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Estate Planning for Retirement Benefits: Recent Developments

Version 2009-4

by

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This paper discusses new developments in the area of estate and distribution planning for retirement benefits. "New" means occurring in approximately the last 14 months prior to the date on the first page. Background necessary to understand each development is briefly summarized in some cases. More detail regarding the underlying subject matter can be found in the authorities cited, or in the referenced section of the author's book *Life and Death Planning for Retirement Benefits* (6th ed., 2006; Ataxplan Publications), which can be purchased for $89.95 plus shipping through www.ataxplan.com, through Amazon.com, or by calling 800-247-6553.

Abbreviations Used in this Document

§	Refers to a section of the Code, unless otherwise indicated
¶	Refers to a section of the author's book *Life and Death Planning for Retirement Benefits* (6th ed., 2006; Ataxplan Publications), which can be purchased for $89.95 plus shipping through www.ataxplan.com, through Amazon.com, or by calling 800-247-6553.

2009 RMD	A plan or IRA distribution made in 2009 that *would have been* a required distribution under § 401(a)(9) if it were not for § 401(a)(9)(H). In other words, a "nonrequired required distribution!" See discussion of IRS Notice 2009-82 below.
ADP	Applicable Distribution Period under the minimum distribution regulations.
AMT	Alternative minimum tax. § 55.
Code	Internal Revenue Code of 1986, as amended through September 2009.
FI	Financial institution.
IRA	Individual retirement account or individual retirement trust under § 408.
IRD	Income in respect of a decedent. § 691.
IRS	Internal Revenue Service
MRD	Minium required distribution under § 401(a)(9) (also called "RMD")
NUA	Net unrealized appreciation. § 402(e)(4).
P	Participant; the employee or IRA owner whose benefits we are talking about.
PPA 2006	The Pension Protection Act of 2006.
QRP	Qualified retirement plan under § 401(a).
Reg.	Treasury Regulation.
RBD	Required beginning date for RMDs. § 401(a)(9)(A).
RMD	Required minimum distribution under § 401(a)(9) (also called "MRD").
S	Spouse; the spouse of the participant.

9/09: IRS Notice 2009-82, 2009-41 I.R.B. *** (9/24/09) Provides Guidance on Suspension of RMDs, Extends Rollover Deadline to 11/30/09 for Certain 2009 Distributions

A. Background: Minimum distribution rules and the one-year suspension

§ 401(a)(9) of the Code contains the minimum distribution rules for qualified retirement plans. These rules are "imported" into other Code sections, so they also apply to 403(a) and 403(b) plans, IRAs, and 457 plans. For details on the minimum distribution rules, see Chapter 1 of *Life and Death Planning for Retirement Benefits* (6th ed. 2006; www.ataxplan.com).

Enacted in December 2008, the "Worker, Retiree, and Employer Recovery Act of 2008" (WRERA) added a new subparagraph (H) to § 401(a)(9), entitled "Temporary waiver of minimum required distribution." The new subparagraph provides that "The requirements of this paragraph shall not apply for calendar year 2009 to" any defined contribution plan under § 401(a), § 403(a) or § 403(b); any governmental 457 plan; or "an individual retirement plan" (IRA). For more details on WRERA, see "12/08: Worker, Retiree, and Employer Recovery Act of 2008 Suspends RMDs for 2009" later in this "New Developments" outline.

Thus, anyone who would otherwise be required to take a distribution from one of these types of plans in 2009—whether participant or beneficiary—is off the hook. He can skip a year.

IRS Notice 2009-9, 2009-5 I.R.B. 419, issued February, 2009, provided guidance on reporting requirements under the new law. In September 2009 the IRS issued Notice 2009-82 to further clarify some of the issues involved in the suspension and help plans, participants, and beneficiaries deal with it. The Notice uses the term "2009 RMDs" to describe plan distributions that are made in 2009 that *would have been* MRDs under § 401(a)(9) if it were not for § 401(a)(9)(H). In other words, the "nonrequired required distributions!"

For many retirees and beneficiaries, it appeared that the right to skip taking RMDs in 2009 was purely theoretical, because qualified retirement plans (QRPs) would keep right on paying those RMDs whether or not they were required by the Tax Code! All QRPs repeat the minimum distribution rules right in the plan document. Thus, a 401(k) plan document (for example) might say, "The plan will distribute to the employee an annual distribution equal to his prior year's account balance divided by the factor for his age as shown in the Uniform Lifetime Table." Since plans are required to be administered in accordance with the plan documents, most plan administrators concluded they had to keep on distributing the "RMDs" called for by the plan unless the plan contained specific language permitting a suspension based on a change in the law. Few plans contained such language, and few plans have been or even could have been amended quickly enough to recognize the last-minute suspension of RMDs for 2009.

Now IRA Notice 2009-82 provides some relief (in the form of an extended rollover deadline) for participants who were forced to take these nonrequired RMDs.

Notice 2009-82's Guidance for Plans

Note: Notice 2009-82 contains extensive material to guide plans in dealing with § 401(a)(9)(H), including sample plan amendments. These rules for plans will affect some participants and beneficiaries, because the plans are given various choices regarding what options they can offer retirees and beneficiaries who are already receiving periodic distributions. The plan's choices differ depending on whether the payments are "2009 RMDs," or are eligible rollover distributions without regard to § 401(a)(9)(H), or are neither of the foregoing or a combination of the foregoing. If the plans weren't confused before, they will be now! *This paper discusses the effect of Notice 2009-82 on individuals, not the rules for plans.*

B. Nonrequired "2009 RMDs" may be rolled over

Required distributions are not eligible rollover distributions. § 402(c)(4)(B), § 408(d)(3)(E). Since the RMD rules are "suspended" for 2009, however, all of a sudden many 2009 distributions that in a normal year would have been ineligible for rollover as RMDs became *eligible* for rollover.

In Notice 2009-82, the IRS attempts to give some relief to individuals who received nonrequired RMDs in 2009 "against their will" (i.e., from plans that insisted on paying the distributions even though the distributions were not required because of WRERA). The relief also helps some people who took nonrequired RMDs early in 2009 because they were unaware of the one-year suspension or for some other reason, but now would like to get that money back inside a retirement plan. Specifically, the IRS has extended the 60-day deadline for rollover of such nonrequired 2009 RMDs until November 30, 2009 (if that is later than the 60-day deadline would otherwise be).

However, the status of a distribution as an RMD or not an RMD is NOT the only factor determining whether that distribution is an "eligible rollover distribution." Here are some of the rules that could prevent someone from rolling over a retirement plan distribution, with a summary of how each rule is affected by Notice 2009-82:

1. All types of plans and IRAs: RMD is not eligible for rollover. The only distribution in 2009 that actually IS "required distribution" is a 2008 RMD that was postponed into 2009 by an individual whose required beginning date was April 1, 2009 (e.g., an IRA owner who turned age 70½ in 2008). 2008 RMDs postponed into 2009 were NOT suspended by WRERA, and accordingly they still ARE "real" RMDs, and they can NOT be rolled over. The extension of the 60-day deadline has no effect on these distributions because they are not eligible rollover distributions. Except for those postponed 2008 RMDs, however, there are no distributions in 2009 that are ineligible for rollover on account of being "required" distributions.

2. NonIRA plans only: Payment that is part of a series of equal periodic payments. Another type of distribution that is not eligible for rollover (if it comes from a nonIRA plan) is a distribution that is part of a series of payments of a certain type. This category has caused the most trouble for plans and for the IRS in Notice 2009-82, because what if a person is receiving a "series of equal payments" that *includes* his RMDs? See "D" below for these troublesome payments.

3. IRAs only: One rollover per 12 months rule. A special rule limits the number of IRA-to-IRA rollovers that can occur within any 12-month period. This rule is illogical and normally is easy to avoid. The IRS has NOT suspended this rule (the IRS has no authority to suspend this rule) for 2009. So despite the extension of the 60-day deadline, some IRA "2009 MRD" distributions *still* cannot be rolled over to another IRA because of this rule. See "E" below.

4. All plans and IRAs: Nonspouse beneficiary may not roll over distribution of inherited benefits. When money or assets are distributed out of an inherited plan or IRA to a nonspouse beneficiary, that beneficiary may NOT roll over the distribution. Not within 60 days, not even within 60 seconds. This type of distribution is simply NOT an eligible rollover distribution. Accordingly, nothing in Notice 2009-82 gives any relief to *nonspouse beneficiaries* who received nonrequired 2009 RMDs "against their will." They do NOT have the option of rolling over such distributions to an inherited (or any other) IRA, or back into the plan they came out of, or anywhere, as illustrated in the following two examples:

Pearl Example: Pearl inherited her father's 401(k) plan and is taking annual distributions over her life expectancy. Even though she was not required to take a distribution in 2009, the plan distributed the annual distribution to her in March 2009, because the plan documents required the distribution to be made. Pearl cannot roll over that distribution.

