of the trust. In your individual capacity, instruct the manager to establish five separate IRA accounts corresponding to each of your children. Each account would be opened in your name with your social security number and would designate one child as the sole beneficiary. Complete the necessary paperwork, and make a note of the five new account numbers.

2. [If applicable, address minimum distributions that must be withdrawn prior to the rollover.]

3. In your capacity as Trustee, complete the enclosed letter to the financial institution once you have the five new IRA account numbers.

4. In your capacity as Trustee, complete the enclosed letter addressed to you in your individual capacity as the sole beneficiary of the trust. This letter is an important part of the paper trail documenting your rollover transaction.

5. Follow up to confirm that the [IRA/balance of the IRA remaining after minimum distributions discussed above] has indeed been transferred into each of the five new rollover IRAs.

MARGO MARRIED, TRUSTEE OF THE MARK AND MARGO MARRIED FAMILY REVOCABLE TRUST
111 BROADWAY
NEWTON, CA 93555

[Financial Institution]
[Address]

Re: IRA Account #______________________
Participant: Mark Married

Dear [Financial Institution]:

2003 Minimum Distribution. I have been advised to proceed with the minimum distribution that was required for 2003, the year of the participant's death. I have been advised that the amount of the distribution should be [$__________]. I direct that you make a distribution from the IRA as soon as possible payable to Margo Married, Trustee of the Mark and Margo Married Family Revocable Trust.

IRA Rollover. Mr. Married passed away on _______________, 2003. I am the trustee of the Trust that was designated as the beneficiary of Mark Married's IRA. I hereby direct you to roll over the balance of the IRA remaining after the 2003 minimum distribution described above. This will take place in accordance with my instructions contained in this letter.

It is my intention that the IRA be distributed to the Trust. I then intend to allocate the IRA to the "A Trust" that arises upon Mr. Married's death. I am also the trustee of the "A Trust," and once allocated, I intend to distribute the IRA to the "A Trust's" sole beneficiary, Margo Married, who intends to establish five rollover IRAs.

I have been advised that all of this must be accomplished within a 60-day window of time. To minimize the risk of exceeding the 60 days, and to simplify these transactions as much as possible, I have determined that the best way to accomplish this is for Margo Married, the beneficiary, to establish her own IRA accounts at your institution, and then for me as Trustee to cause a direct transfer of the IRA assets to the new IRA accounts.

Therefore, I hereby direct you to transfer the IRA assets in equal shares, directly to the following IRA accounts which have just been established by Margo Married, the beneficiary:

[provide five IRA account numbers]

Thank you for your attention to this matter. Please note that time is of the essence and I would appreciate your assistance in completing this transfer as soon as possible. If you have any questions about this transaction, you are authorized to call our attorney [name, address, phone]:

Very truly yours,

Margo Married, Trustee

MARGO MARRIED, TRUSTEE OF THE MARK AND MARGO MARRIED FAMILY REVOCABLE TRUST
111 BROADWAY
NEWTON, CA 93555

Ms. Margo Married, Beneficiary
111 Broadway
Newton, CA 93555

Re: IRA Account #______________________
Participant: Mark Married

Dear Beneficiary:

This letter will document that I have decided to distribute the IRA to the Trust and allocate it to the A Trust. I am also the trustee of the "A Trust," and I intend to distribute the IRA from the "A Trust" to you individually so that you may roll the IRA over into your own rollover IRA.

I am enclosing a copy of my letter to [financial institution] directing this transaction. Once I have completed the allocation of the other trust assets, I will provide additional documentation.

Yours truly,

Margo Married, Trustee

XXVII. PPA of 2006 Allows Direct Rollover to Charity.

The Pension Protection Act of 2006 (PPA)[125] adds IRC 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.[126]

- The plan owner does not claim a charitable deduction,[127] and QCDs are not taken into account in determining limitations that might apply to the plan owner's other charitable deductions under IRC Section 170, which imposes deduction limitations based on a percentage of Adjusted Gross Income (AGI).[128] However, the QCD must satisfy the substantiation requirements that would otherwise apply to support a charitable deduction under IRC Section 170.[129]

- 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,[130] and (ii) does not apply to distributions occurring in taxable years beginning after December 31, 2007.[131]

- Distributions must be from an individual retirement plan (*i.e.*, an individual retirement account or individual retirement annuity), other than a "simplified employee pension"[132] or a "simple retirement account,"[133] to qualify as QCDs.[134]

- A distribution must occur on or after the date on which the "person for whom the plan is maintained" attains age 70-½[135]. Notice 2007-7[136] clarifies that the exclusion

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

[126] IRC § 408(d)(8)(A).

[127] IRC § 408(d)(8)(E).

[128] ¶ 5175, Joint Committee on Taxation Report [JCX-38-06].

