Death and Taxes: The Inherited Retirement Plan

Advising Executors and Beneficiaries

2019 edition

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4

Inherited Retirement Benefits

Considerations that apply in administering retirement plan benefits after the participant's death.

This Chapter examines tax considerations that apply after the death of a retirement plan participant; it deals with *inherited* retirement benefits. It begins with the "Executor's Road Map" (¶ 4.1.01) and ends with the "Beneficiary's Road Map" (¶ 4.7). See also ¶ 2.1.07 (tax effects of plan loans outstanding at death) and ¶ 9.1.04 (death benefits exempt from 10% "early distributions" excise tax).

In this Chapter, unless otherwise specified, the "executor" means the executor, administrator, or personal representative of the estate of a deceased retirement plan participant.

4.1 Executor's Responsibilities

This ¶ 4.1 discusses an executor's responsibilities that are uniquely related to the decedent's retirement benefits.

4.1.01 ***The Executor's Road Map***

Here are matters an executor needs to consider with respect to the decedent's retirement benefits that do not arise with respect to other assets. If the estate is the beneficiary of any retirement plan, the executor should also review the "Beneficiary's Road Map," ¶ 4.7.

- Whether the executor may, on the decedent's behalf, make or withdraw IRA contributions. ¶ 4.1.03.

- Whether the executor should seek to "roll over" any retirement plan distributions made to the participant during life. ¶ 4.1.04.

- Whether the decedent took all "required minimum distributions" he was supposed to take, and if not, what the executor must do about it. ¶ 4.1.05.

- How to report retirement benefits on the participant's federal estate tax return and pay the estate tax. ¶ 4.3.

- Whether the executor can disclaim any retirement benefits on the decedent's behalf. See ¶ 4.4.11(C) and ¶ 4.4.12.

- If retirement benefits are payable to the estate, consider timing distributions from the retirement account to the estate to match deductible expenses; this topic is not covered in this book.

4.1.02 ***Recharacterizing the decedent's Roth conversion***

For a "Roth IRA conversion" (¶ 5.5) completed prior to 2018, the converter had the option to "recharacterize" (undo) his conversion by transferring the converted amount (plus earnings) into a traditional IRA. The deadline for recharacterizing a 2017 Roth conversion was October 15, 2018 (¶ 5.6.07). After that date there can be no further recharacterizations of Roth conversions, other than under IRS procedures under Reg. § 301.9100 for "late recharacterizations." ¶ 5.6.07(C). Thus the possible need to recharacterize the decedent's Roth conversion is no longer a potential concern for executors .

4.1.03 ***Who can make or withdraw decedent's IRA contribution?***

There is almost no guidance on this topic. See also ¶ 3.2.05 regarding the executor's inability to exercise a rollover/election right on behalf of a deceased surviving spouse.

See ¶ 2.1.08 regarding a participant's ability to "cancel" an IRA contribution by withdrawing the contribution (and earnings thereon) prior to the "extended due date" (¶ 5.6.07) of his tax return. If the participant died prior to that deadline without having withdrawn the contribution, can either the executor or the beneficiary exercise this right on the decedent's behalf?

The beneficiary, not the executor, owns the IRA upon the participant's death (¶ 4.2.01). Therefore it would appear that only the beneficiary has the right to withdraw an IRA contribution or any other moneys held in the IRA. However, there is no guidance on the extent (if any) to which a withdrawal by the beneficiary could be considered as a return of the participant's contribution.

In PLR 8439066 the IRS ruled that an executor could not make a regular IRA contribution (¶ 5.4.02) on behalf of the decedent (or on behalf of the decedent's surviving unemployed spouse). However:

- There may be a different rule for a *SEP-IRA*; see IRS Publication 560, "Retirement Plans for Small Business" (2018), which states (p. 6) that "But if you make contributions ...you must contribute to the SEP-IRAs of all participants who actually performed personal services during the year for which the contributions are made, including employees who die or terminate employment before the contributions are made." Rules for contributions to business-sponsored plans are beyond the scope of this book.

- A surviving spouse who files a joint return with the decedent for the decedent's final taxable year would, if such surviving spouse had compensation income in that year, and had lower income than the decedent had in that year, be able to contribute to a spousal IRA for such spouse's own benefit for the final year of the decedent's life based on the decedent's income. See § 219(c). The surviving spouse can make such contribution to a traditional IRA if he/she is younger than age 70½ or to a Roth IRA if he/she is otherwise eligible (¶ 5.4.04).

4.1.04 ***Completing rollover of distribution made to the decedent***

If a distribution is made during the participant's life, but the participant dies before rolling it over to another plan, can the participant's executor complete the rollover?

There are two different situations that can arise. If a distribution clearly was made to the participant before he died, and he did not roll it over prior to his death, the executor may seek to roll the distribution over on the decedent's behalf; see "A" and "B" below. More difficult is when the decedent dies in the middle of a direct rollover. See "C."

If a distribution was made to a *beneficiary* after the decedent's death, see ¶ 3.2 (for the surviving spouse) and ¶ 4.2 (for other beneficiaries) regarding the ability of beneficiaries to roll over such *post-death* distributions.

A. Executor allowed to complete rollover. Rev. Proc. 2003-16, 2003-1 CB 359, appears to concede that an executor can complete a rollover of a distribution made to the decedent prior to his death. The Rev. Proc. states that the IRS will consider requests for waiver of the 60-day deadline applicable to rollovers (¶ 2.7.01) if the failure to timely complete the rollover is due to (among other possible causes listed) "death." Section 3.02(2). Thus, with an IRS hardship waiver (¶ 2.7.07), an executor definitely *can* roll over a distribution made to the participant, if the participant's death prevented the participant from completing the rollover within 60 days of the distribution.

If the decedent's rollover can be completed by the executor *more than* 60 days after the distribution date (under grant of an IRS hardship waiver extending the deadline), then must it not also be true that the executor can complete the rollover (without an IRS waiver) *within* 60 days of the original distribution? Despite Rev. Proc. 2003-16, however, the IRS for a while permitted post-death rollovers of pre-death distributions only when the requestor was the participant's surviving spouse. In these PLRs, it usually appears that the surviving spouse had been the sole beneficiary of the plan from which the pre-death distribution was taken. See, *e.g.*, PLRs 2004-15012, 2004-20037, and 2004-18045, in which the IRS seems to treat the surviving spouse as still being and having the powers of a spouse-beneficiary, even though the money is outside of any retirement plan. But requests by nonspouse executors were denied, on the grounds that only the participant and the surviving spouse were permitted to roll over a distribution. See, *e.g.*, PLR 2004-15011, continuing the IRS's prior negative position on such post-death rollovers as expressed in (*e.g.*) PLR 2001-26038.

Then, in 2005, the IRS started allowing post-death rollovers of pre-death distributions by executors who are not stated to be the surviving spouse, under circumstances that clearly met the "hardship waiver" standard. PLR 2005-16021 involved a distribution that was unintentional due to the participant's lack of mental capacity when he withdrew the money. Others involved financial institution (FI) error (erroneous income tax withholding, PLR 2005-02050; failure to issue 1099-R plus improper advice about the rollover, PLR 2005-16022; financial institution distributed IRA without being requested to do so, PLR 2007-40020; financial institution gave wrong account number to employer plan for direct rollover, PLR 2012-33022). PLR 2005-02050 also involved evidence that

the participant had attempted to complete the rollover prior to death. PLRs 2007-42027 and 2009-10069 involved individuals who died after requesting the distribution but before or shortly after receiving the check. In PLR 2009-24056, the participant's severe medical problems prevented him from completing the rollover prior to death. PLR 2016-11023 involved a "sudden brief illness" after taking the distribution. Typically these PLRs mention evidence that the decedent had intended to roll over the distribution. Executors should have confidence that a rollover is permissible under circumstances similar to those mentioned in these rulings.

Meanwhile, the IRS continued to allow post-death rollovers of pre-death distributions by surviving spouses. See PLRs 2005-23029, 2006-08029, 2007-17021, 2007-19018, 2010-44036, and 2011-21035. In PLR 2005-20038 the IRS seemed irritated that the bank had insisted on a PLR when surviving husband had attempted to roll deceased wife's IRA distribution back in to her IRA within 60 days, implying that obviously no PLR was needed. In PLR 2016-39020 the IRS allowed a late post-death rollover of a pre-death distribution from husband's plan into wife's IRA without any mention of her official capacity (was she executor?) or even of whether she was the beneficiary of the husband's plan or of the rollover IRA he attempted to establish before his death.

B. But executor cannot name a "Designated Beneficiary!" In order for inherited retirement benefits to be eligible for the favorable "stretch" (life expectancy of the beneficiary) payout method under the minimum distribution rules (¶ 1.5.05), the benefits must be payable to a "Designated Beneficiary." Inherited benefits are always payable to some "beneficiary," but not just any old beneficiary qualifies as a *Designated* Beneficiary. A Designated Beneficiary must be named by the participant or plan prior to the participant's death. ¶ 1.7.01, ¶ 1.7.03. The IRS's position is that an IRA created by the participant's executor (to receive a rollover of a distribution made prior to the participant's death) cannot possibly have a "Designated Beneficiary" for minimum distribution purposes. See, *e.g.*, PLRs 2001-26036, 2005-16021, 2005-16022, 2007-17021, 2007-19018, 2007-40020, 2009-10069, 2009-24056, 2010-44036, 2011-21035, 2012-33022, 2013-34046.

In PLR 2005-16021 (see "A"), for example, the IRS recited that the newly-created IRA that was to receive the post-death rollover "will not have a designated beneficiary as that term is defined in section 401(a)(9) of the Code. Thus, the section 401(a)(9) distribution period with respect to the rollover IRA…is that applicable to an individual who died…without having designated a beneficiary thereof." As explained in PLR 2007-17021, the IRS is saying that, regardless of who now takes the benefits as beneficiary of the executor-created rollover account, the account will be treated as having "no designated beneficiary" *for minimum distribution purposes*.

Thus, for example, the state probate court might allow the executor to designate the deceased participant's children as beneficiaries of the recipient account; or the recipient account's plan documents might provide that in the absence of a beneficiary designation completed by the participant, the default beneficiary is the decedent's issue. The IRS is not trying to invalidate those designations of where the money will go. It is merely saying that this method of designating a beneficiary (i.e., the executor names a beneficiary with or without court approval, or rolls the funds into an IRA that has a pre-selected individual default beneficiary as part of its plan documents) does

not satisfy the requirements of § 401(a)(9)'s definition of designated beneficiary because it occurs after the participant's death.

This IRS position is unfortunate. It is not clear why, if (for example) an account was closed and paid out to a participant without his having requested it and when he was mentally incompetent (as in PLR 2007-40020), or a rollover was deposited in the wrong account due entirely to financial institution error (PLRs 2012-33022, 2015-35025), or the rollover-intending participant died suddenly (PLR 2013-34046), and the IRS agrees that the funds should be restored to an IRA after the participant's death to avoid hardship, the IRS would object to having the funds restored to an IRA that has a "Designated Beneficiary," even if the beneficiary is designated by the executor (pursuant to a court order or other proper procedures). The harsh result is especially outrageous when the participant died in the middle of a plan-to-plan transfer; see "C," below.

The IRS had no problem with allowing Designated Beneficiary status for an IRA established post-death (as a result of an executor's recharacterization of the decedent's Roth IRA contribution) in PLR 2002-34074. Why do other beneficiaries not get this same treatment?

It appears that the only way the IRS will recognize "designated beneficiary" status for beneficiaries of an IRA funded by an executor's post-death rollover of a pre-death distribution is if the rollover account was created by the decedent and the beneficiaries were therefore designated by the decedent prior to his death. For example, in PLRs 2005-23029 and 2006-08029, the distribution was to be rolled back into the same IRA it came out of, which had a Designated Beneficiary (the surviving spouse), and the IRS did not recite its mantra about not having a Designated Beneficiary. Similarly, in PLR 2005-20038, the IRS said the surviving spouse could roll his deceased wife's IRA distribution either back into the original IRA she had taken the money from (IRA X), or into a new IRA established in the name of the deceased wife; and went on to say that, unless the money was rolled back into IRA X, the recipient account "will not have a Designated Beneficiary." This implies that rolling the distribution back *into the account the participant took it out of* would allow the deceased participant's beneficiary designation to apply to the rolled funds.

Strangely, however, not every PLR allowing post-death rollover of a pre-death distribution mentions this issue. See PLRs 2016-11023 and 2016-39021 allowing executors (not stated to be surviving spouses) to complete rollovers of distributions the participants had taken just prior to their respective deaths; there is no mention of who was or would be the beneficiary of the IRAs that would receive the late rollovers or of any such beneficiary's status as a DB. See also PLRs 2011-49048 and 2014-51066, similarly, where the executor was the surviving spouse.

See also PLRs 2014-11045, 2015-42011, 2016-39020, and 2016-45023 allowing post-death rollovers, by the surviving spouse, of distributions made pre-death to the participant, *directly into the surviving spouse's own IRA* without reciting the "no DB" mantra. The spouse somehow retains her capacity as sole beneficiary of the retirement plan even for money that is no longer in a retirement plan.

C. **Participant dies in the middle of a direct rollover.** Sometimes a participant has the bad luck to die after having done everything necessary to effectuate a plan-to-plan transfer or direct rollover but before the assets are safely arrived in the transferee plan. The variety of results that accrue in these situations under IRS PLRs is nothing short of arbitrary and

capricious, not to mention extremely harsh on the family of someone whose only mistake was to die at the wrong moment.

The IRS may take the position that no distribution had yet occurred at the time of the participant's death, therefore there is no distribution to be rolled over. See PLR 2002-04038, denying beneficiaries the right to carry out a deceased participant's plan-to-IRA rollover when the participant had requested the direct rollover and done everything necessary to effectuate it, but died two days before the plan was scheduled to transfer his funds to his IRA. But compare that with PLR 2015-35025, where participant similarly died after requesting a direct rollover from his plan to his IRA, and it appears the plan made the distribution after participant's death (into the wrong account), and the IRS allowed the executor to late-roll the money into the IRA. Consistency is not the hallmark of post-death rollover PLRs.

In PLR 2010-35044, the distributing plan sent out a check payable to the transferee IRA, but the participant died before the check got deposited into the transferee IRA. The IRS ruled the executor *could* deposit the check into the transferee IRA. This was one of the PLRs ruling that the 60-day rollover deadline doesn't even apply to a direct rollover; for more of those (as well as PLRs holding the opposite), see ¶ 2.7.02. In PLR 2015-14020, the decedent had requested the distribution and opened an IRA, but died while the money was still inside the qualified plan. The plan distributed the money to the estate and the IRS allowed the executor to roll it into an IRA.

In PLR 2006-08029 the direct rollover check was dated after the date of the participant's death, even though he received it the day he died, and the executrix had to go through the IRS-waiver procedure to get permission to complete the rollover.

In PLR 2014-04017, a direct rollover check was sent to the participant at the request of his daughter as his agent. She had completed the paperwork to open the rollover IRA naming the participant's five children as beneficiaries of the account, but because the IRA had not actually been opened at the time of the participant's death, the IRS allowed the late rollover but said there could be no designated beneficiary.

In PLR 2014-36055, participant "A" (a retired employee of Company E) requested a direct transfer of his funds in "Plan C" to his account in "Plan D," both plans being plans of his former employer. After completing all the distribution/rollover paperwork, A died. "G," his surviving spouse, received the Plan C check payable to Plan D. She sent it to Plan D, but they refused to accept it as a rollover from A because A was dead and the Plan D account now belonged to G as beneficiary! And no IRA provider would accept the check either. So the plan-to-plan transfer check was treated as a taxable distribution! The IRS graciously allowed G to complete the 60-day rollover on A's behalf, but forbade her to name a beneficiary for the rollover account.

D. Post-death rollover requests denied by IRS. Not every request for post-death rollover of a pre-death distribution is granted. Understandably, the post-death rollover was not allowed where the distribution had occurred more than three years prior to the participant's death, and the participant had spent the entire distribution (PLR 2007-35029); where the participant had withdrawn the IRA funds to post bail for felony charges then committed suicide (no evidence of rollover intent or means to carry out rollover; PLR 2014-40030); or where the decedent

had cashed out his IRA, then died without opening a new IRA or leaving any other evidence of an intent to roll over (PLR 2015-42010).

More anomalous is the bizarre PLR 2011-23048, where the IRS stated it was "impossible" to allow a rollover because the participant was dead! This unfortunate ruling is an outlier and was possibly caused by the parties seeking a ruling under the wrong Code section—§ 402(c)(9) (spousal rollover) instead of the usual § 402(c)(3)(B) (deadline extension for *participant's* rollover). It was followed a few months later by a successful ruling (waiver granted) involving similar facts (PLR 2011-49048).

E. Executor must check pre-death distributions. Executors must investigate whether the decedent received any eligible rollover distribution that was not rolled over, and (if so) whether it would be possible (and advantageous to the estate) to complete that rollover on the decedent's behalf.

Distributions even further back than 60 days prior to the date of death (i.e., the normal rollover deadline; see ¶ 2.7.01) could be eligible to be rolled over, under the hardship waiver provisions (see ¶ 2.7.05), if the decedent was hospitalized, disabled, incarcerated, unaware of thefts from his account, or for some other reason unable to complete the rollover within the allotted time. Thus, there is no maximum on the "look-back period" the executor should investigate for incomplete rollovers, other than this: There is no need to investigate distributions prior to 2002, since only post-2001 distributions are eligible for the hardship waiver of the 60-day rollover deadline.

F. Fiduciary issues. The post-death rollover of a pre-death distribution would change the substantive estate plan if the beneficiary of the IRA (into which the rollover is contributed) is not the same as the beneficiary of the estate (where the distribution was sitting prior to the rollover). That would appear to be a problematic step for the executor to take.