Amber Example: Amber inherited her late husband's 401(k) plan and is taking annual distributions over her life expectancy. For some reason she has not yet rolled over that plan to her own IRA or plan (see Chapter 3 of *Life and Death Planning for Retirement Benefits*). Even though she was not required to take a distribution in 2009, the plan distributed the annual distribution to her in March 2009, because the plan documents required the distribution to be made. Amber could have rolled over this distribution within 60 days of receiving it, because she is the surviving spouse of the deceased participant. Thanks to Notice 2009-82, she can still roll it over anytime until November 30, 2009 (see "C," below).

C. Extension of 60-day rollover deadline to November 30, 2009

Any person who received a *plan or IRA distribution* in 2009 that was a "nonrequired required 2009 distribution," receives an automatic extension of the 60-day rollover deadline to November 30, 2009 (if that is later than the individual's 60-day rollover deadline would otherwise be), subject to the following limitations and caveats:

1. If the distribution was made to a *nonspouse* beneficiary, the distribution is still not eligible for rollover. The deadline extension has no effect on this. See B(4) above.

2. If the distribution was of a 2008 RMD that had been postponed into 2009, it is not eligible for rollover, and the deadline extension has no effect on this. See B(1) above.

3. If the distribution was from a nonIRA plan and was part of a series of equal payments, see "D," below.

4. If the distribution came from an IRA, then it is still subject to the one-rollover-per-12-months rule, and Notice 2009-82 does NOT suspend this rule; see "E," below.

5. Finally, unless (possibly) it is part of a "series of equal payments" from a nonIRA plan (see "D," below), if the distribution was not a nonrequired required distribution ("2009 RMD"), it does not benefit from the 60-day extension, as illustrated by the following two examples:

Ruby Example: Ruby, age 75, is retired and receiving distributions from her former employer's 401(k) plan. Each year, the 401(k) plan automatically sends out the year's RMD in February. In addition, a retiree can request additional distributions up to three times per year. Prior to 2009, Ruby had taken her RMDs every year on a timely basis. In February 2009, Ruby received the (nonrequired) 2009 RMD of $7,345. In March she requested and received an additional optional distribution of $10,000. In May, she requested and received another optional distribution, this time of $5,000. In a "normal" year, the first 2009 distribution ($7,345 in February) would not have been an eligible rollover distribution, because it would have been her RMD, but the other two would have been eligible rollover distributions. Because of the one-year suspension applicable to 2009, *all three* of her 2009 distributions were eligible rollover distributions. IRS Notice 2009-82 gives Ruby the option to now roll over the $7,345 "nonrequired RMD" she received in February anytime up to November 30, 2009, even though the 60-day rollover deadline has passed for that distribution.

However, the extension of the 60-day rollover deadline does *not* apply to the additional optional distributions she received in March and May 2009 because those were not "2009 RMDs" and were not part of a series of equal payments (see "D," below). Thus, she cannot now roll over those distributions; the 60-day deadline has passed and the extension does not apply.

Jade Example: Jade, age 68, is retired. In April 2009, she took $25,000 out of her IRA to buy a new car. She had not taken any other distributions from any IRA in the preceding 12 months. Now, in October 2009, she has changed her mind and wishes she hadn't withdrawn that money. It's too late for her to roll that distribution back in to any plan or IRA. Notice 2009-82 does not give her any extension of the 60-day deadline because her $25,000 distribution was not a "2009 RMD." Jade is not subject to the minimum distribution requirements at all because she has not reached age 70½.

D. NonIRA plans only: Payments that are part of a series

Generally, a distribution from a qualified plan (QRP), 403(b) plan, or governmental 457(b) plan is not an "eligible rollover distribution" if it is part of a certain type of "series." Specifically, "[A]ny distribution which is one of a series of substantially equal periodic payments" made annually or more often (a) over the life or life expectancy of the participant, (b) over the joint life or life expectancy of the participant and a designated beneficiary, or (c) over a "specified period of 10 years or more" may not be rolled over. § 402(c)(4)(A); § 403(b)(8)(A); § 457(e)(16)(a)(1). Reg. § 1.402(c)-2, A-5, explains how to determine whether a distribution is part of a series of substantially equal payments.

The one-year suspension of RMDs created massive confusion regarding participants who were taking series payments that included their RMDs. Yes, the distributions were no longer ineligible for rollover on account of being RMDs—but were they *still* ineligible under § 402(c)(4)(A) because they were part of a series?

Here it seems the IRS decided to exceed its authority a little bit. The IRS couldn't "waive" the rule that nonspouse beneficiaries could not roll over distributions from inherited plans (see B(4), above); and couldn't waive the one-rollover-per-12-months rule applicable to IRAs (see "E," below); but the IRS decided it COULD bend the rules about series payments. Specifically, Notice 2009-82 provides that 2009 payments to a plan participant or surviving spouse will NOT be treated as ineligible for rollover under § 402(c)(4)(A) if either:

1. Such "payments equal the 2009 RMDs" or

2. "Are one or more payments in a series of substantially equal distributions *(that include the 2009 RMDs)* made at least annually and expected to last for the life (or life expectancy) of the participant, the joint lives (or joint life expectancy) of the participant and the participant's designated beneficiary, or for a period of at least 10 years." Notice 2009-82, Part IV, "*Rollover relief for plans*," emphasis added.

Furthermore, all payments described in the preceding two numbered subparagraphs are eligible for the extension of the rollover deadline to November 30, 2009.

So, the rollover relief for series payments from plans is "double": First, the payment is magically transformed into an eligible rollover distribution, despite § 402(c)(4)(A); second, the rollover deadline is extended to the later of 60 days after the distribution or November 30, 2009.

Unfortunately it is not entirely clear, at least to me, what the modifying parenthetical clause "(that include the 2009 RMDs)" is intended to modify. Because the verb "include" is plural it does not modify "a series." Therefore we are not concerned with whether the "series" includes some 2009 RMDs. Rather, the parenthetical must modify either "payments" or "distributions." Since it appears after "distributions," it seems logical to conclude that it is intended to modify "distributions," not payments. If it modified "payments," then we would include that the participant could roll over ONLY payments in the series that actually included some 2009 RMD. The fact that it does not modify "a series" means he is not given blanket permission to roll over ALL payments in the series merely because SOME payments in the series include RMDs. So what does it mean exactly? I'm not sure.

There are three possibilities: If the participant is receiving a series of substantially equal periodic payments, and at least one payment in such series includes a 2009 RMD, then the participant can roll over:

1. Only the 2009 RMD, but not any other part of any distribution received in the series.

2. All of any series payment received in 2009 that includes any 2009 RMD, but not any series payment in 2009 that did not include any 2009 RMD.

3. All series payments received in 2009 as long as at least one of the payments included 2009 RMD.

Rocky Example: Rocky is retired and over age 70½. He requested last year that his benefits be distributed to him in monthly payments of $2,000 for the next 15 years. His 2009 RMD would have been (but for WRERA) $7,500. The plan pays him $2,000 a month through June 2009 when he asked to stop receiving the payments for the rest of the year, so he received a total of $12,000 of "series" payments in 2009. The series included his RMD of $7,500. Under interpretation #1, he can roll over only the $7,500 2009 RMD portion of the payments he received. Under interpretation #2, he can roll over the four January through April payments ($8,000), because each of those payments included some 2009 RMD, but cannot roll over the remaining two payments (May and June) because those payments did not include any 2009 RMD. Under interpretation #3, he can roll over all six payments, because at least one series payment received in 2009 included 2009 RMD.

Let's hope not too many people are trying to figure out this rule!

E. IRA distributions only: The one-rollover-per-12-months rule

A participant or surviving spouse may not roll over an IRA distribution to the same or any other IRA "if at any time during the 1-year period ending on the day of…[the receipt of the distribution] such individual received any other amount...from an individual retirement account...which was not includible in his gross income because of the application of this paragraph." § 408(d)(3)(B).

Unlike with the 60-day deadline, the IRS has no authority to suspend this rule, and Notice 2009-82 confirms that this rule is NOT suspended with respect to 2009 RMDs. See Notice 2009-82, Part IV (last paragraph).