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

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

[131] IRC § 408(d)(8)(F).

[132] As defined in IRC § 408(k).

[133] As defined in IRC § 408(p).

[134] IRC § 408(d)(8)(B) (flush language).

[135] IRC § 408(d)(8)(B)(ii).

[136] 2007-5 IRB 395, Q&A 36-37.

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.[137]

- To qualify as QCDs, distributions must be made directly by the plan trustee to so-called "public" charities"[138] (other than so-called "supporting organizations"[139] or "donor advised funds"[140]),[141] and must otherwise be fully deductible.[142] 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.[143] Since the general rules governing taxation of distributions require aggregating all IRAs and all distributions as if from one contract,[144] 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 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.[145]

- QCDs count towards satisfying minimum distribution requirements.[146]

- California income tax rules will be in conformity with this new charitable rollover provision.[147]

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[137] Id., Q&A 37.

[138] As defined in IRC § 170(b)(1)(A).

[139] As defined in IRC § 509(a)(3).

[140] As defined in IRC § 4966(d)(2).

[141] IRC § 408(d)(9)(B)(i).

[142] *I.e.*, fully allowable under IRC § 170, disregarding subsection (b) thereof. See IRC § 408(d)(8)(C).

[143] IRC § 408(d)(8)(B) (flush language).

[144] IRC § 408(d)(2).

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

[146] ¶ 5175, Joint Committee on Taxation Report [JCX-38-06].

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

XXVIII. 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

Other facts assumed are similar to the case studies presented in Section II.[148] Ms. Wellington 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.
(6) Make Gifts With Non-IRA Securities Over Life	Same as (5), except Ms. Wellington structures the donations to include the maximum deductible

[148] This case study is not identical, having been run five years ago with slightly different fact assumptions, including a higher investment return of 10%. Your author has not updated this case study yet, but believes that it is a valid illustration of the issues relating to charitable giving with retirement assets.

Expectancy; No Charitable Gift At Death	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. 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 "After-Tax Assets" received by the charity is equal for each strategy. This allows an "apples to apples" comparison of the assets left for the daughter.

D. 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%

E. 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:

<u>Strategy</u>	<u>Conclusions</u>
(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 the Daughter than to the 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.

XXIX. 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 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.

XXX. 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.[149] However, Ted's Bypass Trust is likely to be under funded, wasting part of his applicable credit for estate tax.[150]

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.[151] 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.[152]

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 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 under funded, wasting part of her applicable credit for estate tax.

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[149] IRC §§ 408(a)(6) and 401(a)(9), and Reg. thereunder, released January, 2001.

[150] 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.

[151] 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.

[152] 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.

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[153] preemption of state law.

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

XXXI. 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[154] 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[155] 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.[156] 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)[157]. 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, 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.

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[154] 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.

[155] 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.

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

[157] RCW § 6.15.020.

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.[158] 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,[159] 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.* 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

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

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

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.[160] 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.

[160] 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.

XXXII. 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 IRC Section 1001.

IRC 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 IRC Section 1001.[161]

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,[162] at death,[163] or other event causing division of community property.[164] Similarly, the division of other jointly owned property is not a sale or exchange if the co-owners are (or were) related by marriage.[165]

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.[166] 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.[167] 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.[168]

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.[169] The assignment of income doctrine does not apply to the transfer of an interest in a retirement

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

[162] *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.

[163] 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.

[164] 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).

[165] 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.

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

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

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

[169] *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.

plan or IRA at divorce or death, since these transfers are governed by a specific statutory framework under IRC Sections 402 and 414.[170]

C. Not a Plan Distribution Under IRC 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 IRC Section 402.[171]

D. Not a Transfer Under IRC Section 691(a)(2).

IRC Section 691(a)(2) directs recognition of income upon the transfer of a right to receive IRD[172] 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 IRC Section 691(a)(2).[173]

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 IRC 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 trust, and concluded it was not.[174] 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.[175]

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.

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[170] 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 IRC § 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).

[171] 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);

[172] Although not an issue in the ruling request, IRC § 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."

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

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

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

XXXIII. 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*.[176] 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.

[176] 117 S. Ct. 1754 (1997).

XXXIV. 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 under funded. 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.[177] 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.

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.[178]

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[177] 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.

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

XXXV. 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
ANDREW THOMAS ANDERSON AND ARLENE TYLER ANDERSON

THIS AGREEMENT ("AGREEMENT") is entered into this date by ANDREW THOMAS ANDERSON ("HUSBAND") and ARLENE TYLER ANDERSON ("WIFE"), sometimes referred to herein individually and collectively as "Party" or the "Parties."