The executor should consider obtaining a court order blessing the proposed rollover if it is not specifically authorized in the will or under state law (see, *e.g.*, PLR 2016-39021 authorizing an executor's post-death rollover "Assuming that Executor B is authorized under the law of State M to complete a rollover..."). If the rollover is going into an account that the participant himself had established, and it is clear that the participant intended to roll the distribution into this account, then the court should approve the rollover as carrying out the decedent's intent. If there is no preexisting IRA to roll the money into, or if the distribution was unintentional (for example because the participant was mentally incompetent when he took it), or if for some other reason it is not clear to whom the participant intended to leave this particular asset, here are two routes to consider:

- One option is for the beneficiary of the rollover IRA to be the estate itself. Even if the estate is the beneficiary of the account (so there is "no Designated Beneficiary" for minimum distribution purposes; ¶ 1.7.04) the rollover could make possible several years of continued deferral under the "no-DB" rules (¶ 1.5.06, ¶ 1.5.08); or could facilitate a spousal rollover

"through" the estate if the surviving spouse is the beneficiary of the estate (¶ 3.2.09; PLRs 2010-44036 and 2013-34046 may be examples of this type of planning).

- Another possibility is to get court permission to name the estate beneficiaries directly as beneficiaries of the proposed rollover IRA. Although at this time the IRS will not accept post-death beneficiary designations to establish a Designated Beneficiary for minimum distribution purposes (see "B" above), the estate might still be better off with this approach if the estate beneficiaries are charities (see ¶ 7.2.01), or if estate assets are vulnerable to creditors' claims or increased administration expenses; or possibly you or a judge or someone else will persuade the IRS to change its mind about allowing executor-named beneficiaries to be considered Designated Beneficiaries.

4.1.05 ***Executor's responsibilities regarding decedent's RMDs***

This section applies only to the estate of a decedent who died on or after his required beginning date (¶ 1.4.01) or who owned any inherited retirement plans (¶ 1.5). If neither of those conditions applies to your decedent you can skip this section.

The Code requires an individual to take annual distributions (called "required minimum distributions" or "RMDs" in this book) from such individual's own retirement plans beginning at a certain point, and from any inherited retirement plans. See Chapter 1. Failure to take an RMD results in a 50 percent excise tax under § 4974. ¶ 1.9.02. It may appear to an executor that the decedent did not take all of his RMDs. Before concluding that the participant owed the excise tax, consider the possibility that, for some or all of the years in question, the decedent may have qualified for a "grandfather" rule, or for some other reason may actually *not* have been required to take distributions. See ¶ 1.3.01.

But if the decedent actually *did* fail to take RMDs during his life, to what extent does that failure become the executor's problem?

A. **RMD for the year of death.** If a participant died on or after his required beginning date (¶ 1.4.01), then a minimum distribution was required for the year of death. If he died before having taken the full required amount, the responsibility to take whatever portion of the year-of-death RMD the participant did *not* take prior to his death passes to the beneficiary of the account. ¶ 1.5.04(A). Similarly, if a beneficiary dies in a year in which such beneficiary was required to take an RMD from an inherited plan or IRA, the responsibility to take the balance of the RMD for that year, and subsequent years, passes to the successor beneficiary of the account. See ¶ 1.5.13.

Thus, the executor of the participant's (or beneficiary's) estate does *not* need to be concerned with the RMD for the year of the participant's (or beneficiary's) death unless the estate is the beneficiary (or successor beneficiary) of the account. If the estate *is* the beneficiary, the executor should take the RMD for the year of death to the extent the decedent failed to take it. The deadline for this RMD is 12/31 of the year of death, even if the estate is on a fiscal year. ¶ 1.2.01, #2. If the executor misses this deadline, the executor must pay (or obtain a waiver of) the excise tax. ¶ 1.9.03.

B. **Years for which the executor must file decedent's return.** The executor must file the decedent's income tax return for any year(s) before the decedent's death to the extent the decedent had not done so. § 6012(b)(1). In most cases that will mean filing just one income tax return (Form 1040), the return for the year before the year of death that the decedent had not yet filed when he died—but there could be multiple years if due to illness or some other cause the decedent had failed to file his tax returns. Form 1040 has a line (line 59 on the 2016 Form) for the entry of "Additional tax on IRAs, other qualified plans, etc. Attach Form 5329 if required." For any year for which the executor is preparing a Form 1040 for the decedent, the executor should *also* prepare and attach Form 5329, and either pay or seek a waiver of any excise tax shown thereon resulting from the decedent's failure to take the RMD; see ¶ 1.9.03.

C. **What about all the other years?** The statute of limitations will have expired on any excise taxes the decedent owed for missed RMDs three years after he filed Form 5329 for that year (or six years after, if the amount of excise tax owed was understated by 25% or more of the amount of excise tax reported on the Form 5329). § 6501(a), (e)(3). The problem is that, even if the decedent duly filed his *income tax returns* (Form 1040) every year, it is unlikely that he ever filed Form 5329. Prior to the *Paschall* case (137 T.C. 8 (2011)) it was rare for anyone to file form 5329 if not aware of owing any IRA penalties, and even now it is probably unusual.

This creates a vexing problem for the executor, because the estate owes to the IRS any excise taxes the decedent failed to pay. An executor will normally feel comfortable about the decedent's income tax obligations if it appears the decedent timely filed his returns and paid the applicable income tax. But with the excise tax for missed RMDs, it will normally not appear that the decedent filed Forms 5329, so there is probably no statute of limitations. There is no clear path to resolving the RMD issue with no evidence that 5329s have been filed, other than having the executor himself prepare and file 5329s for every year in which the decedent was supposed to take an RMD.

Perhaps it would be wise to look at the last few years of the decedent's returns and verify to the extent possible that RMDs were taken. If there are any years (recent or otherwise) for which the executor knows or strongly suspects that the decedent missed taking the full RMD, and for which no Form 5329 appears to have been filed, the executor should investigate the facts and prepare and file Form 5329 for those years based on the best knowledge he can muster, requesting a waiver of the excise tax if applicable. See ¶ 1.9.03. However, unless the retirement plan is actually payable to the estate, the executor is not in a position (because the beneficiaries control the account) to take the missed RMDs as a way of remedying the "shortfall," which is a condition of getting an IRS waiver of the excise tax.

Once the executor has in good faith prepared the decedent's income tax and 5329 returns he thinks are required, and paid from the estate the income and excise tax he thinks the decedent owed (or obtained a waiver), the executor can file Form 4810 with the IRS for prompt assessment and release of liability with respect to such returns under § 6501(d). This will put an 18 month time limit on the IRS to contest those returns.

As a reminder, the executor has personal liability (up to the value of the estate he is administering) for his decedent's federal *estate, income, and gift* taxes. § 2204(a), § 6905(a). The 50 percent tax for failure to take an RMD is an *excise* tax imposed by § 4974 which is part of Subtitle D. There does *not* seem to be an equivalent imposition of personal liability on the executor for the decedent's *excise taxes.* However, the federal government's claims take priority over other "debts" of the estate, and the executor can be personally liable for distributing estate assets knowing that a U.S. government claim is outstanding. See 31 U.S.C. 3713 ("Priority of Government Claims").

4.2 Post-Death Titling, Transfers, Rollovers, Roth Conversions

This ¶ 4.2 explains how to title an inherited IRA, and how and to what extent a *nonspouse beneficiary* can do benefit transfers, rollovers, and Roth conversions after the participant's death. For a spouse beneficiary see ¶ 3.2.

4.2.01 ***First step: Titling the inherited IRA***

When an IRA owner dies, ownership of the account passes immediately and automatically to the beneficiary, by operation of the contract (the IRA agreement and the beneficiary designation form). If there is any doubt about who the beneficiary is (i.e. who is entitled to the account at this point), see ¶ 1.7.02. *This* section assumes there is no doubt or dispute about the identity of the beneficiary(ies).

Because the beneficiary now owns the IRA, the beneficiary theoretically should be able to walk in to the IRA provider's office, present his identification, and get a check for the entire balance payable to himself. It is possible that some IRA providers will operate that way and accept instructions from the beneficiary merely based upon establishing the beneficiary's identity. However, many IRA providers will not accept instructions from a beneficiary until the beneficiary has the account "retitled" as an "**inherited IRA**" Some IRA providers use the term **beneficiary IRA** or **decedent IRA** for such accounts.

The IRA provider's position may be that it can accept instructions (including withdrawal requests) only from a customer (account holder) of the firm, and that until the beneficiary has signed the appropriate documents the beneficiary is not a recognized account owner and customer of the IRA provider company. Furthermore, that signature typically has to be on a brand new account the IRA provider opens to succeed to the existing (deceased participant's) IRA.

The way the Code and regulations discuss the inheritance of IRAs gives the impression that the beneficiary inherits exactly the same account that the deceased participant used to own, just as the beneficiary might inherit a house or a chair that the decedent used to own. It's the same house or the same chair with a new owner. But financial institutions can't cross out the decedent's name on an account agreement and write in the beneficiary's name. They can't put a new name and Social Security number on an existing account. They need a new signature card, new address, new everything. A new owner (the beneficiary of the old owner) must have a new account.

Errors can easily occur here. It sometimes happens that, instead of simply updating the paperwork to show that the account is now an inherited IRA, the parties succeed in distributing the

entire account balance, thereby causing immediate taxation of the entire amount and permanent loss of further deferral (¶ 4.2.02(A)), or depositing the funds in the nonspouse beneficiary's *own* IRA (¶ 4.2.04(E)). The request to the IRA provider should be in writing and emphasize that you are NOT requesting a distribution or rollover of the account at this time, merely informing them that the account is now an inherited IRA.

In this book, "**inherited IRA**" means an IRA inherited by any beneficiary (*including* the surviving spouse, and including a nonindividual such as an estate, trust, or charity). The IRS similarly uses the term "inherited IRA" to mean an IRA held as beneficiary by *anyone* (even the spouse); see [expired] Reg. § 54.4981A-1T, Q&A d-10(b), Notice 2009-68, 2009-39 IRB 423, and IRS Publication 590-B, "Distributions from Individual Retirement Arrangements (IRAs)" (2018). The IRS also uses the term "beneficiary IRA" (see Notice 2008-30, 2008-12 IRB 638, A-7).

Inherited IRA: No Code Definition and No Such Thing

The Internal Revenue Code does not define "inherited IRA." The Code provides that "in the case of an inherited" IRA, distributions from the account may not be rolled over (and rollover contributions may not be accepted). § 408(d)(3)(C). But instead of defining inherited IRA, § 408(d)(3) says only that an IRA "*shall be treated as* inherited if-- (I) the individual for whose benefit the account or annuity is maintained acquired such account by reason of the death of another individual, and (II) such individual was not the surviving spouse of such other individual." Emphasis added. All this sentence tells us is that, *for purposes of the rule that rollovers are not allowed for inherited IRAs*, an IRA held by the surviving spouse as beneficiary is not treated as an inherited IRA. The rule does not mention IRAs held by *non*individual beneficiaries, because the rule allowing rollovers of IRA distributions (§ 408(d)(3)(A)) only applies to distributions to the *individual* for whom the account is maintained.

The term "inherited IRA" simply means an IRA held by a beneficiary as distinguished from an IRA held by the original still-living participant. The term is useful when discussing certain tax rules that apply differently in those cases. But an "inherited IRA" is not a different or new kind of IRA. It is an IRA under Code section 408 just the same as any other IRA. There is not and never has been a separate type of account called an "inherited IRA." There is no such thing!

The IRA provider typically has the beneficiary sign a new account agreement and retitles the account accordingly. See Rev. Proc. 89-52, 1989-2 CB 632, and Notice 2007-7, 2007-5 IRB 395, A-13. An inherited IRA (or plan account) should be titled so as to make clear *that it is an inherited account*, such as by indicating the names of the both the beneficiary (who now owns it) and the deceased participant (whose account it originally was). For example:

Individual: If the beneficiary is an individual, the inherited IRA or plan account could be titled "John Doe, deceased, f/b/o Junior Doe," or "Brian Young as beneficiary of Joan Smith" (see Rev. Proc. 89-52, § 3.01) or similarly.

Estate: For an IRA or plan account that is payable to the deceased participant's estate, the titling could be "John Doe, f/b/o Estate of John Doe," or "XYZ Bank, Executor of the estate of John Doe, as beneficiary of John Doe," or something similar.

Trust: An IRA or plan account held by a trust as beneficiary could be titled "John Doe, f/b/o John Doe Testamentary Trust," or "XYZ Bank, Trustee of the John Doe Revocable Trust, as beneficiary of John Doe," or similarly.

The IRS requires the IRA provider to show the name of the decedent, as well as the name and taxpayer identification number of the beneficiary, when reporting the value of and distributions from an inherited IRA. Rev. Proc. 89-52, § 3.01; see Instructions for IRS Forms 1099-R and 5498 (2018), p. 20. (Some older PLRs suggesting that the decedent's Social Security number should be retained on the account, *e.g.* PLR 2001-09051, are erroneous.)

See ¶ 4.4.04(B) regarding preserving the option of disclaimer by the beneficiary when retitling the account.

*4.2.02 **Nonspouse beneficiary: Transferring inherited account***

For definitions of "direct rollover," "60-day rollover," and "IRA-to-IRA transfer," see ¶ 2.6.01.

A. Nonspouse beneficiary cannot roll over a distribution received. If, after the participant's death, an inherited retirement plan or IRA makes a distribution to a beneficiary who is not the participant's surviving spouse, that distribution cannot be rolled over. It cannot be rolled back into the plan or IRA it came out of, or into any other plan or IRA. Not within 60 days, not within 60 hours. Not to the beneficiary's own IRA and not to an inherited IRA. § 402(c)(4), (9); § 408(d)(3)(C).

This rule applies to every beneficiary who is not the participant's surviving spouse, whether or not such beneficiary is a "Designated Beneficiary" (¶ 4.2.04(C)). A nonspouse beneficiary's taking a distribution from an inherited plan, even if accidental or unintentional, is a mistake that cannot be fixed; the IRS simply does not have the power to authorize the recontribution of the distributed amount to the same or another plan. See PLR 2005-13032, in which a trustee took a distribution from an inherited IRA, intending to roll it over to another inherited IRA, not realizing that this change could be accomplished only by IRA-to-IRA transfer. The IRS refused to allow the trustee to complete the "rollover"; as a nonspouse beneficiary the trustee was not entitled to roll over an IRA distribution.

However, despite the unique clarity and finality of the no-rollovers rule, there are some exceptions and quasi-exceptions:

- The rule applies to distributions that occur after the death of the participant. For the executor's possible ability to roll over a distribution made *prior* to the participant's death, see ¶ 4.1.04.
- For the ability of a *surviving spouse*, as beneficiary of the plan or IRA, to roll over distributions made to her, see ¶ 3.2. If the beneficiary of the plan or IRA is a trust or estate,

but the surviving spouse is the beneficiary of the trust or estate, see ¶ 3.2.09 for the possible ability of the surviving spouse to roll over a distribution made to her "through" the trust or estate.

- For the ability of a nonspouse Designated Beneficiary to effect a transfer of benefits from an inherited *nonIRA* plan to an inherited IRA, see ¶ 4.2.04.

- IRA beneficiaries are permitted to do certain "IRA-to-IRA transfers"; see "B" below.

- For the possibility of "undistributing" a distribution, see "C."

- Finally, there is a "grandfather rule": A nonspouse beneficiary who inherited an IRA from someone who died before 1985 could elect to treat the inherited IRA as the beneficiary's own IRA. See 1987 version of Prop. Reg. § 1.408-8, A-4; this grandfather rule is not mentioned in the final regulations.

B. Post-death IRA-to-IRA transfers permitted. Any IRA beneficiary (including an estate, a see-through trust, a non-see-through trust, a surviving spouse, and a nonspouse individual) can authorize a direct transfer from one IRA inherited from a particular participant to another "inherited IRA" of the same type (traditional or Roth) in the name of the same participant and payable to that same beneficiary. The IRS calls such transfers "**trustee to trustee transfers**." See, *e.g.*, IRS Publication 590-B (2018), p. 5. This book calls them "**IRA-to-IRA transfers**." This rule applies only to IRAs; a nonspouse beneficiary cannot do a "trustee to trustee transfer" of benefits either to or from a *nonIRA* plan except as explained at ¶ 4.2.04–¶ 4.2.05.

IRA-to-IRA transfers are permitted because, under Rev. Rul. 78-406, 1978-2 CB 157, an IRA-to-IRA transfer is not considered a "rollover." It is neither a distribution from the transferring IRA nor a contribution to the recipient IRA. Thus, an IRA-to-IRA transfer avoids several restrictions that apply to "60-day rollovers." See ¶ 2.6.07. An IRA-to-IRA transfer is not a reportable event (unless combined with a Roth conversion); see Instructions for IRS Forms 1099-R and 5498 (2018), p. 6 ("Transfers").

Although Rev. Rul. 78-406 involved an IRA-to-IRA transfer by a living participant, the IRS cites it in PLRs as being equally applicable "if the trustee to trustee transfer is directed by the beneficiary of an IRA after the death of the IRA owner as long as the transferee IRA is set up and maintained in the name of the deceased IRA owner for the benefit of the beneficiary." PLR 2007-07158; see also, *e.g.*, PLRs 2002-23065, 2003-49009, 2006-16040, and 2006-47030. Because an IRA-to-IRA transfer is not a "rollover," it is not subject to the prohibition against rollovers by a nonspouse beneficiary (see "A," above).

If, in the process of attempting to carry out an IRA-to-IRA transfer of an inherited IRA, the funds are distributed to the beneficiary (i.e., money is deposited in the beneficiary's *taxable account*) by mistake, there is no remedy, because a nonspouse beneficiary cannot roll over a distribution—even one made in error (see "A").

If funds from an inherited IRA that are supposed to be transferred directly into another inherited IRA (in the names of the same deceased participant and beneficiary) are instead moved into the beneficiary's *own* IRA, the transfer would not conform with the requirement recited in the PLRs "decided" under Rev. Rul. 78-406. Can this mistake be fixed? See ¶ 2.7.07 and ¶ 5.6.09 for ideas.

For an IRA-to-IRA transfer in connection with the transfer of an inherited IRA from a trust or estate to the beneficiaries of the trust or estate, see ¶ 6.1.05.