Because of this rule, multiple distributions received within 12 months of each other from the same IRA cannot be rolled over to the same or another IRA, regardless of whether such distributions were "2009 RMDs." However, this rule does NOT prevent rolling such distributions to nonIRA plans or Roth IRAs:

Pierre Example: Pierre, age 76, owns one IRA. His RMD from this IRA for 2009 would have been $12,000, if RMDs hadn't been suspended. He didn't hear about the one-year suspension of RMDs until May 2009. By then he had already taken three distributions intended to satisfy his 2009 RMD requirement, $4,000 (in January 2009), $5,000 (in February 2009), and $3,000 (in March 2009). He can roll over ONE and ONLY ONE of these distributions to another IRA (or back into the same IRA) no later than November 30, 2009. The 60-day rollover period has expired for all three distributions, but thanks to Notice 2009-82 his rollover deadline for *all three* distributions is extended to November 30, 2009. However, because of § 408(d)(3)(B), which is NOT suspended, he can shelter only ONE of these distributions from income tax by means of rolling it to an IRA. Presumably, he would roll the largest of the three (the $5,000 distribution received in February 2009) back into his IRA (or into another newly created IRA if he prefers).

If he really wants to get all three distributions back into a retirement plan, Pierre does have two other escape hatches that enable him to avoid the one-rollover-per-12-months rule:

1. **Roll to a nonIRA plan.** If he happens to participate in some other type of retirement plan that accepts rollovers, he can roll any or all of his three distributions into that plan no later than November 30, 2009. § 408(d)(3)(B) only prevents *IRAs* from accepting rollover contributions of IRA distributions made within 12 months after certain other IRA distributions. § 408(d)(3)(B) does *not* prohibit other types of plans from accepting any rollovers from IRAs. Thus, other types of plans CAN accept rollover contributions of IRA distributions (except that such plans cannot accept rollovers of after-tax money from an IRA) regardless of what other IRA distributions received within the preceding 12 months the participant may have rolled over.

2. **Roll to a Roth IRA.** He can contribute any or all of the three distributions to a Roth IRA. § 408(d)(3)(B) does not apply to rollovers into a Roth IRA. Reg. § 1.408A-4, A-1(a). If does complete a rollover into a Roth IRA by November 30, 2009, and he later determines that he is not eligible to roll to a Roth because his 2009 income exceeds $100,000, or if for some other reason he would rather have this money in a traditional IRA, he can "recharacterize" the Roth contribution by taking it (together with its earnings) out of the Roth IRA (transferor IRA) and depositing it in a traditional IRA (transferee IRA) no later than the extended due date of his 2009 income tax return. See ¶ 5.6 of *Life and Death Planning for Retirement Benefits* regarding Roth IRA "recharacterizations," ¶ 5.6.03 regarding the meaning of "extended due date." "…[R]echaracterizing a contribution …is never treated as a rollover for purposes of the one-rollover-per- year limitation of section 408(d)(3)(B), even if the contribution would have been treated as a rollover contribution by

the…[transferee] IRA if it had been made directly to the… [transferee] IRA, rather than as a result of a recharacterization of a contribution to the…[transferor] IRA. Reg. § 1.408A-4, A-8.

F. Effect of WRERA on post-death elections

There are several minimum distribution deadlines that apply to beneficiaries after the participant's death. Notice 2009-82 explains how these are affected by the one-year suspension of the minimum distribution rules:

1. Death before the RBD: Electing between 5-year rule and life expectancy payout. If a participant dies before his required beginning date (RBD), the plan can allow the participant's Designated Beneficiary (DB) to elect which minimum distribution regime will apply. The choice is between annual instalments over the life expectancy of the DB or the 5-year rule. Normally, the deadline for completing this election is the earlier of the end of the fifth year after the participant's death or the end of the year in which distributions would be required to commence under the life expectancy payout. Notice 2009-82 provides that if this deadline would otherwise fall in 2009, it is extended to the end of 2010. Notice 2009-82, Part V ("Other Issues"), A-2.

2. Direct rollover by nonspouse beneficiary. If a nonIRA plan permits nonspouse designated beneficiaries to transfer their inherited benefits via direct rollover to an inherited IRA (all plans will be required to permit this starting in 2010; through 2009 it is optional), and the beneficiary elects to make such a direct rollover, IRS Notice 2007-7 provides that, if the 5-year rule applied to the benefits inside the nonIRA plan, it will CONTINUE to apply to the benefits after they are transferred to the inherited IRA, UNLESS the transfer occurs before the end of the year after the year of the employee's death, in which case the life expectancy payout can be elected. Notice 2009-82 provides that, for deaths in 2008 only, this deadline will expire at the end of 2010, not the end of 2009. Notice 2009-82, Part V ("Other Issues"), A-3.

3. Other post-death deadlines are NOT extended. Thus, for deaths in 2008: The Beneficiary Finalization Date is still September 30, 2009; the deadline for the trustee of a trust named as beneficiary to supply documentation to the plan administrator (in order to qualify as a see-through trust) is still October 31, 2009; and the deadline for division of an inherited plan into separate accounts for multiple beneficiaries is still December 31, 2009. Notice 2009-82, Part V ("Other Issues"), A-4.

G. Effect of WRERA on pre-59½ "SOSEPPs" (§ 72(t))

Notice 2009-82 confirms what has been obvious all along but was nevertheless the source of constant questions: WRERA has absolutely no effect on anyone who is taking advantage of the

"series of substantially equal periodic payments" (SOSEPP) exception to the 10 percent penalty on pre-age 59½ distributions–even if he is using the "RMD" method of computing his series payments. WRERA only suspends required distributions under § 401(a)(9), i.e., distributions that must be made (under the minimum distribution rules) to a participant who is over age 70½ or to a beneficiary. It does not give anyone the right to skip taking any payment that is part of a series payment under § 72(t). Notice 2009-82, Part V, A-9. For background on the 10 percent penalty on pre-age 59½ distributions, and the SOSEPP (and other) exceptions, see Chapter 9 of *Life and Death Planning for Retirement Benefits*.

9/09: IRS Notice 2009-75, 2009-39 I.R.B. * (9/8/09) blasts NUA-to-Roth IRA Conversion Idea.**

For the last few years, participants have been permitted to roll money directly from a qualified plan (QRP) to a Roth IRA, without the intervening step of rolling the money first into a traditional IRA (then converting the traditional IRA to a Roth).

This plan-to-Roth conversion option gave rise to the following planning idea: A retiring employee requests, from his employer's qualified plan, a lump sum distribution (LSD) that includes appreciated employer stock (see ¶ 2.5 of *Life and Death Planning for Retirement Benefits*). He directs that the LSD be rolled directly into a Roth IRA, as permitted by § 408A(e) (if he is eligible; that means having less than $100,000 of modified adjusted gross income if the conversion occurs before 2010. See Chapter 5 of *Life and Death Planning for Retirement Benefits*.). The effect of this "Roth conversion" is, according to the Code, that he is taxed as if he took the distribution outright, meaning (apparently) that he will be liable for current tax on only the plan's "basis" in the stock. The "net unrealized appreciation" in the stock (NUA) is transferred into the Roth IRA without current tax…and then it is NEVER taxed, assuming that later distributions from the Roth IRA are taken as tax-free qualified distributions! See Jones, Mike, "Do Roth IRA Conversions Offer a Brand-NUA Opportunity?," *Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter* (www.leimbergservices.com), Archive Message #390, 11/1/2006.

Based on the statute, this appears to work, BUT the IRS says it will NOT work. In Notice 2009-75, the IRS says this transaction will be taxed "as if": the LSD were transferred first to a traditional IRA; the hypothetical traditional IRA were the employee's only traditional IRA; and the traditional IRA were then transferred to the Roth IRA. Result says the IRS: the entire transfer is taxable since there is no "NUA" deal for distributions either to or from a traditional IRA. Note that if you were counting on paying tax only on the plan-basis portion of the conversion, and NEVER paying tax on the NUA portion, you end up MUCH WORSE under the IRS's interpretation—you have to pay ordinary income tax on the ENTIRE Roth conversion, with NO WAY to resurrect your favorable long-term capital gain treatment for the NUA portion. Yes, if you don't want to pay tax on the entire conversion, you can "recharacterize" the conversion—but the effect of that is to dump the entire distribution into a traditional IRA (the eventual distributions from which will all be taxed as ordinary income). There is no way to get the stock back into the QRP so you can "do it over" as a lump sum distribution of employer stock (and salvage the long-term capital gain treatment for the NUA portion).

Bottom line: Someone might challenge the IRS on this and might even win. But the bottom line is, DON'T use this idea unless you are prepared for the possibility that you may end up owing ordinary income tax on the entire lump sum distribution AND forfeiting your "NUA" deal forever.