RECITALS AND TERMS

TRUST AGREEMENT. The Parties entered into a revocable trust agreement dated January 1, 2008, known as the ANDERSON REVOCABLE TRUST (hereafter, the "Trust").

FIRST DEATH; DECEASED SPOUSE; SURVIVING SPOUSE. The term "First Death" refers to the death of the first Party to die. The term "Deceased Spouse" refers to the first Party to die. The term "Surviving Spouse" refers to the surviving Party.

HUSBAND'S RETIREMENT PROCEEDS. *[Author's Note – "HUSBAND'S Retirement Proceeds" is defined to include all IRAs and Roth IRAs without itemized descriptions. Your author prefers to itemize each plan that is not an IRA or Roth IRA, and your author includes ERISA plans only after careful consideration of the unique issues that apply to ERISA plans.]* At the date of this Agreement accounts are maintained in the HUSBAND'S name **[Specifically itemize HUSBAND'S non-IRA plans or refer to Exhibit]**. 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. *[Author's Note – "WIFE'S Retirement Proceeds" is defined to include all IRAs and Roth IRAs without itemized descriptions. Your author prefers to itemize each plan that is not an IRA or Roth IRA, and your author includes ERISA plans only after careful consideration of the unique issues that apply to ERISA plans.]* At the date of this Agreement accounts are maintained in the WIFE'S name **[Specifically itemize WIFE'S non-IRA plans or refer to Exhibit]**. Such accounts, including any successor accounts, and 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 or quasi-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 have each been advised: (i) that retirement plan assets are subject to specific income tax rules that may produce different overall tax and economic outcome during life and after death; (ii) that the tax and economic outcome may vary depending on how death beneficiaries of retirement plan assets are designated; and (iii) that the default rules under California law for dividing community property that passes by probate or under a joint revocable trust at the First Death may not necessarily take into account retirement plan assets passing outside said probate or said revocable trust.

The Parties acknowledge that facts, circumstances, and laws may change over time, and based on current facts, circumstances, and laws, they believe that the strategy for designating retirement plan death beneficiaries of the Community Retirement Proceeds that is most likely to produce the best overall tax and economic outcome during life and after death is for each spouse to designate the other as primary beneficiary, so that the Surviving Spouse will be the sole owner of the Community Retirement Proceeds.

The Parties acknowledge that if the Surviving Spouse is designated as the primary death beneficiary of the Community Retirement Proceeds, and if the default rules under California law are applied to divide the Probate Community Property and the Trust Community Property, the Surviving Spouse is likely to become the owner of more than one-half of the Community Property Estate.

The Parties have been advised that one way to avoid an unequal division of the Community Property Estate is for each spouse to designate only half of his or her respective Community Retirement Proceeds to the Surviving Spouse. However, the Parties have decided against this approach, since each Party believes, based on current facts, circumstances, and law, that this approach is not likely to produce the best overall tax and economic outcome.

Instead, the Parties intend that each spouse designate his or her respective Community Retirement Proceeds entirely to the Surviving Spouse, and that an "aggregate division rule" (as set forth in this Agreement) be applied to divide the Probate Community Property and the Trust Community Property at the First Death, instead of the default rule that would otherwise apply under California law. The Parties believe, based on current facts, circumstances, and law, that proceeding in this fashion is most likely to produce the best overall tax and economic outcome, while still producing the fairest and most equitable division of their Community Property Estate

AGREEMENT

In order to give effect to their intent, the Parties hereby agree as follows: *[Author's Note – Sections A. through D. illustrate language that might be included if the clients want to document that all of their assets are community property. This language will not be appropriate for all clients, and is not necessary to accomplish an agreement to divide community property using an aggregate theory approach.]*

A. COMMUNITY PROPERTY. Except as provided in Paragraphs B. and C., all property now owned by hereafter acquired by HUSBAND, WIFE or both shall be the community property of HUSBAND and WIFE, including the Community Retirement Proceeds, property interests that prior to the date of this Agreement may have constituted separate property or quasi community property, property held by them in joint tenancy or in any other manner, and property held by one or both Parties with one or more others in any manner. Community property in this context means property in which HUSBAND and WIFE have present, existing, and equal interests as set forth in Family Code Section 751. Accordingly, that portion, if any, of said property that is HUSBAND'S separate property or WIFE'S separate property is hereby transmuted to community property.

B. SEPARATE PROPERTY. Assets acquired after the date of this Agreement by either HUSBAND or WIFE by inheritance, gift, devise, bequest, or descent, as well as the earnings of such assets and the proceeds of their sale or exchange, which shall be the separate property of the person acquiring such assets.