C. "Undistributing" the distribution. Anecdotal evidence indicates practitioners sometimes succeed in persuading an IRA provider or plan administrator to take back money that it distributed to beneficiaries and pretend the distribution never happened—changing the paper trail and amending 1099-Rs as necessary to "undistribute" the money. This approach is apparently most likely to succeed if the IRA provider/plan administrator knows it made a mistake (for example, by not following the beneficiary's instructions, or by giving the beneficiary incorrect advice about the distribution options available). It has been said that IRS agents sometimes even suggest this course when they are consulted about an erroneous distribution. Since there is no apparent legal pathway for money to be "undistributed" back into a retirement plan, I cannot advise regarding this option. See PLR 2011-39011 for an IRS-approved example (child's guardian wrongfully caused plan benefits to be distributed rather than rolled into an IRA).

4.2.03 ***When inherited IRAs must, may, or cannot be aggregated***

For certain tax purposes multiple IRAs are not treated as separate entities. Rather they are "aggregated"—treated as if they were all just one combined account. This section explains when separate inherited IRAs must or may not be "aggregated," and discusses whether separate inherited IRAs may be combined into a single account.

A. Income taxes: Determining taxable portion of distribution. IRA distributions are income-taxable as "income in respect of a decedent" (IRD); see ¶ 4.6. For income tax purposes, IRAs inherited from one decedent are deemed aggregated with (and only with) other IRAs of the same type (traditional or Roth) inherited from that same decedent for purposes of determining the income tax treatment of any particular year's distributions from any of them. Thus, for example, in determining what proportion of a distribution from an inherited IRA is deemed to be tax-free as a return of the participant's investment in the contract (¶ 2.2.07), all IRAs inherited by the distributee from the same decedent are treated as a single IRA. Rev. Proc. 89-52, 1989-2 CB 632, § 3.01. See also IRS Publication 590-B (2018), *Distributions from IRAs*, "What if you inherit an IRA?," "IRA with basis," p. 5.

If the deceased participant had after-tax money in his IRA, the beneficiary succeeds to that "investment in the contract" (IITC) after the participant's death. This statement would appear to hold true even if the account is worth less than the participant's IITC as of the date of death; § 1014(b), providing for an adjustment bringing basis to date-of-death value, does not apply to IRD. ¶ 4.6.01; § 1014(c).

B. Taking RMDs. The required minimum distribution (RMD; Chapter 1) is computed separately for each IRA the individual owns (inherited or noninherited). Having computed the RMD separately for each account, however, an individual is entitled to take the RMD for all of certain "aggregate-able" IRAs from any one or more of the IRAs in that group. For this purpose, IRAs inherited from a particular decedent may be aggregated (only) with other IRAs inherited from that same decedent, provided all the aggregated accounts are being distributed under the life expectancy payout rules. Reg. § 1.408-8, A-9.

C. Combining multiple IRAs. A beneficiary who inherits, from one deceased participant, multiple IRAs (which all have the same beneficiary designation and Applicable Distribution Period) can apparently consolidate the IRAs into one inherited IRA by means of IRA-to-IRA transfer. PLR 2002-11047.

*4.2.04 **Nonspouse beneficiary rollovers from nonIRA plans***

A nonspouse "Designated Beneficiary" (see "C" below) can have funds transferred, by direct rollover (see "D"), from certain types of inherited nonIRA plans (see "B") into an "inherited IRA" (see "E") or inherited Roth IRA (see ¶ 4.2.05). A surviving spouse as beneficiary has more expansive options; see ¶ 3.2.07.

This ¶ 4.2.04 deals only with money that was *still in the plan* at the time of the participant's death. For money that was distributed *prior to the participant's death*, see ¶ 4.1.04 instead. If not certain when the distribution occurred, see ¶ 2.1.03.

A. Legislative background. As a result of the Pension Protection Act of 2006 (PPA '06), a Designated Beneficiary is permitted to transfer certain inherited nonIRA plan benefits, *by direct rollover only*, into an "inherited" IRA. § 402(c)(11).

The main benefit of this type of transfer is that it allows a Designated Beneficiary to take advantage of a deferred "stretch" payout of the benefits over his life expectancy, even if the plan he actually inherited permitted only a lump sum distribution form of benefit. See ¶ 1.5.10. In Notice 2007-7, Section V, the IRS addressed the RMD effects and other details of nonspouse beneficiary rollovers. Notice 2007-7 was further clarified in a special edition of the IRS's *Employee Plan News*; see: http://www.irs.gov/pub/irs-tege/se_021307.pdf

Generally, when a plan is about to make an "eligible rollover distribution" to a Designated Beneficiary (¶ 4.2.04(C)), the plan must offer the recipient the option of having the distribution sent, via direct rollover, to any eligible retirement plan (which includes a Roth IRA) and must comply with the recipient's request for such a direct rollover. § 401(a)(31); Notice 2008-30, 2008-12 IRB 638, A-4. (There are exceptions for certain small distributions and multiple distributions.) See § 402(f)(2)(A).

In the years 2007–2009, § 402(c)(11) provided for nonspouse beneficiary direct rollovers, but the IRS interpreted the statute as merely *allowing* such rollovers and not *requiring* plans to offer them. IRS Notice 2007-7, 2007-1 CB 395, A-14, A-15. The statute was amended again to make Congressional intent clear, for 2010 and later years at least, that the plan *must* offer this option to the

designated beneficiary—it is not merely an option the plan can choose to allow or not. See § 401(a)(31) and § 402(f)(2)(A). Unfortunately, the IRS has never revoked the now-obsolete sections of Notice 2007-7.

The plan *may* allow the beneficiary to have direct rollover of the distribution into multiple "destination" IRAs (*e.g.*, a traditional and a Roth); however, the plan is not *required* to offer that option. All that the plan is *required* to offer with respect to any one distribution is a menu of three choices: 1. Outright distribution of the entire amount to the beneficiary; 2. Direct rollover of the entire amount to a single inherited IRA; or 3. Partial outright distribution to the beneficiary with the balance directly rolled over to a single inherited IRA. Reg. § 1.401(a)(31)-1, A-9, A-10.

B. **Types of nonIRA plans.** § 402(c)(11) applies to 403(b) plans and governmental 457 plans (¶ 5.4.01(B), #3) as well as to qualified retirement plans (QRPs). § 403(b)(8)(B), § 457(e)(16)(B). For ease of reference this section will speak mostly of QRPs, but all statements apply equally to 403(b) and governmental 457(b) plans.

C. **Available only to a Designated Beneficiary.** The direct rollover to an inherited IRA is available only for an "individual who is a designated beneficiary." § 402(c)(11)(A). A Designated Beneficiary means an individual (or group of individuals) who are named as beneficiary(ies) of the plan by the participant or under the terms of the plan. See ¶ 1.7.03.

Though a trust is not an individual, "a trust maintained for the benefit of one or more designated beneficiaries shall be treated in the same manner as a designated beneficiary" for purposes of the nonspouse beneficiary rollover, to the extent provided in rules prescribed by Treasury. § 402(c)(11)(B). Reg. § 1.401(a)(9)-4, A-5(b) sets out tests a trust must satisfy in order for the trust beneficiaries to be treated as Designated Beneficiaries for RMD purposes. ¶ 6.2.03. The IRS calls a trust that meets these requirements a "see-through trust," and has confirmed that the same tests will apply for purposes of determining whether a trust named as beneficiary is eligible to use the nonspouse beneficiary rollover. Notice 2007-7, A-16.

Since the option to transfer inherited plan benefits to an inherited IRA is limited to Designated Beneficiaries, an estate or non-see-through trust cannot transfer inherited plan benefits to an inherited IRA. Thus, such an estate or trust can not use the nonspouse beneficiary rollover as a way to sidestep the plan's payout rules. For example, if the inherited plan offers a lump-sum distribution as its only payout option, the estate or non-see-through trust is stuck with that; it cannot compel the plan to pay distributions over five years (¶ 1.5.06) or what would have been the decedent's life expectancy (¶ 1.5.08), even though the Code would have permitted such a payout; see ¶ 1.5.10.

D. **Direct rollovers only.** Only *direct rollovers* (¶ 2.6.01(C)) to an inherited IRA are permitted. § 402(c)(11)(A). A direct rollover is the transfer of assets directly from the participant's account in a qualified retirement plan (QRP), 403(b) plan, or governmental 457(b) plan ("nonIRA plan") into the inherited IRA. A direct rollover of nonIRA plan benefits of a nonspouse Designated Beneficiary can be made only to an inherited IRA or Roth IRA, not any other type of plan; see "E" below. The Code calls this a **direct trustee-to-trustee**

transfer. § 401(a)(31)(A). The IRS (and this book) call it a **direct rollover**. See, *e.g.*, Reg. § 1.401(a)(31)-1. If the plan distributes funds to the nonspouse *beneficiary* instead of to the *inherited IRA*, the distribution is taxable, and rollover of the distributed amount becomes impossible. ¶ 4.2.02(A). (If the beneficiary takes a partial distribution, he can still have a direct rollover of the *rest* of the benefits to an inherited IRA.)

E. Must roll to an "inherited IRA." The nonspouse beneficiary direct rollover may be made *only* to an "inherited IRA" (i.e., one titled as described at ¶ 4.2.01) which is "established for the purpose" of receiving this distribution. § 402(c)(11)(A); Notice 2007-7, A-13. Regarding whether such accounts can later be combined with other IRAs inherited from the same decedent, see ¶ 4.2.03(C).

If a nonspouse beneficiary rolls a distribution from an inherited plan into the beneficiary's *own* traditional or Roth IRA, the transfer does not meet the requirements of a qualified rollover under § 402(c)(11)). The author believes this mistake can be overcome by a § 408A(d)(6) recharacterization; see ¶ 5.6.08. See also ¶ 2.7.07 (hardship waiver of rollover deadline). However, the result may be that the transaction is treated as a taxable distribution followed by a regular contribution to the beneficiary's own IRA (or Roth IRA). See ¶ 5.3.02, ¶ 5.4.05, ¶ 2.1.08.

F. Applies to post-2006 post-death distributions. The nonspouse beneficiary rollover is available for any otherwise-qualifying post-2006 distribution even if the date of death was before 2007. See PLRs 2007-17022 and 2007-17023, permitting beneficiaries to use § 402(c)(11) in 2007 to cause a direct rollover of plan benefits of a participant who had died in 2005. A distribution made *prior to 2007* cannot be rolled over by the nonspouse beneficiary.

G. Cannot use rollover to "fix" the estate plan. The nonspouse beneficiary rollover cannot be used to "create" a Designated Beneficiary when there is no Designated Beneficiary.

For example, suppose widowed Father dies without having named a beneficiary for his 401(k) plan. Under the plan terms, the benefits are payable to Father's estate (see ¶ 1.7.02). Father's three children are the sole beneficiaries of his estate. An estate cannot be a Designated Beneficiary. ¶ 1.7.04. Even if § 402(c)(11) permitted the estate to transfer the inherited 401(k) plan to an "inherited" IRA (which it does not do; see "C" below), that would not permit the family to change the beneficiary from "the estate" to "the children."

Similarly, if the benefits are payable outright to a minor beneficiary, the beneficiary's guardian cannot use § 402(c)(11) to change the beneficiary to a trust for the minor; all the guardian can do is direct the benefits to be sent via direct rollover to an inherited IRA that is payable to the minor. (Once that direct rollover is completed, see ¶ 4.6.03(C) regarding the possibility of transferring the inherited IRA to a trust on the minor's behalf.)

H. If there are multiple Designated Beneficiaries. See ¶ 2.6.01(C) regarding choices the plan must offer to a recipient of retirement benefits regarding where the plan will "send" a

distribution. It is not clear, when there are multiple Designated Beneficiaries, whether the plan must give each beneficiary the full menu of choices or whether the plan can require all beneficiaries to agree on one distribution method. Hopefully plans will be liberal and allow separate distributions and rollovers to each of multiple beneficiaries and allow them to transfer into multiple inherited IRAs.

If the plan is restrictive on this, and there are multiple Designated Beneficiaries who want different outcomes (for example, some want immediate outright distribution of their shares, others want to establish separate inherited IRAs for their shares), the beneficiaries would have to proceed by having the plan transfer the entire benefit to a single inherited IRA payable to all of them collectively, then divide up the inherited IRA using IRA-to-IRA transfers (¶ 4.2.02), thus allowing each beneficiary to preserve or cash out his newly-created separate "inherited IRA."

I. Plan must distribute RMD before the transfer. Since a required minimum distribution (RMD) is not an eligible rollover distribution (¶ 2.6.03), the plan must distribute the RMD for the year in which the rollover occurs *before* the plan transfers the (rest of the) inherited plan account to the "inherited" IRA. Notice 2007-7, A-18.

J. Beneficiary's RMDs after the transfer. In Notice 2007-7, A-19, the IRS decreed that the minimum distribution rules applicable to the "inherited IRA" which received the direct rollover would generally be the same as the rule that applied to the benefit while it was still in the original plan. So if the original plan decreed that the 5-year rule would apply to all death benefits of participants who died before the RBD (see ¶ 1.5.07(A), #2), the same 5-year rule would automatically apply to the inherited IRA into which the benefits were transferred via nonspouse beneficiary rollover!

Since this rule in Notice 2007-7 would defeat the Congressional purpose in allowing nonspouse beneficiary rollovers, the IRS allows an escape hatch: IF the rollover is completed by December 31 of the year after the year in which the participant died, then the benefits can be distributed from the inherited IRA using the life-expectancy-of-the-beneficiary as the Applicable Distribution Period. Notice 2007-7, A-17(c)(2) ("Special Rule").

*4.2.05 **Nonspouse beneficiary Roth conversions***

This ¶ 4.2.05 explains how *certain* beneficiaries can convert *certain* inherited traditional retirement plans to inherited Roth IRAs by means of the "nonspouse beneficiary rollover" described at ¶ 4.2.04. For how to advise a beneficiary who has inherited an IRA that is *already* a Roth at the time of the participant's death, see (instead of this section) ¶ 5.3.03(B), "Computing Five-Year Period for beneficiaries," and ¶ 5.3.04, "Jules and Jim Example."

A. Nonspouse beneficiary cannot convert an inherited IRA. The participant's surviving spouse can convert a traditional IRA she has inherited from the participant to an inherited (or

to her own) Roth IRA; see ¶ 3.2.04. No other beneficiary (regardless of whether such beneficiary is an individual, a trust, or an estate) can convert an *inherited IRA* to a Roth IRA.

§ 408A(c)(6)(A) provides that "No rollover contribution may be made to a Roth IRA unless it is a qualified rollover contribution." "Qualified rollover contribution" is defined in § 408A(e). It includes a rollover from an individual account plan (i.e., an IRA), but *only* if such rollover meets the requirements of § 408(d)(3). One requirement of § 408(d)(3) is that no rollover may be made from an inherited IRA. An "inherited IRA" for this purpose means an IRA acquired by an individual by reason of the death of another individual who was not the acquirer's spouse (see ¶ 4.2.01). § 408(d)(3)(C). Thus, nonspouse beneficiaries have never been, and are not now, allowed to transfer money from an inherited IRA to a Roth IRA. PLR 2000-13041.

IRA-to-IRA transfers can be used to avoid a number of the restrictions that apply to *rollovers*; see ¶ 2.6.07. However, an IRA-to-IRA transfer can not be used to avoid *this* restriction because the IRS's regulation on Roth IRA conversions says that any transfer from a traditional IRA to a Roth IRA will be treated as (and must meet the requirements for) a rollover, even if the "conversion" is accomplished by an IRA-to-IRA transfer or even just by "redesignating" the account as a Roth. Reg. § 1.408A-4, A-1(a), (c).

If the funds are transferred from an inherited *traditional* IRA to an inherited *Roth* IRA, that would be a "failed" Roth conversion (¶ 5.5.05), which should be fixed by recharacterization (¶ 5.6.09). Reg.§ 1.408A-4, A-1(a), A-3, § 1.408A-1(b)(4).

B. **Code allows Roth conversions from other inherited plans.** The definition of qualified rollover contribution (to a Roth IRA) in § 408A(e) includes a rollover from a qualified retirement plan (QRP) if the rollover meets the requirements of § 402(c). *Unlike* the provision defining qualified rollovers from an IRA (see "A" above), § 402(c) does *not* prohibit rollovers of inherited plans. Accordingly, a Designated Beneficiary who is entitled to a direct rollover of inherited QRP benefits (¶ 4.2.04(C)) can require the QRP to transfer the benefits into either an inherited traditional IRA or an inherited Roth IRA. Notice 2008-30, 2008-12 IRB 638, A-7.

Qualified rollover contribution as defined in § 408A(e) includes a rollover from a 403(b) plan if it meets the requirements of § 403(b)(8), or from a governmental 457(b) plan if it meets the requirements of § 457(e)(16). Since § 403(b)(8)(B) and § 457(e)(16)(B) incorporate § 402(c)(9) and (11), nonspouse beneficiary Roth conversions are permitted for inherited 403(b) plans and governmental 457(b) plans in the same manner as for inherited QRPs.

C. **Nonspouse beneficiary Roth conversions: Various matters.** A Designated Beneficiary who (prior to 2018) converted an inherited nonIRA plan to an inherited Roth IRA had the same ability as other Roth converters then did to "recharacterize" (undo; see ¶ 5.6) that conversion. Notice 2008-30, A-7. However, once he recharacterized he could never "reconvert." Roth conversions after 2017 cannot be recharacterized by anyone.

The minimum distribution rules apply to a beneficiary Roth conversion in the same manner as for other nonspouse beneficiary rollovers; see ¶ 4.2.04(I, J)).

Computation of the Five-Year Period (¶ 5.3.03) for a beneficiary Roth conversion is unclear. For a Roth IRA that the beneficiary inherits from the deceased participant, we know the participant's holding period "carries over" to the beneficiary; see ¶ 5.3.03(B). Does this same "carryover" rule also apply to an "inherited" Roth IRA created by the beneficiary in connection with a nonspouse beneficiary Roth conversion, i.e., if the decedent had already completed his Five-Year Period with respect to his own Roth IRAs, do the beneficiaries get the benefit of that for an "inherited" Roth IRA they created? There is no IRS guidance on this.