01/09: Rev. Rul. 2009-13, 2009-21 I.R.B. 1029: Surrender Vs. Sale of a Life Insurance Contract: Difference Between "Basis" and "Investment in the Contract"

Retirement plan distributions are taxable under § 72; see ¶ 2.1 of *Life and Death Planning for Retirement Benefits*. Taxation under § 72 has two implications. First, the income will be "ordinary income," not capital gain. Second, distributions will not be taxable to the extent they constitute a return of the individual's "investment in the contract." § 72(b). A different set of rules applies to the profit from the sale of a capital asset. That type of income may be taxed as capital gain (§ 1001), and sale proceeds are not taxable to the extent they constitute a return of the individual's "basis" (§ 1011).

In Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, the IRS ruled that an individual's "investment in the contract" in a life insurance policy (used to determine the amount of his income under § 72 if he surrenders the policy to the insurer for its cash value) is not necessarily the same as his "basis" in the contract (used to determine gain when a policy is sold to an unrelated third party investor). Investment in the contract (which is normally the sum of all the premiums the insured policy holder has paid) includes the annual cost for insurance protection prior to the disposition. This cost cannot be included in "basis" if the contract is sold. Thus, "basis" will typically be lower than "investment in the contract."

Chapter 8 of *Life and Death Planning for Retirement Benefits* explains the income tax treatment of life insurance owned by a retirement plan, both during the participant's employment and upon "rollout" of the policy at retirement. In the book, I used "basis" and "investment in the contract" interchangeably. That will need to be changed, now that the IRS has highlighted that these two numbers may be different for the same insured and the same policy! However, Rev. Rul. 2009-13 does not have seem to have any effect on plan-owned insurance policies, or on the tax treatment of the policy "rollout." Rev. Rul. 2009-13 applies only when the insured sells his policy to an unrelated third party investor. It does not affect sales prior to August 26, 2009.

01/09: Medicare Part B Premiums Go "Progressive": The Hidden Tax on the Elderly.

A tax increase is a tax increase is a tax increase…even if it's called a "premium subsidy reduction."

Medicare "Part B" premiums are determined actuarially, then reduced by a "subsidy." The subsidy is then reduced for higher-income individuals. This system started phasing in in 2007. 2009 is the first year the subsidy reduction is fully phased in. 42 U.S. Code §1395r(i). As a result, whereas prior to 2007 all seniors paid the same premium for Medicare, higher income individuals now pay more than triple the Medicare premium paid by lower-income seniors.

I'm someone to whom no part of Medicare makes sense, but it does seem that this new feature is particularly "interesting." Since all workers pay a "Medicare tax" on their earned income throughout their careers, and since the Medicare tax is a percentage of earned income with no cap, higher-income workers have paid much more into the "system" while working. Now they will also have the privilege of paying much more to get benefits out of the system.

So you can help your clients with their income planning, here's how Medicare Part B works.

The "subsidy reduction" is based on "modified adjusted gross income," which is regular AGI determined under § 62 (line 37 on Form 1040), with certain normally-excluded income added back in, namely: tax-exempt interest, U.S. savings bond interest used to pay tuition, etc. (§ 135), and

certain income from foreign or U.S. possession or territory sources (§ 911, § 933, § 935). 42 U.S.C. § 1395r(i). Note that Roth distributions that are excluded from gross income do not increase MAGI for Medicare premium purposes, unlike traditional IRA distributions.

Each year's premium is calculated based on the individual's MAGI for the second prior year (e.g. 2007 income determines 2009 premium). The income levels are increased annually by a COLA. 42 U.S.C. § 1395r(i)(5). There is a procedure for requesting a reduced premium if income has dropped dramatically since the base year due to any of certain "life-changing events" such as divorce; see Form SSA-44.

The following Table shows the ANNUAL Part B Medicare premium for 2009, and is adapted from the "official government handbook" *Medicare and You: 2009* (http://www.medicare.gov/publications/pubs/pdf/10050.pdf), p. 119. In this Table, "Yearly Income" means MAGI for the year 2007.

Note that the premium ratchets up with each income level, without (as far as I can determine) any adjustment to prevent the premium increase from pushing income below the specified level. In other words, a person whose 2007 MAGI was $213,000 pays a $3,006 premium for 2009, but a person whose 2007 MAGI was $213,001 pays $3,699.60. It looks to me as though $1 of additional income costs that fellow $699.60! There may be some adjustment going on in the system somewhere to prevent this, but I didn't find it.

If Your 2007 Yearly Income Is:		**You Pay**
File Individual Tax Return	**File Joint Tax Return**	**For 2009:**
$85,000 or below	$170,000 or below	$1,156.80
$85,001-$107,000	$170,001-$214,000	$1,618.80
$107,001-$160,000	$214,001-$320,000	$2,312.40
$160,001-$213,000	$320,001-$426,000	$3,006.00
Above $213,000	above $426,000	$3,699.60

01/09: *Kennedy, Executrix, v. Plan Administrator for DuPont Savings and Investment Plan et al.*, 555 U.S. * (2009): Disclaimers Don't Violate ERISA; Plan Docs Control**

The following is excerpted from Chapter 4 ("Inherited Benefits: Advising Executors and Beneficiaries") of the forthcoming 7th edition of the author's book *Life and Death Planning for Retirement Benefits*:

A recent Supreme Court case is friendly to disclaimers of qualified retirement plan benefits.

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

One concern is whether a 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.

In the author's view, this is not a correct interpretation of ERISA. QRP documents generally provide that the interpretation of the plan and administration of the trust are governed by state law to the extent not contrary to (or preempted by) ERISA. If the applicable state law permits disclaimers, the plan is required to give effect to them, in the author's view, unless the plan contains a specific provision to the contrary. All trustees, not just ERISA trustees, are required to administer their trusts in accordance with the terms of the trust instrument; most nonERISA trust instruments also say nothing about disclaimers, but no one argues that trustees generally are entitled (let alone required) to ignore valid disclaimers. An ERISA trust is not different from any other trust except to the extent federal law requires it to be.

"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? And, does the disclaimer contravene the terms of the plan document?

These issues are of no concern to IRA administrators, since IRAs are 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 through the medium of 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).

From one perspective it might *appear* that a disclaimer violates this rule. By refusing to accept the benefits, the beneficiary in effect causes the benefits to pass to someone else. However, in *Kennedy, Executrix, v. Plan Administrator for DuPont Savings and Investment Plan et al.*, 555 U.S. *** (2009), the Supreme Court laid to rest any concern that may have existed on this point.

In *Kennedy*, the participant, William Kennedy, designated his then-spouse, Liv, as beneficiary of his death benefits under a certain DuPont retirement plan. Upon their later divorce, Liv waived her rights to this benefit as part of the parties' divorce agreement. The divorce agreement, though apparently valid and enforceable between the parties, did not rise to the level of a QDRO. William never subsequently changed his beneficiary designation. Accordingly, the beneficiary designation form naming Liv as beneficiary was still on file with the plan at his death. The plan paid the benefits to Liv as the named beneficiary, over the protests of William's daughter (and executrix) Kari. Kari sued the plan, claiming the benefits should have been paid to the estate (as default beneficiary under the DuPont plan) because Liv had waived her rights to these benefits.

The plan made several arguments as to why it was not obligated to honor Liv's waiver of the benefits in the divorce agreement. One of these was that the waiver violated the anti-alienation rule.

The Court rejected this argument. The Court held that a beneficiary's giving up the right to an inherited benefit under a qualified plan does not constitute an assignment or alienation that would be void under § 1056(d)(1) provided the beneficiary does not attempt to direct where the inherited benefit will go. According to the *Kennedy* Court, "Common sense and common law both say that '[t]he law certainly is not so absurd as to force a man to take an estate against his will."

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. 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. In fact, the plan involved in *Kennedy* had a specific provision permitting disclaimer, which the court quoted favorably; this should lay to rest any notion that a disclaimer violates ERISA's anti-alienation requirement.

In GCM 39858, the IRS recognized that disclaimers do not violate ERISA. The IRS has blessed disclaimers of QRP benefits in numerous letter rulings; see, *e.g.*, PLRs 9016026, 9247026, and 2001-05058.

Accordingly, there should no longer be, if there ever was, any concern that a disclaimer, *per se*, violates the *anti-alienation rule*. The next question is whether giving effect to the disclaimer would violate some *other requirement* applicable to qualified plans.

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 twice held that this ERISA rule preempts any state law that would require the plan administrator to deviate from the terms of the plan document. 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.

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.