C. CERTAIN JOINT TENANCIES. The following shall be held as true joint tenants and not as community property:

1. Any of the following assets that are titled in the names of HUSBAND and WIFE as joint tenants: checking, savings, certificates of deposit, and money market accounts; automobiles, boats, trailers, and other motor vehicles; and U.S. savings bonds; and

2. Property titles in the names of one Party and a non Party as joint tenants.

D. EFFECT OF SPOUSAL JOINT TENANCY. The Parties understand, with respect to joint tenancy assets listed in Subparagraph C.1., that (i) each Party owns an undivided one half (½) interest in such assets as his or her separate property; and (ii) the Deceased Spouse's interest in such assets will pass by operation of law to the surviving joint tenant, notwithstanding anything to the contrary in the Deceased Spouse's Will or the Trust.

E. NON PRO RATA DIVISION AT FIRST DEATH. California Probate Code Section 104.5 establishes a presumption that community and quasi-community property transferred to a trust is so transferred subject to an agreement (under Probate Code Sections 100 and 101) that said property may be divided on a non-pro-rata basis to carry out any division provided under the trust. The Parties hereby acknowledge the applicability of Probate Code Section 104.5 to the Trust (or any other trust the Parties might establish from time to time). The Parties further agree that the Trust Community Property and the Probate Community Property may be divided in a non pro rata manner at the First Death without the requirement of any further consent of the Surviving Spouse. The Parties shall take any action necessary to cause (i) the Trust (or any other trust either or both might establish from time to time) 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, as authorized under California Probate Code Sections 100 and 101, the Parties hereby agree that 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 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.

The Parties are informed and advised that: (i) neither Party can predict which Party will be the Deceased Spouse; (ii) the effect of this Agreement may be to cause the Surviving Spouse's share of the Community Property Estate to consist of a disproportionately large amount of retirement assets; (iii) the effect of this Agreement may be to cause the Surviving Spouse's share to ultimately be more valuable to the Surviving Spouse and his or her heirs than the Deceased Spouse's share of community property (*e.g.* due to benefits from tax deferred compounding that may arise if retirement plan distributions are "stretched out" over an extended distribution period, due to the unique benefits of Roth IRAs, if applicable, due to the investment performance of retirement assets relative to other assets, or due to numerous other factors); and (iv) the effect of this Agreement may be to cause the Surviving Spouse's share to ultimately be less valuable to the Surviving Spouse and his or her heirs than the Deceased Spouse's share of community property (*e.g.* due to the income and transfer taxes applicable to retirement plan distributions, the investment performance of retirement assets relative to other assets, or due to numerous other factors). Nevertheless, despite these uncertainties, the Parties acknowledge their desire to proceed with this Agreement based on each Party's belief that this Agreement is most likely to produce the best overall tax and economic outcome.

In light of these uncertainties, the Parties hereby agree that the division of the Trust Community Property and the Probate Community Property directed in this section shall be determined by: (i) valuing all assets (retirement and otherwise) 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); and (ii) valuing all

assets (retirement and otherwise) 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 the aggregate division of the Community Property Estate hereunder:

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 in Section B.5. herein.

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 in Section B.6. herein.

[Author's Note – the following two sections are included out of an abundance of caution, and probably are not necessary when the Agreement is limited to IRA and Roth IRA accounts. These sections are intended to comply with ERISA/REA Spousal consent requirements, which only apply to ERISA retirement plan accounts. As noted earlier, the planner should extend this Agreement to ERISA plans only after giving careful consideration to the special issues that arise in connection with ERISA plans.]

3. 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 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.

4. 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.

5. 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. WIFE hereby agrees to execute any documents necessary to maintain said "modification type" consent now or in the future, and any revocation of said consent shall be made only as provided in Section D. of this Agreement.

6. 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. HUSBAND hereby agrees to execute any documents necessary to maintain said "modification type" consent now or in the future, and any revocation of said consent shall be made only as provided in Section D. of this Agreement.

G. BINDING AGREEMENT. This Agreement shall be binding on the administrators, executors, successors, and assigns of the Parties hereto.

H. 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.

I. 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.

J. 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.

K. 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.

L. REPRESENTATION BY ATTORNEY. ANDREW THOMAS ANDERSON and ARLENE TYLER ANDERSON have consented to joint representation by ANGLIN, FLEWELLING, RASMUSSEN, CAMPBELL & TRYTTEN, LLP, 199 S. Los Robles, Suite 600, Pasadena, California, 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 January 1, 2008.

____

ANDREW THOMAS ANDERSON - HUSBAND

____

ARLENE TYLER ANDERSON - WIFE

STATE OF CALIFORNIA)
) ss.
COUNTY OF LOS ANGELES)

On January 1, 2008, before me, STEVE TRYTTEN, the undersigned Notary Public, personally appeared ANDREW THOMAS ANDERSON and ARLENE TYLER ANDERSON, who 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 entities upon behalf of which the persons acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

____

Signature [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.

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).