Even if the beneficiary wants, and can afford, a Roth conversion, he will get more value by converting his own plans or IRAs to a Roth IRA than by converting an inherited plan to an inherited Roth IRA, if the cost is the same. "His own" Roth IRA would have no RMDs during his lifetime (¶ 5.2.01(A)), and could be left to his surviving spouse for a spousal rollover (¶ 3.2), or to another Designated Beneficiary for a stretch payout (¶ 1.5.05), after his death. In contrast, an inherited Roth IRA would have to be distributed, starting the year after the year of the participant's death, over the beneficiary's single life expectancy. ¶ 1.5.03(C), ¶ 1.5.13.

Despite these factors, a beneficiary might want to convert an inherited plan to an inherited Roth IRA if the beneficiary would prefer to own an inherited Roth IRA (perhaps he expects to always be in a high tax bracket); or if the conversion is "cheap": *e.g.*, the beneficiary is in a low tax bracket, or the converted account contains a high proportion of after-tax money (so that not much of the conversion is taxable), or there is a substantial "IRD" deduction that would offset the income generated by the conversion (¶ 4.6.04). As an example of a desirable beneficiary Roth conversion, IRA expert Mike Jones, CPA, of Monterey, CA, points to the example of young grandchildren inheriting a 401(k) that they convert to a Roth IRA at their low income tax rate to create a long-term tax-free life expectancy payout.

4.3 Federal Estate Tax Issues

This ¶ 4.3 discusses how retirement benefits are treated for federal estate tax purposes. With an exemption now (as of 2019) exceeding $11 million, few estates will have to contend with the federal estate tax. This discussion may be relevant for those few estates and for some estates that are still subject to a state estate tax.

4.3.01 ***Retirement benefits on the estate tax return***

All death benefits payable under the tax-favored retirement plans discussed in this book (except for proceeds of life insurance) are includible in the decedent's gross estate under § 2039 of the Code, which (though titled "Annuities") taxes "annuities *or other payments*" receivable by a beneficiary if the decedent had the right to the annuity "or other" payments before his death (for exception see ¶ 4.3.04). § 2039 (emphasis added); Reg. § 20.2039-1. Thus, all such retirement benefits are reported on Schedule I (Annuities). IRS Instructions for Form 706 (Nov. 2018) , p. 30.

To complete the Form 706, it is necessary to determine the value of the decedent's retirement benefits as of the date of death. If the executor is unable to file such a return due to the plan administrator's refusal to supply the necessary information to the executor, the plan administrator itself becomes obligated under federal law to file an estate tax return for the assets it holds. § 6018(b).

When valuing an IRA for estate tax purposes, review the IRS Forms 5498 (¶ 8.4.01) for recent years. The year-end account value shown on Form 5498 is used to compute the decedent's required minimum distributions (RMDs) during life. If the estate tax valuation is substantially different, the IRS may seek an explanation of the discrepancy, or, worse, impose excise taxes for failure to take RMDs (¶ 4.1.05).

4.3.02 ***Problems paying the estate tax***

How to pay the estate tax is always a problem when a major portion of the estate consists of nonprobate assets, because such assets pass directly to the beneficiaries. The executor (who controls only the probate estate) may not have enough assets under his control to enable him to pay the estate taxes, or the assets he controls may not be the assets that are supposed to be burdened with the tax. He is left chasing the recipients of the nonprobate assets to recover their shares of the tax.

Retirement benefits that pass directly to a beneficiary other than the estate are nonprobate assets and thus can put the executor into this difficult position. Compounding the problem, retirement benefits are often nonattachable, making the executor's job of recovering taxes owed to the estate by the beneficiaries of the plans even more difficult or impossible. In the planning stage, consider who will pay the estate taxes on the retirement benefits and with what funds. Make sure the fiduciary responsible for paying the tax will have control of the money.

For examples of how executors have dealt with this problem, see PLRs 2002-09026 and 2004-40031.

4.3.03 ***Alternate valuation method (AVM) for retirement benefits***

Though normally assets are valued for federal estate tax purposes as of the date of death, § 2032(a) provides that, generally, if the estate so elects, "In the case of property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date of distribution, sale, exchange, or other disposition. In the case of property not distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date 6 months after the decedent's death." The executor must elect this "alternate valuation method" (AVM) for all assets of the estate or none, and can elect it only if the effect of the election is to decrease both the gross estate and the estate tax. § 2032(a), (c).

How does the AVM apply to IRAs? What events occurring within six months after the date of death would constitute a "distribution, sale, exchange, or other disposition" with respect to the IRA, that would "freeze" the alternate estate tax valuation as of the date of the event?

Proposed regulations issued in 2011 provide some answers. As of June 2019 these regulations are still "proposed" and thus are not legal authority. However, in the absence of any other

guidance on how IRAs are treated for AVM purposes, these regulations could be considered "persuasive."

(Note that only self-directed individual-account plans (such as the typical custodial IRA) raise the question posed here regarding the application of § 2032. Defined benefit plan death benefits are typically payable in the form of a survivor annuity, which must be valued for estate tax purposes using the IRS's tables for valuing life estates, annuities and terms-for-years (if it is not a commercial annuity) (Reg. § 20.2031-7(a)) or based on the cost of comparable annuity contracts (if it is a commercial annuity contract) (Reg. § 20.2031-7(b), § 20.2031-8(a)(1)). The AVM is generally not allowed for such true annuities because generally any change in value after the date of death is solely attributable to the lapse of time. Reg. § 20.2032-1(f), *Estate of Welliver*, 8 TC 165 (1947). Thus, annuity payouts are *not* impacted by the proposed regulation.)

The primary impetus for the new proposed regulation was the IRS's desire to stop valuation "game-playing" by executors. Some executors had attempted to take advantage of the AVM by manipulating the value of estate-held assets during the six-months period—for example, by contributing estate-owned assets to a family limited partnership or distributing to the estate beneficiary(ies) a partial interest in an asset that had been wholly owned by the estate on the date of death. The executors' goal in taking these actions was to obtain a valuation discount for "lack of marketability" that would apply as of the AVD, even though there was no such discount applicable as of the date of death. The proposed regulation aims at this manipulation by providing greater detail regarding *what events and transactions fall within the definition of "distributed, sold, exchanged, or otherwise disposed of,"* i.e., what transactions trigger closing of the AVM period. Prop. Reg. §20.2032-1(c)(1). If contemplating such "game playing" with IRA assets, the executor should review this proposed regulation.

The Proposed Regulation also contains some very benign enlightenment on some longstanding questions regarding how the AVD/AVM concept applies to IRAs. The questions revolve around one theme: What ordinary and typical IRA events do or do not constitute a sale, distribution, or other disposition that closes the alternate value period for the IRA?

A disposition is an event "by which property ceases to form a part of the gross estate." Reg. § 20.2032-1(c)(1). The phrasing does not convey a clear meaning. We do know that a *mere change in form* is not a disposition. Reg. § 20.2032-1(c)(1), fourth sentence. Here is how some particular post-death IRA "events" fit in to the AVM picture according to the Proposed Regulation:

Retitling the account as an inherited IRA (¶ 4.2.01) merely formalizes the change of ownership of the account that has *already occurred* (at the moment of the participant's death). The sole purpose of this step is for the IRA provider to get the beneficiary's address and Social Security number so it knows who owns the account. This bit of paperwork does not constitute a sale, distribution, or other disposition of the asset for alternate valuation purposes. This "event" does not even rise to the level of a "mere change of form," let alone a "disposition" of the asset. The proposed regulation confirms this conclusion, stating that the transfer of ownership of an asset that occurs upon the death of the decedent, from the decedent to the beneficiary, is not a "distribution" for purposes of the AVM—regardless of whether the property passes by operation of law (for example, through joint ownership) or under a contract (for example, a beneficiary designation under a retirement plan). Prop. Reg. § 20.2032-1(c)(2). Prop. Reg. § 20.2032-1(c)(5), Example 9.

The transfer of an inherited IRA to a new custodian (¶ 4.2.02) should not trigger closing of the AVM period. See ¶ 4.2.02. The proposed regulation indirectly confirms that conclusion by its treatment of dividing the account: The division of an inherited IRA left to multiple beneficiaries into separate inherited IRAs for each beneficiary is not a "distribution" that triggers closing of the AVM period according to Prop. Reg. § 20.2032-1(c)(5), Example 12. Since such a division involves transferring assets from one account (the originally-inherited IRA that belonged to the deceased participant) into new IRA accounts (newly created separate inherited IRAs in the names of the individual beneficiaries), we can conclude that transferring an inherited IRA from one IRA custodian to another is also not an AVD-closing "disposition" so long as both accounts are titled in the name of the same deceased participant and beneficiary.

A distribution from the inherited IRA closes the AVM period with respect to the distributed asset, but not as to the rest of the account—unless the effect of the distribution is to alter the fair market value of the total asset. Prop. Reg. § 20.2032-1(c)(5), Example 11.

Under the proposed regulations, it is clear that a *distribution* to the surviving spouse (from an inherited IRA or other plan) would constitute an AVD-closing disposition, whether or not the distribution was followed by a tax-free "rollover" to the spouse's own plan. It is not clear whether a spouse's *election* to treat the deceased spouse's IRA as the surviving spouse's own IRA would also be treated as an AVD-closing disposition, since there is no "distribution" involved.

The sale of a security inside the IRA within six months after the date of death would cause the AVM period to end for that security (with the results of reinvestment of the proceeds of the sale being irrelevant for estate tax valuation purposes). Prop. Reg. §20.2032-1(c)(5), Example 10.

4.3.04 ***Federal estate tax exclusion for retirement benefits***

At one time, retirement benefits were not subject to the federal estate tax. Though the estate tax exclusion for benefits was diminished and then repealed in the early 1980s, there are some "grandfathered" individuals: If the decedent died holding benefits in a qualified retirement plan and had separated from the service of the employer that sponsored the plan prior to 1985; or at his death held benefits in an IRA as to which he had irrevocably elected a form of benefit prior to 1984; then the estate may be entitled to a partial or full exclusion of the benefits from the federal estate. For details, see Instructions for IRS Form 706 (Estate Tax Return; Nov. 2018), Schedule I, "Annuities under Approved Plans," pp. 31–32, and the *Special Report: Ancient History* (www.ataxplan.com).

4.3.05 ***Valuation discount for unpaid income taxes***

It has been suggested that the value of a retirement benefit should be discounted because the asset is subject to unpaid income taxes. Proponents of this theory assert that a "willing buyer" would pay less for a retirement plan benefit because subsequent distributions from the plan to the buyer would be taxable.

This theory is wrong. If the beneficiary assigns the benefit to a buyer, the seller's recognition of income upon sale is mandated by § 691(a)(2). The "willing buyer" then has a basis equal to what he paid for the benefit, so the willing buyer can liquidate the entire benefit immediately with no income tax whatsoever (except to the extent he receives more from the plan than he paid for it).

Cases recognizing a discount for future income taxes in the *valuation of corporate stock* have no relevance to the *valuation of a retirement plan benefit*, because the buyer of corporate stock does not get a "basis step-up" for appreciated assets held by the corporation (so the company he is buying has an ongoing "built in" liability for income tax on such appreciation). See, *e.g.*, *Est. of Jameson*, 267 F. 3rd 366 (5th Cir. 2001). A valuation discount on retirement benefits for built-in income taxes is not a defensible position. See *Est. of Smith*, 300 F. Supp. 2d 474, 93 AFTR 2d 2004-556; *Est. of Kahn*, 125 T.C. 227 (2005); PLR 2002-47001.

4.3.06 § ***6035, § 1014(f): Rules enforcing "basis consistency"***

§ 6035 requires the executor of a decedent's estate, if a federal estate tax return was required for such estate, to furnish to the IRS and "to each person acquiring any interest in property included in the decedent's gross estate for Federal estate tax purposes a statement identifying the value of each interest in such property as reported on such return and such other information with respect to such interest as the Secretary may prescribe." § 6035(a). The IRS issued proposed regulations on this topic on 3/4/16. See Prop. Reg. § 1.6035-1, and Preamble at Fed. Reg. Vol. 81, No. 43, p. 11486. See IRS Form 8971.

Most estates will have no involvement with the reporting requirement because it applies only to an executor "required to file a return under section 6018" (i.e., a federal estate tax return). An estate that is below the federal exemption amount ($11,400,000 for deaths in 2019) is not required to file an estate tax return, and most estates are under that amount.

For an estate that *is* subject to the furnishing requirement, how does the requirement apply to the decedent's retirement plan benefits?

The apparent purpose of § 6035 is to give beneficiaries the information they need to comply with § 1014(f)'s requirement of consistency between the value of an asset as finally determined for federal estate tax purposes and the basis claimed by the beneficiary when the inherited asset is later sold, depreciated, or otherwise disposed of. The beneficiary is entitled to a "stepped up basis" for the inherited asset but Congress doesn't want the beneficiary to "step up" the basis beyond what was actually reported and taxed on the federal estate tax return. The legislative background shows the only purpose of these 2015 Code amendments was to enforce basis consistency. Nevertheless, Congress did add a clause under § 6035 compelling the executor to also furnish "such other information with respect to such interest as the Secretary may prescribe."

The Preamble to the Proposed Regulation does not mention any purpose or goal other than 1014-basis consistency. The Prop. Reg. exempts from the reporting requirement several classes of assets where basis-consistency would not matter, such as non-estate-taxable marital deduction assets....and income in respect of a decedent (IRD; § 691).

Does § 6035 apply to retirement benefits? § 6035's statement-furnishing requirement does not apply to income in respect of a decedent (IRD; ¶ 4.6). Prop. Reg. § 1.6035-1(b)(1)(ii). Retirement benefits are generally 100% IRD and thus exempt from the § 6035 reporting requirement.

However, two elements of retirement plan death benefits do not constitute IRD, namely, qualified distributions from a Roth IRA (¶ 5.3.01) and the participant's basis (after-tax money) in a traditional retirement plan (¶ 2.2). In the author's opinion, § 6035 still should not apply to such accounts because the income tax treatment of the beneficiary will be based on § 72 and has nothing

to do with the date of death value of assets in the account. Unfortunately, neither the statute nor the Proposed Regulation nor Form 8971 and its Instructions exempts Roth plans or traditional accounts that contain after-tax money. Therefore some practitioners have concluded that executors are required to furnish this statement for such plans.

4.3.07 ***Useful information executor could provide to beneficiary***

Regardless of what reporting duties the executor does or does not have under § 6035, there is information the beneficiary will need for proper income tax reporting of retirement plan distributions, and it is hoped that executors will start to provide this to their decedent's beneficiaries, to the extent the executor has the information. The beneficiary needs to know:

- Whether distributions from any Roth IRA will be "qualified" because the 5-year holding period requirement has been met.

- If the 5-year holding period had not yet been met as of the date of death for any Roth IRA, when it will be met. ¶ 5.2.

- The amount of the decedent's investment in the contract for his IRAs and other traditional retirement plans. For IRAs, see Form 8606 (¶ 2.2.06). For traditional plans, the information should be provided by the plan administrator to the beneficiary.

- Having inherited an IRD asset from an estate that was subject to federal estate tax, the beneficiary is entitled to take an income tax deduction, whenever he takes a distribution from the plan, for the amount of federal estate tax paid on that distribution amount. ¶ 4.6.04. It would be helpful to the beneficiary if the executor could tell him how much estate tax was attributable to the IRD portion of the plan he inherited.

4.4 Qualified Disclaimers of Retirement Benefits

A disclaimer is the refusal to accept a gift or inheritance. Federal tax law recognizes that a person cannot be forced to accept a gift or inheritance. Therefore, a disclaimer (provided it meets the requirements of § 2518; ¶ 4.4.02) is not treated as, itself, a gift. § 2518(a). Since the person making the disclaimer never accepted the property in the first place, the theory goes, he never owned it and therefore he could not have given it away.

Disclaimers of inherited retirement benefits can be useful in *post mortem* planning. However, not every refusal to accept an inheritance is a *qualified* disclaimer, entitled to the blessings of § 2518. If a beneficiary renounces an inheritance in a manner that does not meet the requirements of § 2518, the renunciation would be considered (for purposes of the federal gift tax) as a transfer to the person who received the property as a result of the renunciation, potentially resulting in imposition of gift taxes (and income tax; see ¶ 4.4.03).

4.4.01 ***Post-mortem disclaimer checklist***

Use the checklist at ¶ 4.4.13 for building retirement-benefit disclaimers into the estate plan. After the participant has died, use *this* checklist to prepare for and/or carry out disclaimers of his retirement benefits:

A. **Delay "acceptance" until disclaimer decision is made.** Upon the death of a client, all plan and IRA beneficiary designations should be reviewed as soon as possible. Either (1) no benefits should be distributed to any beneficiary until this review is completed or (2) if a beneficiary wants to take a distribution (other than the RMD for the year of death; see ¶ 4.4.05(A)) the request for the distribution should be accompanied by a statement that the beneficiary is not thereby accepting the entire account (just the amount distributed) (see ¶ 4.4.05(B)). No beneficiary should exercise investment (or other) control over inherited plan benefits until this review is completed; see ¶ 4.4.04. If any beneficiary designation appears undesirable, consider the use of a qualified disclaimer, if that will cause the benefits to pass to the "right" beneficiary (see ¶ 4.4.08).

B. **How to do partial disclaimers.** If making a partial disclaimer, review Reg. § 25.2518-3, which discusses and gives examples of disclaimers of part of an inheritance. Follow the "successful" examples, and the rules stated in Rev. Rul. 2005-36 (¶ 4.4.05(A)) as closely as possible.

C. **Comply with state law requirements.** See ¶ 4.4.03. Should a beneficiary's disclaimer comply with the law of the participant's domicile? The beneficiary's domicile? Or the state where the plan or IRA is administered? If there is any doubt, comply with all of the above!