In *Kennedy*, as we have seen, there was a conflict between the participant's divorce agreement (under which 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 carry out the terms of the plan document. "What goes for inconsistent state law goes for a federal common law of waiver that might obscure a plan administrator's duty to act 'in accordance with the documents and instruments.'"

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…."

The Court noted that the DuPont plan provided a way for beneficiaries to disclaim benefits and Liv Kennedy did not follow that way. So, under *Kennedy*, a QRP should honor a disclaimer only if permitted or required to do so by the plan document.

C. Effect of the plan's "state law" provision

Some plan documents, as in *Kennedy*, explicitly recognize disclaimers. Such a plan is obviously required to honor a beneficiary's disclaimer if it satisfies the plan's requirements regarding disclaimers.

Other plans do not specifically mention disclaimers, but do state that they are governed by a particular state's laws to the extent not preempted by ERISA. One widely-used national prototype 401(k) plan, for example, provides that the administration of the plan is governed by Massachusetts law except to the extent such law is pre-empted by ERISA.

Under *Egelhoff* and *Boggs*, state law is pre-empted to the extent it would require the plan administrator to do something that is not in accordance with the plan documents. For example, under Massachusetts law, a surviving spouse is entitled to claim a certain share of the deceased spouse's estate. Since ERISA spells out certain spousal death benefits, and Massachusetts law spells out different spousal inheritance rights (See, *e.g.*, Mass. Gen. Laws Ch. 191, § 15), the Massachusetts rule is preempted by ERISA, and accordingly the plan is not to follow Massachusetts law on this point.

With respect to disclaimers, however, as discussed above, nothing in ERISA prohibits disclaimers. On the contrary, 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 preempt 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

Massachusetts law (except to the extent preempted) is required by the terms of the plan document to honor a disclaimer that complies with Massachusetts law.

Is this burdensome or otherwise a "bad thing" for plan administrators? Not necessarily. Plan administrators want to avoid uncertainty, and avoid (as the *Kennedy* court put it) the need to examine "numerous external documents" in order to ascertain who is entitled to receive benefits under the plan. To get certainty, it would appear that *Kennedy* gives the plan's drafter only two ways to go. One would be for the plan document to provide that the plan will not honor any disclaimer. This would apparently be permissible under *Kennedy*, despite the federal policy favoring a right of waiver.

The other way to get certainty is to permit disclaimers pursuant to a procedure that is spelled out either in the plan documents or under the law of a particular state. The latter is preferable: By tying the plan's administration to a particular state's disclaimer statute, the plan does not have to reinvent the wheel as far as procedures for the disclaimer are concerned and also would have the benefit of any state court cases interpreting the applicable statute. Massachusetts law, for example, provides several procedures that operate to protect the plan administrator from uncertainty (and from the need to examine external documents), such as a requirement that the disclaimer be delivered to the person holding the disclaimed property and a requirement that the property holder can require the disclaimant to certify certain things to it.

The way to get UNCERTAINTY, so dreaded by plan administrators, would be to say absolutely nothing in the plan document that could be construed as either banning disclaimers or permitting them pursuant to a particular state's law. A plan in that situation would (according to *Kennedy*) be subject to the "federal common law of waiver" in dealing with purported disclaimers by beneficiaries. The problem is that, as with any common law, there is no procedure laid out for carrying out such a waiver (such as a time limit, or any requirements regarding content or delivery of the waiver document). A search of a legal database revealed that there is almost zero federal common law of waiver that could operate to guide a puzzled plan administrator.

Relying on the Massachusetts law of disclaimers makes things easy for the plan administrator. The Massachusetts statute requires that a copy of the disclaimer must be delivered to the person or entity "having custody or possession of the property" (in this case, the trustee of the plan), thus eliminating the concern that the plan administrator would have to go out searching for extraneous documents. Ch. 191A, § 5, third paragraph. Also, the statute excuses the holder of the property if the holder distributed the property before receiving the disclaimer, and provides that the property-holder has no liability for "any good faith distribution or other disposition made in reliance upon a disclaimer" that has been delivered to it in accordance with Ch. 191A, § 5, "if the form of the disclaimer is in accordance with the requirements of" Ch. 191A, § 4. Ch. 191A, § 6, first paragraph.

By spelling out these reasonable procedures and limitations of liability, the Massachusetts statute functions as part of the plan document, in a manner far preferable to relying on an undefined "federal common law waiver" whose requirements only the Supreme Court can ascertain and which provides no explicit limitations of liability. This effect buttresses the wisdom of the plan document's reliance on Massachusetts law to the extent the same is not preempted by ERISA. The plan document gives the plan administrator the protections of the Massachusetts disclaimer statute, provided its procedures are followed.

Thus, honoring a beneficiary's disclaimer would be consistent with, even required by, the plan document, since the plan is required to follow Massachusetts law (to the extent not inconsistent with ERISA) and Massachusetts law permits beneficiaries to disclaim.

12/08: Worker, Retiree, and Employer Recovery Act of 2008 Suspends RMDs for 2009, Fixes Beneficiary Rollovers and Roth-rollover Glitch.

On December 11, 2008, Congress passed the "Worker, Retiree, and Employer Recovery Act of 2008" (WRERA). President Bush signed it into law on December 23. IRS Notice 2009-9, 2009-5 I.R.B. 419, provides guidance on the new law, as does Notice 2009-82 (discussed at "9/09: IRS Notice 2009-82, 2009-41 I.R.B. *** (9/24/09) Provides Guidance on Suspension of RMDs, Extends Rollover Deadline to 11/30/09 for Certain 2009 Distributions," earlier in this outline). Though most of the new law deals with how employers fund retirement plans, WRERA contains three provisions that directly affect participants and beneficiaries. I thank Sy Goldberg, Esq., Mike Jones, CPA, Barry Picker, CPA, and Kaye Thomas, Esq., for their input into this section.

EXECUTIVE SUMMARY:

Under WRERA,

✓ Minimum required distributions are suspended for 2009 for defined contribution plans, for both retirees and beneficiaries.

✓ Qualified plans will be required to allow beneficiary rollovers to inherited IRAs effective in 2010. Currently, offering such rollovers is optional for plans.

✓ The Pension Protection Act glitch that prohibited rollovers from Roth 401(k)s to Roth IRAs for high-income individuals has been fixed.

DETAILS:

I. MINIMUM REQUIRED DISTRIBUTIONS SUSPENDED FOR 2009 (DEFINED CONTRIBUTION PLANS ONLY)

For background on the minimum distribution rules and the one-year suspension of "RMDs" for the year 2009, see "9/09: IRS Notice 2009-82, 2009-41 I.R.B. *** (9/24/09) Provides Guidance on Suspension of RMDs, Extends Rollover Deadline to 11/30/09 for Certain 2009 Distributions" at the beginning of this "New Developments" outline.

Here's a look at how this change affects various clients, and some questions the suspension raises. The following paragraphs A–G deal only with IRAs that have not been annuitized. For other qualified defined contribution plans, the rules are the same as for IRAs. For defined benefit plans and IRAs that have been annuitized or that are annuitized in 2009, see paragraphs H–I.

A. Effect on over-age 70½ participants

An IRA owner ("participant") generally must start taking annual "minimum required distributions" (RMDs) from his traditional IRA or other retirement plan at age 70½ (or, in the case of 403(b) plans and some qualified retirement plans (QRPs) upon retirement if later). Each year's RMD is computed by dividing the prior year-end account balance by a factor from the IRS's Uniform Lifetime Table (ULT) (or in certain cases by a factor based on the joint life expectancy of the participant and his or her spouse). Under WRERA, participants may simply skip the 2009 RMD; there is no RMD for 2009.

Roland Example: Roland has an IRA. He computes his RMDs using the Uniform Lifetime Table. In 2008, he reached age 74. His 2008 factor from the ULT is 23.8. His 2008 RMD is the account balance as of 12/31/2007 divided by 23.8. Roland was required to withdraw that amount from his IRA in 2008. In 2009, he turns age 75, so his ULT factor for 2009 is 22.9. If it were not for WRERA, he would be required to withdraw 1/22.9th of the 12/31/2008 account balance by the end of 2009. Because of WRERA he can simply skip taking any distribution in 2009. He can take as much or as little as he wants to from the IRA in 2009. Any distribution he takes in 2009 will be includible in his gross income, to the same extent as in any other year; it just will not be considered a *required* distribution. In 2010, he'll pick up again with RMDs. He will attain age 76 on his 2010 birthday, so his factor that year will be 22.0. In 2010, he will have to withdraw 1/22nd of the 12/31/2009 account balance.