D. **Comply with requirements of the plan or IRA.** Check whether the plan or IRA has its own requirements for disclaimers and comply with those (see ¶ 4.4.09(B)).

E. **Keep disclaimer short**. It's tempting to recite, in the disclaimer, who will receive the property as a result of the disclaimer, but (unless required by state law) it may not be advisable. If you mention who the property will pass to, it might appear that the disclaimant is trying to direct who will receive the property, or to make the disclaimer conditional on the property's passing to those recipients, either of which actions would make the disclaimer not qualified under § 2518. ¶ 4.4.02(A), ¶ 4.4.08(B).

F. **Know where the property will go before disclaiming it.** Investigate thoroughly who will receive the property as a result of the disclaimer. A child (*e.g.*) may assume that if he disclaims an inheritance from his father this will cause the inheritance to pass to his mother, only to find out later that the disclaimer caused the property to pass to some distant relatives of the father. See ¶ 4.4.08(C).

4.4.02 ***Requirements for qualified disclaimer: § 2518***

Here are the requirements for a qualified disclaimer under § 2518; see ¶ 4.4.03 for the importance of its being "qualified."

A. The disclaimer must be irrevocable, unqualified (unconditional), and in writing. § 2518(b). Yes: In order to be qualified, the disclaimer must be unqualified!

B. The person who is disclaiming (the "disclaimant") must not have "accepted the interest disclaimed or any of its benefits." § 2518(b)(3). See ¶ 4.4.04, ¶ 4.4.05.

C. The disclaimer must be delivered by a certain deadline. For retirement plan death benefits, the deadline is normally nine months after the participant's death. See ¶ 4.4.06.

D. The disclaimer must be delivered to the correct party(ies). See ¶ 4.4.07.

E. The property must pass, as a result of the disclaimer, *to someone other than the disclaimant*. ¶ 4.4.08(A). Exception: Property can pass to the decedent's spouse as a result of the disclaimer, even if she is also the disclaimant. § 2518(b)(4).

F. The property must pass, as a result of the disclaimer, to whomever it passes to *without any direction on the part of the disclaimant*. Disclaimers by the surviving spouse are NOT excepted from this rule. § 2518(b)(4). See ¶ 4.4.08(B).

G. It may be that a beneficiary's renunciation of an inheritance (though meeting all the other requirements of a qualified disclaimer) does not *automatically* cause the property to pass to the next beneficiary. For example, applicable state or foreign law may not recognize the disclaimer for some reason. In that case the disclaimant can execute a deed or other instrument of transfer to give effect to his disclaimer, and the disclaimer will still be "qualified" under § 2518 provided (apparently) that the transferee is the person who would have inherited the property if the disclaimer had been given effect, i.e. (presumably) the person who would have inherited the asset if the disclaimant had predeceased the decedent. See § 2518(c)(3). The income tax effects of a qualified disclaimer that is not valid under state law are uncertain; see ¶ 4.4.03.

4.4.03 ***Income tax treatment of disclaimers***

Disclaimers are primarily a gift tax concept; the point of having a "qualified disclaimer" is to avoid having a gift tax imposed on the disclaimant's act of refusing to accept an inheritance. However, when the inherited property is a *retirement plan*, the income tax consequences may be more important than the gift tax effects.

§ 2518 recognizes qualified disclaimers "for purposes of this subtitle." § 2518 is part of Subtitle B of the Code, "Estate and Gift Taxes." Income taxes are governed by Subtitle A. Except

for a minor provision dealing with disclaimers of powers by a trust beneficiary (§ 678(d)), there is no Code provision dealing with the effect of disclaimers *for purposes of Subtitle A*.

The IRS Chief Counsel's office has filled the statutory gap, at least with respect to certain disclaimers. GCM 39858 ruled that a disclaimer of retirement benefits, if it meets the requirements of § 2518 and applicable state law, shifts the income tax burden of the benefits from the disclaimant to the person who receives the benefits as a result of the disclaimer.

GCM 39858 did not purport to decide the income tax effects of a disclaimer that was either *not qualified* under § 2518 or *not valid under state law*. The IRS has at least once treated a nonqualified disclaimer of QRP benefits as effective to transfer the income tax burden of the benefits to the person who took the benefits as a result of the disclaimer. See PLR 9450041. Nevertheless, a nonqualified disclaimer is clearly outside the safe harbor of GCM 39858.

There are cases in which "you don't care," for *gift tax purposes*, whether a disclaimer is qualified. However, when the disclaimed property is a retirement plan, it is normally vital to have the disclaimer not be treated as an assignment, since assignment of a retirement plan generally results in loss of the income tax-sheltered status of the benefits. ¶ 4.6.03.

*4.4.04 **What constitutes "acceptance" of a retirement benefit***

One requirement of a qualified disclaimer is that the disclaimant must not "have accepted the interest or any of its benefits." § 2518(b)(3). Under Reg. § 25.2518-2(d)(1), acceptance must involve some action on the part of the beneficiary. Mere passive title-holding is not acceptance. Rather, "Acceptance is manifested by an affirmative act which is consistent with ownership...," such as accepting "dividends, interest or rent from the property" (Reg. § 25.2518-2(d)(4), Examples (6), (11)) or "[D]irecting others to act with respect to the property" (Reg. § 25.2518-2(d)(4), Example (4)).

If a beneficiary causes inherited benefits to be transferred to a different account after the participant's death (¶ 4.2.02), that probably constitutes "directing others to act" with respect to the benefits and therefore constitutes acceptance. However, a direction as to only part of the benefits would not necessarily be considered acceptance of the whole; see PLR 2005-03024, in which a surviving spouse exercised control by selling some securities in a joint account that had passed to her by right of survivorship but was not thereby deemed to have accepted the *entire* account (just the securities she had traded), and was accordingly allowed to disclaim the rest of the account.

"[A]cceptance of any consideration in return for making the disclaimer" is treated as acceptance of the property. Reg. § 25.2518-2(d)(1), last sentence; (d)(4), Example (2).

A. Exception for certain fiduciary actions. This ¶ 4.4.04(A) discusses whether a person who is both a beneficiary and a fiduciary of the inherited property can disclaim an interest *as beneficiary* despite having taken actions with respect to the property in his capacity *as fiduciary*. For disclaimers by a fiduciary *in his capacity as fiduciary* see ¶ 4.4.08(B) (last paragraph), ¶ 4.4.11(C), and ¶ 4.4.12(B).

Actions taken by a person who is both a beneficiary and a fiduciary "in the exercise of fiduciary powers to preserve or maintain the disclaimed property" do not constitute acceptance by the beneficiary. Reg. § 25.2518-2(d)(2).

This exception can lead practitioners astray. This is a very limited exception for which the IRS provides no examples. The only fiduciary powers blessed are "to preserve or maintain the disclaimed property." Any exercise of discretionary powers *to direct the enjoyment of the property*, even if exercised in a fiduciary capacity, would preclude a qualified disclaimer of the property by the individual in his personal capacity, unless the exercise of discretion is limited by an ascertainable standard. ¶ 4.4.08(B).

B. Titling of account not determinative. The fact that a retirement plan account is retitled in the name of the beneficiary after the death of the participant does not in and of itself mean the beneficiary has accepted the account. See Reg. § 25.2518-2(d)(4), Example (6); PLR 8817061 (a surviving spouse's filing an election to take a statutory share of the decedent's estate did not constitute acceptance of the statutory share; the spouse could disclaim part of the statutory share); and PLR 9214022.

C. Naming a successor beneficiary. A beneficiary's designating a successor beneficiary for his interest in the account is probably not "acceptance," *unless* the beneficiary dies while that designation is in effect (i.e., before he disclaims), in which case see ¶ 4.4.12(A). This conclusion is reached by analogy from the way the regulations deal with a disclaimer by the holder of a power of appointment: "The exercise of a power of appointment to any extent by the donee of the power is an acceptance of its benefits," says Reg. § 25.2518-2(d)(1); see *Estate of Engelman*, 121 T.C. 54 (2003), in which widow's exercise of power of appointment prior to her death constituted acceptance of the trust property subject to the power, precluding disclaimer of such property by her executor. But this rule apparently does not apply in the case of an *executory* exercise: See Reg. § 25.2518-2(d)(4), Example (7), in which B has a testamentary power of appointment under A's trust, and signs a will which would exercise the power, but then makes a qualified disclaimer of the power *before* he dies (so the "exercise" is never activated).

4.4.05 ***Effect of taking a distribution; partial disclaimers***

Taking a distribution from an inherited retirement plan does not necessarily constitute acceptance of the entire plan.

A. Taking RMD for year of death not acceptance of entire plan. The IRS has issued a safe-harbor ruling that a beneficiary can take the required minimum distribution (RMD) from the decedent's IRA for the year of the participant's death (¶ 1.5.04(A)) and still disclaim all or part of *the rest* of such beneficiary's interest in the decedent's IRA. Rev. Rul. 2005-36, 2005-1 CB 1368. There is one minor limitation: By taking the RMD, the beneficiary is deemed to have accepted not only the RMD itself but also the "income" that the plan earned on that

"pecuniary amount" (as the IRS calls it) between the date of death and the date the RMD is distributed to the beneficiary. See the Ruling for how to compute this income.

B. **Taking other distributions from the plan.** If the beneficiary takes out more than just the year-of-death RMD (and income thereon), such excess distribution is not within the safe harbor of Rev. Rul. 2005-36. However, he has still not necessarily accepted the entire plan; see, *e.g.*, PLR 2012-45004 allowing the surviving spouse to disclaim all of an IRA in excess of certain distributions (more than the RMD) already taken.

The Code permits a beneficiary to disclaim part of an inheritance while accepting other parts of it. A person may disclaim "any interest" in property, he doesn't have to disclaim all or none. § 2518(a). Reg. § 25.2518-3 is entirely devoted to disclaimers of "less than an entire interest." Several types of partial disclaimers are recognized, including a disclaimer relating to "severable property."

Severable property is "property which can be divided into separate parts each of which, after severance, maintains a complete and independent existence. For example, a legatee of shares of corporate stock may accept some shares of the stock and make a qualified disclaimer of the remaining shares." Reg. § 25.2518-3(a)(1)(ii). When a beneficiary inherits an estate, or a joint securities account, the beneficiary has inherited in effect a collection of severable property. The beneficiary can take some assets from the inherited collection and disclaim others. See Reg. § 25.2518-3(d), Example (17). The IRS's proposed alternate valuation date regulations support the concept that the typical IRA is just a collection of separate securities and not a unitary nondivisible entity in itself; see ¶ 4.3.03.

The IRS has in rulings allowed beneficiaries to accept some assets from an estate, trust, or joint investment account and later disclaim other assets. Although they did not involve retirement plan accounts, PLRs 8113061, 8619002, 9036028, 9214022, and 2005-03024 support the conclusion that a beneficiary may take a distribution from a typical IRA (which is, like an estate or a joint investment account, a collection of severable property) without being deemed to have accepted the entire account. (The only exception would be if the distributions taken could somehow be construed as representing the "income" of the entire account; see ¶ 4.4.04.)

If the beneficiary does disclaim part of the account, see Rev. Rul. 2005-36 for elaborate rules regarding how the "income" of the retirement plan must be apportioned between the portions disclaimed and not disclaimed.

Taking a distribution *would* preclude a later disclaimer if the retirement benefit is not a collection of "severable" property. For example, if the plan in question is a defined benefit plan, and the death benefit is a life annuity of $100 per month, as soon as the beneficiary accepts the first $100 check, he has accepted the entire benefit, because there is no way to "sever" the annuity.

C. **Automatic deposit of benefits should not, but may, be "acceptance."** It is common for a participant to arrange his retirement plan so that periodic distributions are automatically deposited in his bank account. If the bank account is a joint account co-owned with the retirement plan beneficiary, the mere continuation of the automatic deposits after the participant's death should not, *in itself*, constitute acceptance of the retirement plan; since

there has been no "affirmative act" by the beneficiary, it should not even (in my opinion) constitute acceptance of the amounts deposited (let alone the entire plan), unless the beneficiary actually withdraws from the automatically-deposited amounts. See, *e.g.*, PLR 2000-03023. However PLRs 2011-25009 and 2012-45004 do not support this conclusion.

4.4.06 ***Deadline for qualified disclaimer***

At first it appears the deadline for disclaimers of retirement benefits is simply stated: nine months after the participant's death. When stated with all its exceptions and wrinkles, however, the deadline is more complicated.

A. Nine months after participant's death (or beneficiary's 21st birthday). § 2518(b)(2) states that a person's qualified disclaimer must be delivered "not later than the date which is 9 months after the later of--(A) the day on which the transfer creating the interest in such person is made, or (B) the day on which such person attains age 21."

Normally, in the case of retirement plan death benefits, the date of transfer is the date of the participant's death, so the deadline for a disclaimer is nine months after that date (or, if later, the beneficiary's 21st birthday). Reg. § 25.2518-2(c)(3)(i). The fact that the deadline for finalizing the identity of the Designated Beneficiary for minimum distribution purposes is September 30 of the year after the participant's death (¶ 1.8.03) does NOT mean that the deadline for making a qualified disclaimer is extended to that date; the RMD rules have *no effect* on the deadline for a qualified disclaimer.

If the deadline for delivering the disclaimer falls on a Saturday, Sunday, or legal holiday (see Reg. § 301.7503-1(b) for definition), the deadline is extended to the next day which is not a Saturday, Sunday, or legal holiday. Reg. § 25.2518-2(c)(2).

In rules borrowed from the deadline for filing tax returns, the IRS provides that "a timely mailing of a disclaimer" to the correct person (¶ 4.4.07) "is treated as a timely delivery." Reg. § 25.2518-2(c)(2). See Reg. § 301.7502-1(c)(1), (2), and (d), for requirements of "timely mailing." Note that applicable state law may or may not follow the IRS's rules on "timely mailing."

B. Is the starting point ever earlier than the date of death? A qualified disclaimer must be made within a certain time period "after the...date of the transfer creating the interest" being disclaimed. If a beneficiary acquires rights in the participant's benefits earlier than the date of death we need to consider whether the time starts earlier. An irrevocable designation of beneficiary prior to the participant's death could raise this problem if the beneficiary later attempted to disclaim the benefits.

Irrevocable beneficiary designations are rare, but see ¶ 3.4.07.

4.4.07 ***To whom is the disclaimer delivered?***

§ 2518(b)(2) requires that the disclaimer be "received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates." Reg. § 25.2518-2(b)(2) adds one more candidate, "the person in possession of such property," but provides no further elucidation and no examples.

In the case of retirement benefits, the disclaimer cannot be delivered to "the transferor" (the participant) because he is dead, so that leaves "his legal representative" (i.e., the executor or administrator of the participant's estate), "the holder of the legal title to the property," and "the person in possession." The legal title to retirement benefits is generally held by the trustee (of a QRP or individual retirement trust) or custodian (of an individual retirement account or 403(b) mutual fund account), who also has "possession" of the retirement plan's assets.

The "or" in the Code and Regulation makes it appear that § 2518(b)(2) would be satisfied if the disclaimer is delivered *either* to the executor of the participant's estate *or* to the trustee or custodian of the retirement plan, i.e., that you have a choice regarding where to send the disclaimer. However, see Reg. § 25.2518-2(a)(3) and § 25.2518-2(c)(2), both of which speak of delivery to "*the person*" described in Reg. § 25.2518-2(b)(2), as though in the case of any particular asset there is only one correct recipient of the disclaimer.

Regardless of which destination would satisfy § 2518(b)(2), it is normally *also* necessary to comply with applicable state law (see ¶ 4.4.03), which may have different requirements about where the disclaimer must be delivered. If in doubt, send to "all of the above."

For what it's worth, in PLR 9016026 a qualified disclaimer of QRP benefits was filed with the employer and the plan trustee; in PLR 9226058, a qualified disclaimer of an IRA was filed with the probate court. Other letter rulings discussing qualified disclaimers of retirement benefits don't say where the disclaimers were filed.

4.4.08 ***Who gets disclaimed benefits and how do they get them?***

When a beneficiary disclaims inherited benefits, the benefits will generally pass to the person or entity who would have been entitled to the benefits if the disclaimant had predeceased the participant. *To whom* those benefits pass as a result of the disclaimer, and *how they pass to such person*, are very important questions. If the benefits do not pass to the right type of person (see "A" below) in the right way (see "B"), the disclaimer is not qualified. Even aside from the tax consequences, the disclaimant also normally cares about who gets the benefits as a result of the disclaimer; see "C."

A. Property must pass to "someone other than" disclaimant. § 2518(b)(4) requires that the property must pass, as a result of the disclaimer, either to the transferor's (i.e., the participant's) *surviving spouse* or to *someone other than the disclaimant*. Passing the benefits by means of a disclaimer from an individual primary beneficiary to a trust named as contingent beneficiary works as a *qualified* disclaimer only if the disclaiming primary beneficiary is (1) the surviving spouse or (2) not a beneficiary of the trust (or a trustee with

discretionary powers). See PLR 2008-46003 for a disclaimer of retirement benefits that (according to the IRS) violated this rule.

B. Property must pass "without direction" by disclaimant. § 2518(b)(4) also requires that the property pass, as a result of the disclaimer, to whomever it passes to *without any direction on the part of the disclaimant*. Disclaimers by the surviving spouse are NOT excepted from this rule.

If a surviving spouse named as outright beneficiary is to disclaim, she cannot thereafter retain any discretionary distribution powers over the disclaimed benefits (unless limited by an ascertainable standard; Reg. § 25.2518-2(e)(1)). For example, if the spouse is disclaiming benefits that will pass, as a result of her disclaimer, to a trust for the benefit of the deceased participant's issue, she cannot be a trustee of that trust if the trustee has, say, discretionary power to "spray" trust income among the issue; nor can she have a power of appointment enabling her to, *e.g.*, decide which issue will receive the trust after her death. See PLRs 9442032, 2001-05058 and 2005-22012, in which surviving spouses (because of this rule) disclaimed their testamentary powers of appointment over trusts to which decedent's retirement benefits would pass as a result of the spouses' disclaimers.

C. How to determine who gets the disclaimed benefits. Generally, unless the plan documents provide otherwise, the disclaimed benefits pass as if the disclaimant had died before the participant. For example, normally a disclaimer by the primary beneficiary will cause the property to pass to the contingent beneficiary, and a disclaimer by all named beneficiaries will cause the benefits to pass to the default beneficiary under the plan document. Sometimes the beneficiary designation form specifies one contingent beneficiary in case of the primary beneficiary's disclaimer, and a different contingent beneficiary if the primary beneficiary actually predeceases the participant. See ¶ 4.4.13(C).

4.4.09 ***Disclaimers, ERISA, and the plan administrator***

One concern is whether the plan administrator of a qualified retirement plan (QRP) might cite ERISA requirements in refusing to recognize a disclaimer. A plan administrator might take the position that the plan requires the benefits to be paid to the beneficiary named by the participant, and the plan has no authority to pay the benefits to someone else if the named beneficiary is in fact living; that ERISA requires the plan to be administered in accordance with its terms; and that ERISA preempts state laws including disclaimer statutes.

"ERISA," which stands for the Employee Retirement Income Security Act of 1974, refers to the constellation of requirements that apply under the United States Code to "employee pension benefit plans" (usually called "retirement plans") as defined in 29 U.S.C. § 1002 (§ 3(2)(A) of ERISA). There are two concerns regarding enforceability of a disclaimer with respect to a qualified retirement plan: Does a disclaimer violate ERISA's "anti-alienation" requirement? See "A." And, does the disclaimer contravene the terms of the plan document? See "B."

These issues are of no concern to administrators of IRAs and other nonqualified plans not subject to ERISA and its preemption rule.

A. Disclaimers and ERISA's anti-alienation rule. One of the requirements a retirement plan must meet in order to be "qualified" under § 401(a) is that the plan document must provide that benefits under the plan "may not be assigned or alienated," except via a "qualified domestic relations order" (QDRO; § 414(p)), which is a court-ordered transfer of benefits between spouses in connection with a divorce. § 401(a)(13). This "anti-alienation rule" is also a requirement applicable to retirement plans under ERISA. 29 U.S.C. § 1056(d)(1).

In GCM 39858 (¶ 4.4.03), the IRS stated that disclaimers do not violate ERISA, and that a disclaimer is not an "assignment or alienation" of plan benefits of the type forbidden by § 401(a)(13). The IRS has blessed disclaimers of QRP benefits in many letter rulings; see PLRs 9016026, 9045050, 9247026, and 2001-05058.

In *Kennedy, Executrix, v. Plan Administrator for DuPont Savings and Investment Plan et al.*, 129 S.Ct. 865 (2009), the Supreme Court (confirming GCM 39858) held that a beneficiary's giving up the right to an inherited benefit under a QRP does not constitute an assignment or alienation, provided the beneficiary does not attempt to direct where the inherited benefit will go. Although *Kennedy* dealt with a divorcing spouse's waiver of her rights to benefits under her ex-husband's plan, the same principle would apply to a disclaimer which, under federal tax law, must not involve any direction by the disclaimant regarding who shall inherit the asset as a result of the disclaimer. ¶ 4.4.08(B). In fact the Court compared the spousal waiver to a disclaimer, pointing out that the law of trusts serves as a backdrop to ERISA, and "*the general principle that a designated spendthrift beneficiary can disclaim his trust interest* magnifies the improbability that a statute written with an eye on the old law would effectively force a beneficiary to take an interest…." Emphasis added. The plan involved in *Kennedy* had a specific provision permitting disclaimer, which the court quoted favorably. *Kennedy* should put an end to any notion that a disclaimer violates ERISA's anti-alienation requirement.

B. Disclaimers and the plan document. Another ERISA requirement applicable to QRPs is that the plan administrator must administer the plan in accordance with "the terms of the plan." 29 U.S.C. § 1132(a)(1)(B). The Supreme Court has held that this ERISA rule preempts any state law that would require the plan administrator to deviate from the terms of the plan document:

1. In *Egelhoff v. Egelhoff*, 532 U.S. 141 (2001), the named beneficiary under the plan was (as in *Kennedy*) the participant's ex-spouse. Under Washington state law, which otherwise applied to these individuals, the designation of the participant's spouse as beneficiary would have been automatically revoked by their divorce. Had Washington state law been applied to the QRP benefits in question, the former spouse would have been treated as having predeceased the participant. The Court ruled that the Washington state law was preempted by ERISA; the ex-wife, as the named beneficiary under the plan, was still entitled to the benefits because *nothing in the plan documents* said that divorce revoked her rights as named beneficiary.

2. In *Boggs vs. Boggs,* 520 U.S. 833 (1997), the Court held that a state's community property law purporting to grant the participant's spouse the right to transfer part of the participant's plan benefits was preempted by ERISA because the right, as in *Egelhoff*, would require the plan administrator to look beyond the plan documents to determine who was entitled to the benefits.

These holdings would appear to "overrule" PLR 8908063, in which the IRS ruled that a plan must conform to a state's "slayer" statute, and not pay benefits to the person who murdered the participant, even if that person is named as beneficiary under the plan.

In *Kennedy* (see "A"), there was a conflict between the participant's divorce agreement (under which the participant's ex-wife Liv had waived her rights to the benefits) and the written beneficiary designation form on file with the plan (under which Liv was the named beneficiary). The Court viewed the divorce agreement as a valid "federal common law waiver" of the benefits by Liv, but held that a federal common law waiver, like a state law revoking a beneficiary designation in case of divorce, would have to give way to the *superior rule* that the plan administrator must comply with the plan document.

The point of this rule, the Court explains in *Kennedy*, is to avoid forcing "plan administrators to examine numerous external documents purporting to be waivers and draw them into litigation like this over those waivers' meaning and enforceability." The *Kennedy* Court reiterates the importance of "holding the line" "in holding that ERISA preempted state laws that could blur the bright-line requirement to follow plan documents in distributing benefits." ERISA and the Court favor "a uniform administrative scheme, [with] a set of standard procedures to guide processing of claims…."

Kennedy suggests that a plan may choose to recognize disclaimers—or not. If the plan document specifies that disclaimers are not recognized, then the plan administrator cannot honor a disclaimer, regardless of state law.

C. Effect of plan's "state law" provision. Some plan documents, as in *Kennedy*, explicitly recognize disclaimers. Such a plan is obviously required to honor a disclaimer that satisfies the plan's requirements regarding disclaimers.

Other plans do not specifically mention disclaimers, but do recite that they are governed by a particular state's laws to the extent not preempted by ERISA. Under *Egelhoff* and *Boggs*, state law is pre-empted only to the extent it would require the plan administrator to do something that is not in accordance with the plan documents. With respect to disclaimers, however, the Supreme Court has stated in *Kennedy* that there is a federal common law right of waiver and/or disclaimer and that these rights do not, per se, violate ERISA. Since ERISA does not outlaw disclaimers, and in fact federal law favors the right of disclaimer, according to *Kennedy*, it would appear that a plan that is to be administered in accordance with the law of a particular state (except to the extent preempted) is required by the terms of the plan to honor a disclaimer that complies with such state's law.

4.4.10 ***Disclaimers and the minimum distribution rules***

Who is liable for the § 4974 excise tax for a missed RMD (¶ 1.9.02) for the year of the participant's death if a qualified disclaimer causes the identity of the beneficiary to change after the end of the year? If you find the answer to this question please let me know.

Howard Example: Howard died in November, Year 1, after his RBD, leaving his IRA to his daughter Stephanie. Howard's RMD for Year 1 was $30,000; he had not yet taken that distribution at the time of his death. In January, Year 2, Stephanie disclaimed the entire IRA by means of a qualified disclaimer. As a result of Stephanie's disclaimer, the contingent beneficiary, Howard's son Milton, became "the" beneficiary. It appears that Milton is liable for the 50 percent excise tax for failure to take the Year 1 RMD—even though at no time in Year 1 could he have legally accessed the account! He can presumably obtain a waiver for the tax based on reasonable cause. ¶ 1.9.03.

4.4.11 ***How a disclaimer can help after the participant's death***

Disclaimers have proven to be of great value in cleaning up beneficiary designations where the deceased participant named the "wrong" beneficiary. See, *e.g.*, PLR 9442032 where a disclaimer was used to allow retirement benefits to flow to the decedent's "credit shelter trust" that otherwise would have been unfunded. Disclaimer can also just help the survivors move the benefits to a preferred choice; see PLR 2008-50004 (disclaimer by named individual beneficiary allowed IRA to pass through decedent's estate to charities), or fix a see-through trust (see, *e.g.*, PLR 2012-03033 in which a beneficiary disclaimed a power of appointment that would otherwise have caused the trust to lose its "see-through" status).

A. **Changing the Designated Beneficiary.** A qualified disclaimer made by September 30 of the year after the year of the participant's death (the "Beneficiary Finalization Date"; see ¶ 1.8.03) is effective to "remove" the disclaimant as a beneficiary of the disclaimed portion for purposes of determining who is the participant's Designated Beneficiary under the minimum distribution rules. Reg. § 1.401(a)(9)-4, A-4(a). The fact that the Beneficiary Finalization Date is not until September 30 of the year after the year of death does *not* extend the deadline for making a qualified disclaimer. ¶ 4.4.06. If somehow a disclaimer occurs after that deadline, the Designated Beneficiary for RMD purposes will be determined as of the Beneficiary Finalization Date. See PLRs 2014-37025 and 2014-37034 (involving the same decedent).

By means of a qualified disclaimer, an older beneficiary (such as a surviving spouse or child) can disclaim the benefits and allow them to pass to a younger contingent beneficiary (such as a child or grandchild) and the younger beneficiary will then be "the Designated Beneficiary" with respect to the disclaimed portion. RMDs with respect to the disclaimed portion will be determined based on the identity of the beneficiary who takes as a result of the disclaimer rather than on the identity of the original beneficiary who disclaimed. See, *e.g.*, PLRs 2004-44033–2004-44034.

Trust beneficiaries can disclaim interests or powers they have under the trust, to help the trust qualify as a "see-through trust" under the IRS's minimum distribution trust rules. See ¶ 6.3.03(B) and, *e.g.*, PLR 2002-34074.

B. Salvaging spousal rollover. If the participant dies having named the "wrong" beneficiary, it may be possible to get the benefits to the spouse (so she can roll them over; ¶ 3.2) by having the named beneficiary disclaim the benefits. This strategy works if, as a result of the disclaimer, the benefits pass outright to the spouse either as contingent beneficiary, or as the default beneficiary under the plan (¶ 1.7.02). See PLRs 9045050, 1999-13048. If the default beneficiary under the plan is the participant's estate, this strategy still works *if* (as a result of the disclaimer) the benefits will pass (through the estate) outright to the spouse as residuary beneficiary under the participant's will or by intestacy. See ¶ 3.2.09 and PLRs 9609052, 9615043, 2005-32060, 2009-34046, 2009-38042.

In PLR 9450041, benefits were redirected from a marital trust to the spouse via a chain of qualified and nonqualified disclaimers; the rollover was allowed.

In PLR 2005-05030, a participant died without having named a beneficiary for his retirement plans. The benefits therefore became payable to his estate, which in turn was left to "Trust #2." The beneficiaries of Trust #2 were the participant's spouse, issue, sister, sister's issue, sister-in-law, and sister-in-law's issue. Qualified disclaimers were filed by the spouse, and all the then-living issue (two daughters and two grandchildren), and by the sister and sister-in-law and *their* then-living issue (seven nieces and nephews). As a result of these disclaimers, the trust passed to the surviving spouse under applicable state law, and the IRS approved the spousal rollover.

C. Disclaimer by participant's estate. When retirement benefits are payable to the *participant's own estate*, can the estate disclaim the benefits? The only IRS pronouncement is PLR 9437042 in which the IRS stated that the participant's executor could not disclaim the benefits because the participant had "accepted" his own retirement benefits (¶ 4.4.04). However, since the disclaimers involved in this ruling were filed more than nine months after the participant's death, they weren't qualified disclaimers anyway, so this one "dictum" statement in a single decades-old PLR is not worth much as "authority."

4.4.12 ***Double deaths: Disclaimer by beneficiary's estate***

If the beneficiary of a retirement plan dies after becoming entitled to the benefits, the beneficiary's executor generally can disclaim the benefits on the beneficiary's behalf if permitted by state law. This approach is often useful when a husband and wife die within a short time of each other, and the first spouse to die named the surviving spouse as primary beneficiary and their children (or a see-through trust for their children) as contingent beneficiary. The executor of the now-deceased surviving spouse disclaims the benefits (and any interests granted to the now-deceased surviving spouse under any trust named as contingent beneficiary) on behalf of the now-deceased surviving spouse, allowing the benefits to flow directly to the next generation (or to a trust for the next generation) as contingent beneficiary. As a result of the disclaimer, the participant's "contingent

beneficiary" becomes the "primary beneficiary," which often produces better results under the minimum distribution rules.

For example, in PLR 2012-02042 the participant ("P") died, leaving his IRA to a trust under which his surviving wife "S" was the oldest beneficiary. S died 11 days later. The executor of S's estate, on S's behalf, disclaimed S's interest in the IRA and the trust, which made their daughter the oldest trust beneficiary, substantially lengthening the Applicable Distribution Period (ADP; ¶ 1.2.03) for the IRA. Had S's executor not disclaimed her interest, S would have been the oldest trust beneficiary as of P's death and S's (shorter) life expectancy would have governed the distributions to daughter and grandson even after S's death. PLR 2000-13041 is similar. See "B" for additional examples.

The deadline for this type of disclaimer is nine months after the death of the *participant* (not nine months after the subsequent death of the primary beneficiary). This is a very short deadline, especially if any fiduciary disclaimer is involved for which applicable state law requires court permission.

Here are issues to consider with respect to such disclaimers:

A. Who is the successor beneficiary? When a beneficiary dies after becoming entitled to the benefits, the person who succeeds to the deceased beneficiary's interest is called the successor beneficiary. ¶ 1.5.12. If the successor beneficiary is not the deceased beneficiary's own estate there are two potential obstacles to a disclaimer by the beneficiary's executor:

First, if the beneficiary himself had designated a successor beneficiary (¶ 1.5.12(A)), then a qualified disclaimer by the beneficiary's executor is probably not possible. The beneficiary's death would cause his "executory" designation of a successor beneficiary to be considered "executed," and this could be deemed acceptance by the beneficiary, precluding disclaimer. See ¶ 4.4.04(C).

Second, if there is a successor beneficiary (other than the participant's own estate) who has been designated by the participant or by the plan (¶ 1.5.12(C), (E)), one case held that the successor beneficiary is automatically entitled to ownership of the benefits upon the death of the original beneficiary, so the estate of the original beneficiary had no standing to disclaim—the first beneficiary's rights were extinguished upon his/her death. *Nickel v. Estate of Estes*, 122 F. 3d 294 (5th Cir. 1997). Under the *Estes* case, if there is a successor beneficiary named by participant or plan, the estate of the primary beneficiary cannot disclaim—unless the said successor beneficiary *also* disclaims, as was done in PLR 2009-34046 (deceased participant had named his children as primary beneficiaries and the children's estates as contingent beneficiaries; the children *and their estates* executed qualified disclaimers, allowing the benefits to flow to the participant's estate as default beneficiary of the IRA). How there can be an "estate" of a living person is not explained.

B. If the fiduciary is also a beneficiary. When the beneficiary's executor disclaims benefits that are payable (as a result of the beneficiary's death) to the now-deceased beneficiary's estate, the interest he is disclaiming is the *deceased beneficiary's* interest in those benefits. Thus, the executor of the now-deceased original beneficiary can make such a disclaimer on behalf of the deceased beneficiary even if the executor in his *individual* capacity (1) is a

beneficiary of the original beneficiary's estate and (2) will receive the benefits personally as a result of the estate's disclaimer.

Such a disclaimer *appears* to violate the rule that the disclaimed assets must pass to someone other than the disclaimant (¶ 4.4.08(A)), since the asset is beneficially owned by the same individual both before and as a result of the disclaimer. However, it does not violate that rule, because when he disclaims in his capacity as *executor of someone's estate* he is not deemed to be disclaiming on behalf of *himself individually as beneficiary* of that estate.

See *Dancy*, 872 F. 2d 84 (4th Cir. 1989), in which a nephew, as executor of his aunt's estate (of which he was also the sole beneficiary), was allowed, on her behalf, to make a qualified disclaimer of her interest as surviving joint owner of certain property she held with her husband. This disclaimer was allowed even though the disclaiming-nephew-executor was also the sole beneficiary of the husband's estate which would receive the property as a result of the disclaimer. PLR 8749041 is similar (niece instead of nephew).

4.4.13 ***Building disclaimers into the estate plan: Checklist***

It is wise, at the planning stage, to anticipate the possibility of disclaimers. For example, the participant may be trying to choose between naming his spouse as beneficiary, to achieve deferral of income taxes via a spousal rollover, on the one hand, and naming a trust as beneficiary, on the other hand, to keep assets out of his spouse's estate. Each choice has its merits and a clear "winner" may not be apparent during the planning phase.

The participant may decide to make the benefits payable to the spouse as primary beneficiary, because his main goal is to provide for the spouse's financial security, but provide that, if the spouse disclaims the benefits, the benefits will pass to a family trust. If funding the family trust appears to be the more attractive alternative at the time of the participant's death, the spouse can disclaim the benefits, which will then pass to the trust as contingent beneficiary. PLR 9320015 illustrates this type of planning. See also PLR 2005-22012 (benefits payable to spouse as primary beneficiary, with marital trust as contingent beneficiary if spouse disclaimed, and family trust as second contingent beneficiary if spouse also disclaimed all her interests in the marital trust, and participant's children as third contingent beneficiaries if spouse also disclaimed all her interests in the family trust); PLR 2005-21033 is identical.