Note that qualified charitable distributions (direct transfers to a charity from an IRA; for details, see "10/08: Emergency Economic Stabilization Act of 2008 (a/k/a Troubled Asset Relief Program or "TARP") Extends "Qualified Charitable Distributions" from IRAs Through 2009, Plus Other Retirement Plan Tidbits," below) are still permitted for 2009 for IRA owners over age 70½. They just won't count towards the minimum required distribution because there IS no minimum required distribution!

B. Effect on participants turning age 70½

§ 401(a)(9)(H) deals with the RBD: "The required beginning date with respect to any individual shall be determined without regard to [new subparagraph § 401(a)(9)(H)] for purposes of applying [§ 401(a)(9)] for calendar years afer 2009." § 401(a)(9)(H)(ii)(I).

Let's see how this applies to IRAs. (When dealing with a 403(b) plan, or a 401(a) plan where the participant is not a five-percent owner of the sponsoring employer, for "age-70½-year" read "age-70½-year (or year of retirement, if later).")

1. Person who reached age 70½ in 2008

An IRA owner who attained age 70½ in 2008 can be said to have "accrued" the obligation to take an RMD for the year 2008 (although if he dies before his required beginning date the 2008 RMD "disappears"; it is no longer required). Normally, the deadline for taking any particular year's RMD is December 31 of that year, but a special rule applies for the first year: The deadline for the

age-70½-year RMD is April 1 of the following year. That deadline is called the required beginning date or RBD.

Minimum distributions must be distributed annually, beginning "not later than" the RBD, for the rest of the participant's life. § 401(a)(9)(A)(ii).

WRERA provides that the minimum distribution requirements of § 401(a)(9) "shall not apply" for calendar 2009. If this were applied literally, then *there would be no such thing as an RBD in 2009*, since § 401(a)(9)(A)(ii) does not apply in 2009. However, the new law apparently does NOT mean that a person who postponed his 2008 age-70½-year RMD into 2009 is excused from taking the 2008 RMD. IRS Notice 2009-9 provides that "The Act does not waive any 2008 RMDs, even for individuals who were eligible and chose to delay taking their 2008 RMD until April 2, 1009 (*e.g.*, retired employees and IRA owners who turned 70½ in 2008). These individuals must still take their full 2008 RMD by April 1, 2009."

This is consistent with the legislative history (Joint Committee on Taxation Report), which repeatedly states that under the new law no minimum distribution is required "for" the year 2009, and specifically provides, "However, the provision does not apply to any required minimum distribution for 2008 that is permitted to be made in 2009 by reason of an individual's required beginning date being April 1, 2009."

Matthew Example: Matthew reached age 70½ in 2008. He did not take any distributions from his IRA in 2008. He planned to take the 2008 RMD from the IRA in the first three months of 2009, before his RBD (April 1, 2009). He is still required to take that 2008 RMD by April 1, 2009. Only the RMD for the next year (2009) is eliminated.

2. <u>Person who reaches age 70½ in 2009</u>

Again, if § 401(a)(9)(H) is applied literally, it would appear that this individual must still take his 2009 RMD because the deadline for it is not until April 1, 2010, and § 401(a)(9) will be back in force in 2010. However, IRS Notice 2009-9 makes clear that this individual is excused from taking the 2009 distribution even though the deadline for it is in 2010: "The 2009 RMD waiver under the Act does apply to individuals who may be eligible to postpone taking their 2009 RMD until April 1, 2010…." This is again consistent with the legislative history (Joint Committee on Taxation Report), which states that "In the case of an individual whose required beginning date is April 1, 2010…the first year for which a minimum distribution is required under current law is 2009. Under the [new law], no distribution is required for 2009, and thus, no distribution will be required to be made by April 1, 2010."

Claire Example: Claire has an IRA. She turns age 70½ in 2009. She does not have to take an RMD in 2009, nor does she have to take a 2009 RMD by April 1, 2010. Her first RMD will be the one for her age 71½ year, which is 2010, and the deadline will be December 31, 2010.

3. <u>The "RBD" is not changed</u>

Even though a person turning age 70½ in 2009 does not have to take an RMD for 2009, April 1, 2010, will still be considered her RBD for other purposes—such as the determination of whether she died before or after her RBD for purposes of computing post-death RMDs to her beneficiaries.

The new code section provides that the RBD "with respect to any individual shall be determined without regard to this subparagraph for purposes of applying this paragraph for calendar years after 2009." § 401(a)(9)(H)(ii)(I).

C. RMDs suddenly become eligible rollover distributions

Required distributions are not eligible rollover distributions. § 402(c)(4)(B), § 408(d)(3)(E). For 2009, since there will be no required distributions from IRAs and defined contribution plans (other than 2008 RMDs postponed to April 1, 2009, by individuals turning age 70½ in 2008), almost all distributions from such plans will suddenly become eligible rollover distributions. (For list of distributions that are NOT eligible rollover distributions, see ¶ 2.6.02 of *Life and Death Planning for Retirement Benefits*.)

When a qualified plan makes an "eligible rollover distribution" to a participant, the plan is generally required: to give the participant certain notices (§ 402(f)); to transfer the distribution directly to an IRA for the participant (direct rollover) unless the participant has elected *out* of direct rollover treatment (§ 401(a)(31)); and to withhold 20 percent federal income tax from the distribution if the participant elects to take the distribution outright (§ 3405(c)).

In an apparent effort to ease the burden on plan administrators, WRERA makes a special exception for 2009. Any 2009 distribution that WOULD have been a minimum required distribution but for § 401(a)(9)(H) is NOT treated as an "eligible rollover distribution" for purposes of those three provisions. § 402(c)(4), as amended by WRERA.

This does not mean the participant cannot roll over the distribution. The distribution is still an eligible rollover distribution *for purposes of the participant's ability to roll it over under § 402(c)(1)(A)*. It's just that the employer does not have to withhold income taxes from the distribution, etc., if the distribution WOULD have been an RMD but for WRERA.

For more on rolling over nonrequired 2009 RMDs, see "9/09: IRS Notice 2009-82, 2009-41 I.R.B. *** (9/24/09) Provides Guidance on Suspension of RMDs, Extends Rollover Deadline to 11/30/09 for Certain 2009 Distributions," at the beginning of this outline.

D. Effect on beneficiaries: life expectancy payouts

If a participant dies before his RBD his benefits must be paid out either (i) in annual instalments over the life expectancy of his designated beneficiary, or (ii) by the end of the calendar year that contains the fifth anniversary of his date of death (5-year rule), or (iii) more rapidly. If he dies on or after his RBD, benefits must be paid out over the life expectancy of the designated beneficiary or of the participant; the life expectancy of the participant applies if there is no designated beneficiary or if the participant's life expectancy is longer than that of the beneficiary. For explanation of the RBD, and definitions of designated beneficiary and see-through trust, see, respectively, ¶ 1.4, ¶ 1.7, and ¶ 6.2 of *Life and Death Planning for Retirement Benefits*.

For ongoing <u>life expectancy payouts</u> to beneficiaries (regardless whether the payout is over the life expectancy of the beneficiary or of the participant), the effect of the suspension of RMDs is that the beneficiary can simply skip one year's RMD:

Phoebe Example: Phoebe inherited an IRA as designated beneficiary of her father who died in 2002. She is withdrawing the benefits in annual instalments over her life expectancy. She reached

age 58 on her birthday in 2003 (the year after the year of her father's death), so her life expectancy in that year (using the IRS's single life table) was 27.0 years. Thus, her required distribution for 2009 (the seventh year of the payout) would normally be 1/21st of the 12/31/2008 account balance. She can skip taking any distribution in 2009 if she wishes. In 2010, she'll resume taking required distributions just as if nothing had happened. In 2010, her RMD will be 1/20th of the 12/31/2009 account balance.

What if 2009 would have been the final year of the beneficiary's life expectancy? For example, what if 2009 were year 27 of Phoebe's 27-year payout? If it were not for WRERA, Phoebe would have had to withdraw 1/1th, or 100 percent, of the account in the final year of her fixed-term 27-year payout. Presumably, the effect of WRERA is that she will now have to withdraw 100 percent of the account no later than December 31, 2010, rather than December 31, 2009.

No IRS guidance has addressed this point as of 10/1/09.

E. Effect on beneficiaries: the 5-year rule.

The "5-year rule" always applies if the participant died before his RBD and did not leave his benefits to a "designated beneficiary" (generally an individual or qualifying "see-through trust"), or sometimes even when benefits ARE left to a designated beneficiary. See ¶ 1.5.07 of *Life and Death Planning for Retirement Benefits* regarding when the 5-year rule applies.