While it is wise to consider the possibility of disclaimers, the apparent flexibility of disclaimers can tempt planners to rely excessively on future disclaimers as a way of carrying out the estate plan. One justification offered for this approach is that it avoids the need to spend time analyzing the choices at the planning stage. Thus, professional fees are lower—at the planning stage. The estate plan relies on the fiduciaries and beneficiaries to make the decisions later, after the participant's death, when a more informed choice can be made. Before making important estate planning goals dependent on prospective disclaimers by beneficiaries or fiduciaries, or whenever considering the impact of disclaimers on an estate plan being drafted, use this checklist for issues to be reviewed.

A. Consider risks and drawbacks of disclaimers. Disclaimers are not a simple solution:

1. One requirement of a qualified disclaimer is that the disclaimant must not have "accepted" the disclaimed property. ¶ 4.4.04. If the surviving spouse is the sole beneficiary, and is considering a disclaimer, no one can exercise investment authority over the account pending her decision, unless the benefits are in a trusteed plan under which the trustee can exercise such authority. Assets in a custodial or self-directed plan would essentially be frozen, since the participant's powers of attorney or grants of investment authority would expire at his death and the spouse could not grant new authority without accepting the account.

2. Disclaimers generally have an inexorable deadline of nine months after the date of death. ¶ 4.4.06. Thus, an estate plan that depends on disclaimers requires rapid action *post mortem*.

3. No matter how apparently cooperative and disclaimer-friendly the proposed disclaimant may have been in the planning stage, he could have a change of heart and not sign a disclaimer when the time comes.

4. Make sure the tax payment clause in the decedent's Will will operate correctly if there is a disclaimer.

B. Consider having disclaimer occur at trust level. If it is anticipated that a beneficiary might want to make a "formula" disclaimer (*e.g.*, a surviving spouse as primary beneficiary disclaiming an amount sufficient to fully fund the participant's "credit shelter" trust), consider the practicalities of drafting such a formula, getting the plan administrator to accept it, and carrying out its terms all within a brief nine-month window after the participant's death.

If that looks like it might be difficult to accomplish, or if there is any other reason to anticipate that the plan administrator may pose obstacles to the disclaimer (see ¶ 4.4.09), consider naming, as primary beneficiary, a trust which gives the surviving spouse the right to (1) all income for life, plus (2) principal if needed for health or support, plus (3) an unrestricted power to withdraw all principal during her life, plus (4) a general power of appointment at death. If she wants to keep the retirement benefits, she can withdraw them from this trust and roll them over; see ¶ 3.2.09. If she wants to convert the trust to a "credit shelter trust" for her life benefit, she can disclaim rights (3) and (4). If she wants to disclaim all interests, she can do that. She can disclaim any of these rights as to all or a fractional portion of the trust, if the trust contains the proper language. In doing all this, she will need to deal only (or primarily) with the (friendly, expert, understanding) trustee. This sidesteps the problems of dealing with the (cold, bureaucratic, nonexpert) plan administrator.

C. Consider naming different contingent beneficiaries for death vs. disclaimer. The most common use of this dual designation of contingent beneficiary is where: (1) the primary

beneficiary is the spouse and (2) the contingent beneficiary in case of the spouse's disclaimer is a trust of which the spouse is a life beneficiary, and (3) the contingent beneficiary in case of the spouse's death is the same person (or group of people) who is the remainder beneficiary of the trust at the spouse's death.

D. **Facilitate disclaimers.** When a disclaimer is anticipated at the estate planning stage, take steps beforehand to facilitate that process, including: spousal waiver of REA rights (¶ 3.4), if needed; instructions to the beneficiaries regarding the choices that will be available to them and what considerations should be applied in making the choices; granting disclaimer authority to fiduciaries, or in a power of attorney (see PLR 9015017 for example) along with guidelines for exercise of the power to disclaim; and review the plan documents, § 2518 requirements, and state law to make sure these pose no obstacles to the proposed disclaimers.

4.5 Other Cleanup Strategies

When a retirement plan participant dies leaving benefits to a beneficiary who is not the ideal choice, there are other "cleanup strategies" besides disclaimers. See the rest of this ¶ 4.5; also see cleanup strategies described in other parts of this book:

- See ¶ 1.8.03 and ¶ 7.2.02(C) for how a post-death distribution can eliminate an "undesirable" beneficiary for minimum distribution purposes. See ¶ 6.3.03 for the same strategy with respect to a trust.

- See ¶ 1.8.01(A) for how dividing an inherited plan into separate accounts can improve minimum distribution results.

- See ¶ 3.2.09 for achieving a spousal rollover of benefits that are payable to a trust or estate.

So what's the best cleanup strategy? In general: If the decedent *tried* to do something, or *thought he had done* something, or *had agreed to do* something, but that "something" did not end up getting done in the actual documents in effect on his death, the correct strategy is to reform the documents so they reflect what the decedent tried to do, thought he had done, or was supposed to do. Disclaimer is typically not the right remedy for this problem; see, *e.g.*, PLR 2008-46003.

In contrast, if there is no evidence that the decedent had tried or agreed to do something that did not in fact get done, but the beneficiaries just don't like whatever it is the decedent did, then reformation is usually not the right remedy. Disclaimer *may* help the beneficiaries get things the way they want them to be (see ¶ 4.4.11) or try one of the following.

4.5.01 ***Check the plan's default beneficiary***

If the participant failed to name a beneficiary (or no named beneficiary survived the participant), the plan document or IRA agreement will indicate who is the **default beneficiary**. See ¶ 1.7.02. Don't assume the estate is the default beneficiary. In the case of a qualified retirement plan

(QRP), the Retirement Equity Act of 1984 (REA) requires that all or part of the death benefits pass to the surviving spouse if the participant was married for more than a year at the time of his death. See ¶ 3.4. Whether or not REA requires the benefits to be paid to the surviving spouse, the QRP or IRA may provide for a human default beneficiary such as surviving spouse, children, issue, or next of kin.

4.5.02 ***Invalidate the beneficiary designation***

Investigate whether an undesirable beneficiary designation could be invalidated. Perhaps the participant was incompetent, or did not comply with the formalities required by the plan to have a valid designation. This approach could be fruitful *if* invalidating the designation would reinstate a more favorable prior beneficiary designation or default beneficiary.

In *Liberty Life Assurance Co. of Boston v. Kennedy*, 358 F.3rd 1295 (11th Cir. 2004), the court ruled that the deceased employee's will (filed with the plan administrator after the employee's death) was effective as a beneficiary designation *under the terms of the plan* (an employee life insurance plan subject to ERISA), where (1) the will specifically disposed of the insurance proceeds, (2) the plan permitted any writing to constitute a beneficiary designation (i.e., the employer's forms did not have to be used), and (3) the plan permitted posthumously-delivered beneficiary designations to be effective. The will terms superseded the beneficiary designation form that was on file with the employer (which named a former spouse as beneficiary).

In PLR 2003-17033, the deceased husband's IRA beneficiary designation was complex, possibly unclear, and evidently considered to produce an undesirable result. Three years before his death, the spouses had signed an agreement providing that, on the death of either spouse "title to all property" would immediately vest outright in the survivor. "It has been represented that this agreement applies to…[the IRA]. It has been further represented that this agreement is being treated as the beneficiary designation with respect to" the IRA. The IRS allowed the spouse to roll over the IRA.

4.5.03 ***Spousal election to take share of estate***

Most practitioners concur that spousal rights in IRAs and other "nonERISA" plans are governed by state rather than federal law. Perhaps applicable state law gives the spouse the right to claim a share of all marital assets (including IRAs) *and* the right to choose which assets will be used to fulfill her statutory share. A surviving spouse could exercise these rights by taking the IRA in fulfilment of her share and rolling it over to her own retirement plan. This strategy may not be helpful if the spouse is required to waive other benefits, or otherwise give up too much to exercise the right, or for a QRP (spousal rights under which cannot be governed by state law due to REA's preemption; see ¶ 3.4.01). See PLR 2001-50036, permitting rollover of the portions of decedent's IRAs payable to the surviving spouse as part of her statutory share of the estate.

4.5.04 ***Legal challenge to the estate plan ("will contest")***

If there is a bona fide dispute regarding who is entitled to the retirement benefits, and the question is decided by litigation or via a reasonable settlement of the bona fide claims, the IRS will generally recognize the resulting new beneficiary designation. This is in contrast to uncontested "reformation" court proceedings; see ¶ 4.5.05–¶ 4.5.06.

For post-death IRA modifications arising out of settlement of a dispute, that won IRS approval, see PLR 2001-27027 (compromise settlement "after strenuous negotiations"; the IRS permitted spousal rollover of the portion of the IRAs payable to the spouse under the settlement agreement); 2007-07158 (undue influence suit); 2014-32029 (the litigation was a "bona fide controversy regarding enforceable claims of the parties," the settlement was "based on arm's length negotiations among the parties after years of litigation," and the approved settlement was "within the range of reasonable outcomes under the governing instruments and applicable state law)"; and PLRs 2014-37025 and 2014-37034. There was no whiff of possible "collusion" in these, nor was there any particular tax advantage to the settlement in most cases.

4.5.05 ***Reformation of beneficiary designation form***

Consider state court proceedings to reform a defective beneficiary designation. See ¶ 4.5.06 regarding which state court actions are binding on the IRS.

This ¶ 4.5.05 deals with post-death reformations and other post-death state court actions that are carried out on an *uncontested basis* by the decedent's fiduciaries and/or beneficiaries. For post-death changes in the estate plan resulting from a *contested* matter, see ¶ 4.5.04.

The usual way this comes up is, the decedent or someone made or is alleged to have made some kind of mistake in filling out the beneficiary designation form. The survivors go to court to change the form so it says what it was supposed to say or what the decedent thought it said or what the decedent meant to say.

Prior to 2007, the IRS ruled favorably on a few such post-death modifications of the beneficiary designation. Since 2007, however, the IRS has turned hostile to these changes.

A. **Pre-2007 PLRs: All favorable.** In PLRs 2006-16039 and 2006-16040, the participant had an IRA that named his wife as primary beneficiary and his two daughters as contingent beneficiaries. He moved the IRA to a different firm and instructed the new firm to prepare a beneficiary designation form identical to that of the old IRA. The new firm admitted (in an affidavit submitted with the ruling request) that it mistakenly did not insert the name of any contingent beneficiary. Apparently the participant didn't notice this mistake when he signed the form, with the result that his estate was the default contingent beneficiary of the account at the time he died. His wife survived him for only a short time, and her executor disclaimed the benefits on her behalf (see ¶ 4.4.12).

A court reformed the beneficiary designation form to name the daughters as contingent beneficiaries, so that the disclaimed benefits would pass to them rather than to the decedent's estate, and the IRS ruled that the daughters would be treated as the decedent's "Designated Beneficiaries"

for minimum distribution purposes. This is a classic case of reformation to correct a "scrivener's error."

In PLR 2006-52028, decedent "mistakenly" designated his estate as beneficiary; the state court allowed the beneficiary designation to be changed to his trust as he had intended. The IRS ruled the trustee could transfer the decedent's IRAs to fulfill residuary gifts to charities under the trust.

B. Post-2006 PLRs: All unfavorable. In PLR 2007-42026, the IRS refused to honor a post-death reformation for RMD purposes. The participant had named his spouse as primary beneficiary. Though he had named his daughter as contingent beneficiary on a prior beneficiary designation form, there was no contingent beneficiary named on the form that was in effect at the participant's death.

Unlike in PLRs 2006-16039 and -16040, where the financial institution admitted that its error had caused the contingent beneficiary line to be left blank, in PLR 2007-42026 the IRA provider had actually mailed the participant a new form, after his wife died, to name his daughter as beneficiary of the IRA, but the participant never signed it. Because there was no named beneficiary, the IRA would pass to the participant's estate as beneficiary. Two years after the participant's death a court order was obtained reforming the beneficiary designation to name the daughter as beneficiary. The IRS refused to grant a ruling that the daughter should be treated as the participant's "Designated Beneficiary" for minimum distribution purposes.

One could say that this negative ruling simply reflects the factual differences between the 2006 and 2007 PLRs, but that's not what the ruling says. The language of this 2007 ruling suggests rather that the IRS is closing the door on post-death reformations as a way to improve RMD results, reversing the prior longstanding trend of the IRS's apparent strong approval of post-death "cleanup" actions.

Subsequent rulings bore out this prediction. See PLRs 2008-46028 and 2008-49020 (IRA beneficiary designation form said only "as stated in wills"; state court "interpreted" this—without "reforming" the document—as a direct designation of the individual beneficiaries of the decedent's pourover trust as "Designated Beneficiaries" and that the "separate accounts" rule (¶ 1.8.01) was applicable in determining the ADP for each beneficiary's share of the benefits; the IRS rejected this attempt to bypass; IRS refused to accept this overreaching state court order in any respect, ruling that the beneficiary designation form failed to indicate ANY beneficiary, therefore the benefits were payable by default to the participant's estate. One can only speculate whether, if the court order had been limiting to just interpreting the beneficiary designation form as naming the trust as beneficiary, the IRS might have accepted it.

Later rulings confirm IRS hostility to post-death reformations. In PLRs 2016-28004, -28005, and -28006, the participant moved his IRAs to a new firm. "The financial advisor" presented the participant with a beneficiary designation form naming the participant's estate as sole beneficiary of the new IRA (his old IRAs had designated his trust). The participant signed the form and died while that form was still in effect. It was represented that the participant did not intend to change the beneficiary of his IRA, just to move the account to a different company. The trustees of the trusts obtained a court order retroactively changing the beneficiary designation form so that the see-through

trusts, as named on the original account, were also named directly as beneficiaries on the new account. Citing many cases as precedents (unusual in a letter ruling) the IRS ruled that it was not bound by a state court reformation, and that a post-death reformation of the beneficiary designation by the state court was not effective to change the tax results. Offering policy reasons why it should not be bound by a reformation in a case such as this, the IRS mentioned the possibility of collusive state court actions and the need for finality (noting how "unsettled" decedents' affairs would be if they were subject to endless changes *post mortem*).

In PLR 2016-23001 decedent named his son as IRA beneficiary. His wife (W) and son, via a state court proceeding, got the IRA awarded to W to fulfill her community property (CP) rights. The IRS refused to allow a spousal rollover of the IRA based on this state court reformation, stating that § 408 must be "applied without regard to any community property laws." § 408(g). The IRS may have believed the court proceeding was collusive and the real purpose of the reformation was tax saving. One cannot be certain that a published PLR presents all relevant facts correctly or at all, so the following comment is speculative, but: It appears that the parties wanted to satisfy *all* of W's CP interest in the decedent's estate with the IRA money, not just her interest in the IRA itself. Such "overreaching" may have triggered IRS hostility. Also, the parties had the state court rule, not just on the value of W's CP interest (a state law question), but also that the transfer to W should be in the form of a spousal rollover IRA. By ruling on such federal issues that are outside its jurisdiction, the state court signals it will sign whatever the parties put in front of it.

4.5.06 ***Reformation or interpretation of trust or will***

"[A]bsent specific authority in the Code or Regulations, the [post-death] modification of…[a trust] will not be recognized for federal tax purposes."—Frances V. Sloan, IRS, in PLR 2010-21038.

The post-death "reformation" of the decedent's trust or will should be granted by a court and recognized by the IRS if it appears that (for example) the attorney who drafted the document made a mistake and did not write what the now-deceased client told him to write. But many PLR requests involving post-death reformations do not involve such "scrivener's errors." Rather, it often appears that the income tax effects of the estate plan were not considered until after the client's death, at which point "reformation" was used to redraft the documents in a way that (it was hoped) would produce better income tax results. The IRS will likely not accept this type of "reformation."

The IRS will not accept such a reformation even if it is embodied in a state probate court order. How can the IRS ignore a state court order interpreting or modifying a trust? It's easy. With regard to questions of state law, state probate court judgments and rulings are NOT binding on the IRS. The only state court whose judgment the IRS must defer to on such questions is the highest court in the state. *Estate of Bosch*, 387 U.S. 456 (1967). Thus, generally, the IRS is not impressed with lower state court orders, and will make its own independent judgment regarding state law matters, even if you have a court order supporting your position.

A. **Modification to achieve see-through status.** When retirement benefits are left to a trust as beneficiary, the trust must comply with the IRS's "RMD trust rules" (¶ 6.2.01) to be considered a "see-through trust" and allow benefits to be paid to the trust over the life expectancy of the oldest trust beneficiary rather than under the "no designated beneficiary"

(no-DB) rules (¶ 1.5.06, ¶ 1.5.08). If the parties discover, after the client has already died, that the trust to which the client left his retirement benefits does not qualify as a see-through trust they may seek a court order or take other steps to amend the trust so it does qualify. Will the IRS accept such a modification?

Prior to its mid-2007 about-face (see ¶ 4.5.05), the IRS had in many cases "blessed" post-mortem court actions that caused noncomplying trusts to be reformed, settled, divided into separate trusts, or otherwise re-engineered to comply with the IRS's minimum distribution trust rules. See, *e.g.*, PLRs 2002-18039 (court divided trust into separate trusts for charitable, individual, beneficiaries, so the individuals' separate trust would qualify as a see-through). In each of PLRs 2006-08032 and 2006-20026 the trust named as beneficiary of the decedent's retirement plans was modified by a court order after participant's death and the IRS ruled the trusts qualified as see-through trusts; although the PLRs do not specify what the modifications were, it appears the purpose of the modifications was to achieve see-through trust status.

The above rulings probably would not be repeated today. PLR 2010-21038 (see quote at the beginning of this section) states the new IRS position on trust reformations loud and clear. In this PLR, "B" died leaving his IRA to a trust for "C" and "D." C and D had both lifetime and testamentary powers of appointment over the trusts, including the power to appoint to charity (i.e., a nonindividual beneficiary). After B's death, the trustee obtained a court order reforming the trust—eliminating the charitable beneficiaries, prohibiting use of retirement benefits to pay taxes, requiring pass-through of IRA distributions to the individual beneficiaries, etc.—then sought an IRS ruling that the trust qualified as a see-through. The IRS refused to grant the ruling, citing, in support of its position, numerous cases as well as the possibility of collusive reformations solely for the purpose of reducing federal tax. The IRS ruled that "B" had "no DB."

B. **Modification to achieve spousal rollover.** The pattern is similar in cases where retirement benefits are payable to a trust of which the surviving spouse is a life beneficiary, and it is believed a payment of the entire IRA outright to the spouse would be more favorable tax-wise because it would allow a spousal rollover (¶ 3.2.01). So the parties modify the trust to allow the IRA to be paid to the spouse "through" the trust to enable the rollover (see ¶ 3.2.09). At one time the IRS was amenable to these post-mortem modifications (see PLRs 2006-15032, 2007-03047, 2007-04033).

But more recently: In PLR 2009-44059 the IRS refused to bless a spousal rollover based on a state court's modification of trust made for the purpose of allowing the spousal rollover.

C. **Court modification for other reasons.** There are reasons other than attempting to achieve see-through status or a spousal rollover why a post-death reformation or modification of the trust in some way could improve tax results with respect to retirement benefits. For example, if retirement benefits are payable to a trust or estate that has charitable beneficiaries, it can be tax-favorable to use the benefits for those bequests, provided the governing instrument permits or requires such use. As with the other issues, the IRS has hardened its heart against post-death modifications to achieve that result. Compare the earlier PLR 2008-50004 (IRS

allowed transfers of IRAs from estate directly to charities [¶ 6.1.05, ¶ 7.4.05] where the Will was reformed to specify that the IRAs would be the source of funding for these bequests), with the later PLR 2014-38014, in which the IRS refused to recognized a trust reformation to specify that IRAs would be used to fund the charitable bequests because the state court order "did not resolve a conflict" under the trust, rather "the purpose of the court order was to obtain...tax benefits..."

D. Amendment pursuant to specific authorization in the trust. If the trust instrument states the donor's intent to qualify for designated beneficiary status with respect to retirement benefits payable to the trust, and specifically authorizes or directs the trustee to amend the trust if and as needed in order to achieve that goal, a post-death amendment for that purpose should be seen as carrying out the participant's stated intent in the trust instrument rather than as post-death modification.

The IRS confirmed this conclusion in PLR 2005-37044, where the IRS approved the post-death amendment, noting that the amendment power granted to a trust protector to change the trust from a "conduit trust" (¶ 6.3.05) to an "accumulation trust" (¶ 6.3.07) was granted by the trust instrument itself (i.e., "by decedent"), not just pursuant to a state court proceeding, and was (pursuant to the trust instrument) retroactive to the date of death, and in PLR 2006-07031. This principle should survive the 2007 about-face, but we await confirmation of that conclusion.

4.6 Income in Respect of a Decedent (IRD)

When the participant dies the plan benefits become payable to his beneficiaries. They must pay income tax on distributions they receive from the inherited pan because such distributions are "income in respect of a decedent" (IRD) under § 691. § 61(a)(14). This ¶ 4.6 provides the basics of the IRD rules, with emphasis on how the rules apply to retirement benefits.

Generally, the same income tax rules apply to beneficiaries as applied during the participant's life: Benefits are taxable only when they are actually distributed (¶ 2.1.01), distributions are taxable as ordinary income unless one of the exceptions listed at ¶ 2.1.06 applies, etc. However, additional considerations arise:

- **Rollovers:** The ability to use a rollover (¶ 2.6) to avoid income tax on a distribution is curtailed or eliminated, unless the beneficiary is the participant's surviving spouse; see ¶ 4.2 and ¶ 3.2 regarding beneficiary rollovers.

- **IRD deduction:** The beneficiary is entitled to an income tax deduction for federal estate taxes paid on the inherited benefits. See ¶ 4.6.04–¶ 4.6.08.

- **"Kiddie tax":** Under § 1(g) and (j)(4), a child who is under age 24 may be taxable on his "unearned income" at special higher income tax rate. Income resulting from a distribution from an inherited retirement plan is considered "unearned income" for this purpose. Reg. § 1.1(i)-1T, A-9.

*4.6.01 **Definition of IRD; why it is taxable***

Income in respect of a decedent (IRD) is not defined in the Code. The IRS defines it as "amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year…." Reg. § 1.691(a)-1(b).

The date of death balance of a decedent's IRA will be IRD when paid to the beneficiary; however, the decedent's after-tax contributions, and post-death income or appreciation in the account, are not IRD. See Rev. Rul. 92-47, 1992-1 CB 198; Reg. § 1.663(c)-5, Example 9; PLR 9341008. IRD does not qualify for any "basis step-up" at the decedent's death; see ¶ 4.3.06(A). Although "qualified" distributions from Roth plans and Roth IRAs are nontaxable, nonqualified distributions from such accounts may taxable and to that extent would constitute IRD. See ¶ 5.3.01.

*4.6.02 **When IRD is taxed (normally when received)***

Normally, IRD is includible (when received) in the gross income of the person or entity who acquired, from the decedent, the right to receive such income. § 691(a)(1).

Barbara Example: The beneficiary designation for Barbara's 403(b) account (which is entirely pretax money) provides that the first $20,000 of the account shall be distributed to Lucy, and the balance shall be paid to Tom. Upon Barbara's demise, Lucy withdraws her $20,000; that distribution is includible in her gross income as IRD. Whenever Tom withdraws from the account, such withdrawals will be includible in his gross income as IRD. § 691(a)(1)(B).

*4.6.03 **Tax on transfer of the right-to-receive IRD***

Although much less common than distributions, there is another event that can cause IRD to be taxable. If the person or entity who inherited the right-to-receive the IRD from the decedent transfers that right-to-receive-IRD to someone else, § 691(a)(2) provides that the IRD is immediately taxable, *to the transferor*. A distribution from a retirement plan is IRD; the retirement plan account *itself* is a right-to-receive IRD. Even without § 691(a)(2), the transfer of a *retirement plan* by gift or pledge would normally be a taxable event; see ¶ 2.1.04(C).

Here are examples of how a transfer of the right-to-receive IRD could occur:

A. Gift of right-to-receive IRD (rare).

Stokely Example: Stokely is named as beneficiary of his father's IRA. After taking distributions for several years after his father's death (and including such distributions in his income as IRD), Stokely decides he does not need this money and gives the inherited IRA to his sister. His gift is a transfer of the right-to-receive IRD, and the full value of the IRA becomes immediately taxable *to Stokely* under § 691(a)(2).

B. **Transfer from estate or trust to beneficiary.** Although the Stokely Example is unrealistic, one type of transfer of the right-to-receive IRD is very common: the transfer of an inherited retirement plan by an estate or trust to the individual beneficiary(ies) of the estate or trust. See ¶ 6.1.05. This type of transfer may or may not be taxable; see ¶ 6.5.07–¶ 6.5.08.

C. **Transfer to grantor trust.** Rev. Rul. 85-13, 1985-1 CB 184, established the principle that transactions between (1) an individual and (2) a trust all of whose assets are deemed owned by such individual under the "grantor trust rules" (¶ 6.3.10) are not taxable transactions, because "A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction."

If a beneficiary transfers an inherited IRA to a trust of which he is considered the sole owner under § 678 (one of the "grantor trust rules"), the transfer, being a nonevent for income tax purposes, should not trigger deemed income under § 691(a)(2), *provided* that (under the terms of the transferee trust) the benefits cannot be distributed to anyone other than that beneficiary during his lifetime. Several PLRs confirm this conclusion. See PLRs 2006-20025 and 2011-16005 (disabled beneficiary allowed to transfer inherited IRA to an irrevocable "special needs trust" ("(d)(4)(A)" type) and 2008-26008 (minor child's guardian allowed to transfer child's inherited IRA to an irrevocable trust for the minor's benefit, with probate court approval). The IRS ruled in each case that the trusts were "grantor trusts" as to the transferring-IRA beneficiaries and therefore the transfers were nontaxable because "a transfer of the grantor's assets to [a grantor trust] is not recognized as a sale or disposition for federal income tax purposes," including § 691(a)(2).

In the later two of these three PLRs the IRS adds the limitation "assuming the transfer of X's share of the IRAs to the Trust is not a gift by X." Completed gift status could be avoided by having the donor retain a power of appointment at death over the portion of the trust remaining after satisfaction of applicable debts.

However, no IRS ruling blesses the transfer of the participant's *own* (noninherited) IRA to the participant's grantor trust. The only PLR touching the subject is 2011-29045, in which the IRS granted the taxpayer a late rollover (¶ 2.7.05) when her attempt to transfer her IRA to her revocable trust failed because (says the ruling) the recipient financial institution "correctly determined that a grantor trust could not be the owner of an IRA."

4.6.04 ***Income tax deduction for estate tax paid on IRD***

The federal estate tax paid on IRD is deductible for federal income tax purposes by the recipient of the IRD. § 691(c). State estate taxes are not deductible for federal income tax purposes.

To determine the amount of the deduction, first determine the estate tax due on the entire estate. Next, determine the net value of all items of IRD that were includible in the estate (for definition see § 691(c)(2)(B)). The estate tax attributable to the IRD is the difference between the actual federal estate tax due on the estate and the federal estate tax that would have been due had the net value of the IRD had been excluded from the estate.

Harvey and Emma Example: Harvey dies in 2009, leaving his $5 million taxable estate (including a $1 million pension plan) to his daughter Emma. The federal estate tax in 2009 on a $5 million taxable estate was $675,000. If the $1 million IRA were excluded from the taxable estate, the taxable estate would be only $4 million, and the federal estate tax would be $225,000. Thus the amount of federal estate tax attributable to the IRA is $675,000 − $225,000, or $450,000. Emma will be entitled to an income tax deduction of $450,000 which she can claim when she receives the $1 million pension distribution. Note that:

1. The deductible portion of the estate tax is computed at the marginal rate, not the average rate; this is favorable to the beneficiary. In the Harvey and Emma Example, even though the IRA constituted only 20 percent of the taxable estate, it accounted for 67 percent of the estate tax, so the IRD deduction equals 67 percent of the total estate tax.

2. The estate tax need not be paid before the deduction is taken, as long as it is owed and attributable to the IRD. PLR 2000-11023.

3. There is a limited deduction for generation-skipping transfer (GST) taxes; see § 691(c)(3).

4. Computation of the § 691(c) deduction becomes more complex if a marital, charitable, or state death tax deduction is involved; see Reg. § 1.691(c)-1(a)(2). These topics are beyond the scope of this book. See instead *Estate Planner's Guide to Income in Respect of a Decedent* by Alan S. Acker.

The IRD deduction can create an incentive to cash out (or convert to a Roth IRA; see ¶ 4.2.05) retirement benefits soon after the participant's death, especially if:

- The estate has non-IRD net assets equal to or exceeding the estate's federal estate tax exemption, so that all the IRD is exposed to federal estate tax. This scenario creates in effect a 40% deduction to offset against the IRD (so only 60% is exposed to income tax). However, if the recipient of the IRD is an individual, § 68 may reduce the income tax deduction in years prior to 2018 or after 2025; see ¶ 4.6.08. § 68(f).

- The beneficiary of the retirement plan is a trust that will not immediately pass through, to individuals, the income it receives. Trusts are not subject to § 68 in any year.

4.6.05 ***Who gets the § 691(c) (IRD) deduction***

The IRD deduction goes to the person who receives the IRD, regardless of who paid the estate tax. § 691(c)(1)(A).

Jack Example: Jack dies in 2002 with an estate of $3 million. He leaves his $1 million IRA (which is entirely IRD) to his daughter Jill. He leaves his $2 million probate estate (which is not IRD) to his son Alex and provides that all estate taxes shall be paid from the residue of his estate. Accordingly,

Alex pays the federal estate tax of $897,500. The § 691(c) deduction goes to Jill because she received the IRD, even though Alex paid the estate tax. (Jack could have provided for a different result by using a different tax-apportionment clause.)

4.6.06 ***IRD deduction for deferred payouts***

Calculating the § 691(c) deduction is easy when the beneficiary receives a distribution of the entire benefit all at once, but what if the retirement benefit is distributed in installments over the life expectancy of the beneficiary? Clearly the deduction will also be spread out; but how much of the deduction is allocated to each payment? How much of each distribution represents "IRD" that was included in the gross estate, and how much represents income earned by the retirement plan after the date of death?

When IRD is in the form of a joint and survivor *annuity*, the Code requires that the deduction be amortized over the surviving annuitant's life expectancy and apportioned equally to the annuity payments received by the survivor. § 691(d). No official source discusses the allocation of the deduction to nonannuity payouts, such as instalment payments. The method used by many practitioners: All distributions from the retirement plan are assumed to be coming out of the IRD (rather than out of the post-death earnings of the plan) until the § 691(c) deduction has been entirely used up.

Jack Example, continued: Suppose the total § 691(c) deduction was $427,600, which is 42.76 percent of the total $1 million IRA. Suppose the IRA has grown to be worth $1.2 million by the time Jill takes her first withdrawal of $30,000. She assumes the distribution comes entirely from the $1 million original principal of the IRA (from the IRD, in other words) and none of it from the $200,000 of post-death earnings, so Jill takes a deduction equal to 42.76 percent of her $30,000 distribution, or $12,828. She keeps doing this until she has received a total of $1 million of distributions from the IRA, at which point she has used up all of her $427,600 § 691(c) deduction.

A beneficiary can "lose" his IRD deduction if the value of the inherited IRD declines. Suppose that, instead of increasing in value after his death, Jack's IRA had declined in value from the $1 million used for estate tax purposes to just $400,000 a year after his death. Jill cashes out the IRA, receiving $400,000. It *seems* as if this distribution should be tax-free, because Jill was entitled to a $427,600 IRD deduction and she received only $400,000 total from the IRA…but the IRD deduction doesn't work that way. Jill is entitled to a deduction of only 42.76 percent of each distribution she receives. Her IRD deduction on the $400,000 IRA distribution is only $171,040.

What happened to the rest of Jill's IRD deduction? It just disappeared. After all, the purpose of the IRD deduction is to ease the pain of including the IRD in income. If the IRD ceases to exist due to a decline in value, the beneficiary does not suffer the pain of including it in income and so does not need the deduction. See IRS Publication 559, "Survivors, Executors and Administrators" (2016), page 12.

Suppose that, instead of cashing out the IRA, "Jill" keeps it alive until eventually its investments appreciate back to their original value. Presumably the unused IRD deduction can be

fully applied to distributions from the re-appreciated account despite the fact that the value on which estate tax was paid was "lost" for some period of time (there is no authority on this point).

4.6.07 ***IRD deduction: Multiple beneficiaries or plans***

If multiple beneficiaries inherit IRD items from the same decedent, the IRD deduction is apportioned among them in proportion to the amount of IRD each receives. § 691(c)(1)(A). It appears that IRD payable to a trust in a particular year is passed out as part of any DNI distributed in the same year to trust beneficiaries and the deduction follows the income. § 691(c)(1)(B).

It is not clear whether the deduction must be apportioned among multiple plans inherited by a single beneficiary. Suppose a beneficiary inherits an IRA and a 403(b) plan, each worth $100,000, and she is entitled to a § 691(c) deduction of $80,000 for this $200,000 of IRD. The IRA experiences investment losses and becomes worthless, while the 403(b) plan doubles in value to $200,000. She cashes out the 403(b) plan. Can she use the entire § 691(c) deduction against the $200,000 403(b) distribution? Or is she required to apportion half the deduction to the now-vanished IRA, so she can never use it?

4.6.08 ***IRD deduction vs. § 67(a), § 68, and the AMT***

"Miscellaneous itemized deductions" are nondeductible by individuals in the years 2018–2025. Before 2018 these were deductible, but only to the extent the total of such deductions exceeded two percent of the individual's adjusted gross income (AGI)). § 67(a), (g). The § 691(c) deduction is *not* a miscellaneous itemized deduction, so it is fully deductible. § 67(b)(7). This deduction *is* allowed in computing the alternative minimum tax (AMT). § 56(b)(1)(A)(i).

In years before 2018 and after 2025, the § 691(c) deduction is subject to § 68, under which an individual's itemized deductions are reduced by an amount equal to as much as three percent of the individual's AGI in excess of an annually-adjusted threshold amount, or (if less) 80 percent of total itemized deductions. § 68(a), (b). This reduction of itemized deductions does not apply in 2018–2025. § 68(g). The § 68 reduction of itemized deductions does not apply to trusts or estates; therefore a trust named as beneficiary of a retirement plan can get the full benefit of the IRD deduction in *any year* with no § 68 "haircut," assuming the trust does not pass out the IRD to beneficiaries (see § 691(c)(1)(B)). See ¶ 6.5.04.

4.7 Road Map: Advising the Beneficiary

Here are matters the advisor needs to review with a client who has inherited a retirement plan. If the client is the deceased participant's surviving spouse, see also the Road Map at ¶ 3.1.02.

- Go through the post-mortem disclaimer checklist at ¶ 4.4.01.

- Consider other ways to "clean up" the estate plan after the participant's death, if he named the "wrong" (or no) beneficiary for his retirement plan. ¶ 4.5.

- How to correctly title an inherited IRA. ¶ 4.2.01.

- Advise the beneficiary regarding the option for Roth conversion of the inherited plan if that option is available. ¶ 4.2.05.

- Assist with transferring the account to the beneficiary's preferred financial institution if appropriate. ¶ 4.2.02–¶ 4.2.04.

- Compute the beneficiary's required minimum distributions (RMDs) using the Road Map for determining post-death RMDs at ¶ 1.5.02. Make sure the beneficiary understands the obligation to take RMDs and help him comply with it by offering to compute the RMDs and sending annual reminders.

- Determine whether there is after-tax money in the inherited plan and if so how it will be distributed; see ¶ 2.2.07.

- If the participant's estate is subject to federal estate tax, advise the beneficiary regarding the IRD deduction, how much it is and how to take it; see ¶ 4.6.04–¶ 4.6.08.

- Make sure the inherited benefits are integrated into the beneficiary's own estate plan, for example, by advising the beneficiary to name a successor beneficiary for his interest. ¶ 1.5.12(A).