WRERA specifies how the 2009 suspension affects payouts under the 5-year rule: The 5-year period "shall be determined without regard to calendar year 2009." § 401(a)(9)(H)(ii)(II). Effectively, the "5-year rule" becomes the "6-year rule" for beneficiaries of decedents who die in the years 2004–2009. So, the new deadline for such beneficiaries is the end of the year that contains the sixth anniversary of the participant's death.

Claude Example: Claude died in 2004, before his required beginning date, leaving his traditional IRA to his estate. Because an estate is not a designated beneficiary, the 5-year rule applied, meaning that (but for WRERA) all amounts would have had to be distributed out of the IRA no later than 12/31/2009. Because of WRERA, that deadline is extended to 12/31/2010.

F. Effect on beneficiaries: Other issues

For the effect of WRERA on other post-death deadlines, see Part F of "9/09: IRS Notice 2009-82, 2009-41 I.R.B. *** (9/24/09) Provides Guidance on Suspension of RMDs, Extends Rollover Deadline to 11/30/09 for Certain 2009 Distributions" at the beginning of this outline.

G. Effect on Roth conversion eligibility

For one final year (2009), the ability to convert a traditional plan or IRA to a "Roth" IRA is limited to individuals whose adjusted gross income (AGI) does not exceed $100,000 (and whose filing status is not "married filing separately"). See § 408A(c)(3)(B), as in effect for years prior to 2010. AGI for this purpose excludes the gross income resulting from the conversion itself and (for the years 2005–2009) also excludes minimum required distributions from an IRA. See § 408A(c)(3)(C) as in effect for years prior to 2010 and Reg. § 1.408A-3, A-6.

However, in 2009 there will be no "required distributions" from the taxpayer's IRA (other than, in the case of a participant who turned age 70½ in 2008, a postponed 2008 RMD; these are still required distributions). Thus (except for postponed 2008 RMDs and for an IRA that has been annuitized; see paragraph I, below), this element of the determination of "AGI" for Roth conversion purposes is nugatory for 2009. Does this create a hardship for someone who was planning to convert in 2009 but still needs to take those (formerly) required IRA distributions for living expenses? No, because the problem is easily avoided:

Ruth Example: Ruth's AGI in 2009, before she does a Roth IRA conversion and before taking any distributions from her IRA, will be $90,000. Her minimum required IRA distribution in 2009 would normally be $30,000. She needs that $30,000 IRA distribution, because she's planning to live on that plus her $90,000 of other income. She also wants to convert $500,000 of her $2 million IRA to a Roth IRA in 2009. In a "normal" year, she could take the $30,000 RMD and her AGI (for Roth conversion purposes) would still be only $90,000, because the $30,000 IRA RMD would be disregarded. But this year if she takes $30,000 out of the traditional IRA it is NOT going to be "disregarded" for Roth conversion purposes because it is no longer a REQUIRED distribution. So what she should do instead is this: Convert $530,000 of her IRA to a Roth. That generates $530,000 of gross income, but that income is disregarded for purposes of determining her Roth-conversion eligibility. Then she can take $30,000 out of the Roth IRA tax-free for her living expenses. See Chapter 5 of *Life and Death Planning for Retirement Benefits* regarding taxable and tax-free distributions from Roth IRAs.

H. Effect on defined benefit plans

The new temporary Code section, § 401(a)(9)(H), does not apply to qualified plans that are defined benefit plans. Thus a defined benefit plan is *not* authorized to suspend paying minimum required distributions. Any participant or beneficiary who is receiving required distributions from a defined benefit plan is not authorized to stop taking them, or to roll over any such distributions received.

This distinction makes sense. The purpose of the WRERA provision is to provide relief to investors whose plan values collapsed in the market crash of 2008. The participant in a defined benefit plan does not need this relief because he/she does not take any investment risk. The investment risk falls only on the plan, and obviously Congress is not going to authorize pension plans to suspend payments to retirees and beneficiaries to give the plan relief!

Under the minimum distribution rules as they apply to defined benefit plans, once the annuity payout begins to the retiree or beneficiary, *all* distributions under the annuity payout are considered minimum required distributions. Reg. § 1.401(a)(9)-6, A-1(a).[See complete explanation of the defined benefit minimum distribution rules in Chapter 10 (¶ 10.2) of *Life and Death Planning for Retirement Benefits*.] Thus, such distributions are not eligible rollover distributions.

I. Effect on annuitized IRAs and DC plans

A participant can purchase an immediate annuity contract "inside" a defined contribution plan account or individual retirement account, as long as the contract requires distributions that comply with the minimum distribution rules. See Reg. § 1.401(a)(9)-6, A-1(a), and ¶ 10.2.03 of *Life*

and Death Planning for Retirement Benefits. Once an IRA or other defined contribution plan is thus "annuitized," the defined contribution minimum distribution rules cease to apply, and the defined benefit rules apply instead. All distributions under the annuity contract are considered nonrollable minimum required distributions, just like distributions from a defined benefit plan, even if the participant could have elected a slower annuity payout. Reg. § 1.401(a)(9)-6, A-1(a).

When a defined contribution plan is "annuitized," the participant's benefit is converted to an annuity through purchase of an insurance company annuity contract, and the investment risk is shifted from the participant to the insurance company. Logically, therefore, the suspension of minimum distribution rules that applies only to defined contribution plans should NOT apply to a defined contribution plan or IRA that has been annuitized. Annuitized defined contribution plans should be treated the same as qualified defined benefit plans. Possibly WRERA would be interpreted that way. However, it would be helpful if the IRS would clarify this point.

The answer (does it or doesn't it apply?) may not make much difference to most participants who have annuitized their IRAs. If a participant is receiving annuity payments from an immediate annuity contract purchased inside his IRA, he will not want to suspend those payments; doing so would require renegotiating the annuity contract, which typically is not even possible. Furthermore, if the annuity payments extend for life or for 10 or more years, the annuity distributions cannot be rolled over tax-free to another plan regardless of whether WRERA applies: "[A]ny distribution which is one of a series of substantially equal periodic payments" made annually or more often (1) over the life or life expectancy of the participant, (2) over the joint life or life expectancy of the participant and a designated beneficiary, or (3) over a "specified period of 10 years or more" is not an eligible rollover distribution *regardless* of whether it is a required distribution. § 402(c)(4)(A). Reg. § 1.402(c)-2, A-5.

However, it would be in the IRS's best interest to promptly clarify that the minimum distribution rules still do apply in 2009 to IRAs that have become subject to the defined benefit plan RMD rules, AND to the purchase of an immediate annuity inside an IRA in 2009. Otherwise, someone might attempt to use the 2009 suspension of the RMD rules to purchase an immediate annuity, using IRA funds, that (in a "normal" year) would violate the "incidental death benefit" rule:

Alex Example: Alex turns age 78 in 2009. She wants to minimize distributions from her $1 million IRA during her lifetime and pass as much of the value as possible to her daughter Ginger, age 55. In 2009, she purchases an annuity contract, inside the IRA, that pays her $100/year for her life, and after her death will pay $50,000 a year to Ginger for life. In a "normal" year this would violate the minimum distribution "incidental death benefit" rule. In a normal year, Alex could not legally purchase inside an IRA an annuity contract that would shift almost all the benefits into a survivor annuity for a much younger beneficiary. However, in 2009 there are no minimum distribution rules for IRAs, so Alex says she can buy whatever type of annuity she wants. After 2009, the rules come back into existence but by then the annuity contract has already been bought and it is in payout phase, so Alex doesn't care.

To head off game-playing by Alex and her ilk, the IRS should swiftly make it clear that the defined benefit plan minimum distribution rules DO apply in 2009 to the process of "annuitizing" a defined contribution plan. The WRERA suspension should be ONLY for individual account plans that STAY as such throughout 2009.

II. PLANS MUST OFFER BENEFICIARY ROLLOVERS STARTING IN 2010; NOTICE 2007-7 REVERSED

The Pension Protection Act of 2006 added § 402(c)(11) to the Code, thereby for the first time allowing any designated beneficiary to have qualified retirement plan benefits he had inherited transferred, via plan-to-plan transfer (direct rollover), to an "inherited IRA" (an IRA opened after the participant's death, in the name of the deceased participant payable to the beneficiary). This long-awaited reform finally enabled designated beneficiaries to benefit from the "life expectancy payout method" even though the qualified plan they had actually inherited did not permit that form of distribution.

To the consternation of the estate planning community, the IRS decreed (in Notice 2007-7, 2007-5 I.R.B. 395) that qualified plans were not required to allow such nonspouse beneficiary rollovers. Beneficiary rollovers were strictly optional with the plan, according to the IRS! This position eviscerated beneficiary rollovers, as many plans decided not to bother offering beneficiary rollovers, or to offer them only under certain circumstances.

In WRERA, Congress has now made it clear that plans MUST offer nonspouse beneficiary rollovers to designated beneficiaries; unfortunately (to give plans time to gear up for this change, presumably) the "fix" is not effective until 2010. Here is the change WRERA made:

§ 401(a)(31) is the section that imposes on qualified plans the obligation, if "the distributee of any eligible rollover distribution" so elects, to transfer such distribution directly to an eligible retirement plan selected by the distributee. For purposes of § 401(a)(31), "eligible rollover distribution" "has the meaning given such term by section 402(f)(2)(A)." Prior to WRERA, § 402(f)(2)(A) did not explicitly mention *beneficiary* rollovers. WRERA amends § 402(f)(2)(A) to add "Such term [i.e., eligible rollover distribution] shall include any distribution to a designated beneficiary which would be treated as an eligible rollover distribution by reason of" § 402(c)(11), if the requirements of § 402(c)(11) were satisfied, effective for years after 2009.

III. DRAC-TO-ROTH-IRA ROLLOVERS ALLOWED FOR HIGH-INCOME EMPLOYEES

Prior to 2008, only IRAs, and not other kinds of retirement plans, could be "converted" (rolled over) into Roth IRAs. So, to "convert" money in a qualified plan to Roth status, the participant first had to move the money from the QRP into a traditional IRA, because direct transfers to a Roth IRA from a QRP were not permitted. (See Chapter 5 of *Life and Death Planning for Retirement Benefits* regarding all aspects of Roth IRA "conversions.")

Beginning in 2008, that changed, and direct rollovers from a qualified plan to a Roth IRA were permitted under § 408A(e)(1)(B). In order to make clear that the income and filing status limitations on Roth IRA conversions also applied to these direct plan-to-Roth-IRA conversions, Congress provided that no rollover to a Roth IRA from any eligible plan (other than a Roth IRA) was allowed if the taxpayer's adjusted gross income exceeded $100,000 (or if the taxpayer was "married filing separately"). See § 408A(c)(3)(B), as originally enacted to be effective for the years 2008–2009. Unfortunately Congress failed to notice that the way it had worded this section, NO money could be rolled from a QRP to a Roth IRA by an individual who exceeded the income limit (or was married filing separately)…not even from a designated Roth account (DRAC; also called "Roth 401(k)")! This made no sense…a rollover from a DRAC to a Roth IRA would not be a

"conversion" of the rolled funds since they were ALREADY in a Roth-type account prior to the rollover.

WRERA fixed this glitch by adding the following sentence to § 408A(c)(3)(B), effective for the years 2008 and 2009: "this subparagraph shall not apply to a qualified rollover contribution from a Roth IRA or to a qualified rollover contribution from a designated Roth account which is a rollover contribution described in" § 402A(c)(3)(A). Accordingly, a participant in a designated Roth account can now roll that money directly to a Roth IRA regardless of his or her income level or filing status.

10/08: Emergency Economic Stabilization Act of 2008 (a/k/a Troubled Asset Relief Program or "TARP") Extends "Qualified Charitable Distributions" from IRAs Through 2009, Plus Other Retirement Plan Tidbits

On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act of 2008 (also known as the "Bailout Bill") into law. EESA 2008 contains some tidbits dealing with retirement plans: renewing "qualified charitable contributions" from IRAs for 2008–2009; allowing the government to purchase "troubled assets" from certain types of plans; and permitting recipients of settlements in the Exxon Valdez litigation to contribute up to $100,000 to a retirement plan.

The Pension Protection Act of 2006 added § 402(c)(11) to the Code, thereby creating the extremely popular "qualified charitable contribution" (QCD), under which an individual could transfer up to $100,000 from the pre-tax money in his IRA directly to a charity. The transfer would "count" as a distribution for minimum required distribution purposes under § 401(a)(9), but would not be included in the individual's gross income.

§ 402(c)(11) contained several restrictions (for example, QCDs were limited to individuals over age 70½, transfers could not be made to a split-interest charitable trust, etc.), and also provided that QCDs were permitted only in tax years 2006 and 2007.

EESA 2008 keeps all of the original restrictions, but extends the availability of QCDs to two additional tax years, 2008 and 2009. Thus, participants over age 70½ can make charitable contributions in 2008 and 2009 directly from their IRAs, as was true in 2006 and 2007. A beneficiary can also make QCDs from an inherited IRA, if the beneficiary is over age 70½.

Kudos to Barry Picker, CPA, who told his clients throughout 2008 that they should continue to make charitable contributions directly from their IRAs, since Congress just might do exactly what it has done, namely, retroactively "bless" 2008 QCDs already made.

The main purposes of EESA 2008 was to enact the "Troubled Asset Relief Program" (TARP). Trouble assets are defined (in Section 3(9) of the law) as pre-March 14, 2008, mortgages (and securities or other instruments based on such mortgages) the purchase of which the Secretary determines "promotes financial market stability"; plus other types of financial instruments the purchase of which the Secretary determines (in consultation with the Federal Reserve) would promote financial market stability.

Under Title I, Section 103(a)(8), in carrying out its program of purchasing troubled assets, the government is to take into consideration, among other things, the goal of "protecting the retirement security of Americans" by purchasing troubled assets held "by or on behalf of" certain types of retirement plans, namely: qualified plans (§ 401); 403(a) and 403(b) plans and contracts; and governmental 457 plans.

IRAs and Roth IRAs are NOT among the permitted sellers of troubled assets. So if your IRA is stuck with a bunch of troubled mortgages or mortgage-backed securities consider rolling them over to your 401(k) plan, then call the Secretary of the Treasury and see if he wants to take them off your hands.

No federal legislation would be complete without a new type of retirement plan contribution. Section 504 of EESA 2008 permits certain recipients of settlements in the Exxon Valdez litigation to contribute up to $100,000 of their settlement to a retirement plan. The contribution can be made on a tax-deductible basis to any type of traditional retirement plan (including IRAs, QRPs, and 403 plans, but NOT a nongovermental 457 plan), or on a nondeductible basis to a Roth IRA.

10/1/08: ROBS?....or J-O-B-S? IRS Directive Addresses "Rollovers as Business Startups"

EXECUTIVE SUMMARY: For the first time, the IRS has addressed the use of an IRA rollover to a 401(k) plan to finance a startup business, a planning idea that has been promoted via a number of web sites. Apparently, there are now many new businesses that are up and running as a result of this innovative use of the retirement plan rules—with favorable IRS determination letters in hand. In a new directive to IRS personnel responsible for auditing retirement plans, the IRS signals it is hostile to this off-label use of rollover funds. Although the Service can't figure out exactly what is wrong with ROBS, it is nevertheless determined to end this creative and productive use of retirement plan benefits—*especially* if the entrepreneur uses his retirement plan to hire other people and create new jobs!

I. Background

In my seminar outline *The 188 Best & Worst Planning Ideas for Your Client's Retirement Benefits* [Downloadable for $39.95 from the website www.ataxplan.com], here's how I described this planning idea:

"**BEST? WORST? Proceed with caution! Finance your business with an IRA rollover.** Your small business needs capital. Your IRA has money, but your IRA cannot invest in your business because that would be a prohibited transaction. So instead, you have your business adopt an ESOP (Employee Stock Ownership Plan), the kind of qualified retirement plan that is specifically designed to invest in employer stock, then roll your IRA into that plan, and *voila* your rollover plan account can legally buy stock in your business. On its face, this Idea sounds plausible. The Tax Code DOES encourage ESOPs, and exempts ESOPs from all kinds of "prudent investment rules" that other retirement plans have to comply with, because Congress wants employees to own stock in the employer through their retirement plan…."

On October 1, 2008, the IRS finally reacted to this idea, issuing a "Memorandum" to the IRS Directors of, respectively, Employee Plans Examinations and Employee Plans Rulings & Agreements. The memo's author is Michael D. Julianelle, Director of Employee Plans, in the Tax Exempt and Government Entities Division of the Service. The subject of the memo is "Guidelines regarding rollovers as business start-ups," which the rest of the memo shortens to "ROBS." This acronym accurately telegraphs the IRS's hostility to the device.

The memo is posted at: http://www.irs.gov/pub/irs-tege/rollover_guidelines.pdf.

II. How ROBS works

Here is how Mr. Julianelle's memo describes the idea in question. An individual (let's call him "Entrepreneur") wants to start a business. The money he needs for seed capital for his new business is currently sitting inside his IRA.

At this point, the IRS thinks, the proper way for Entrepreneur to access that money is to liquidate the account, paying income tax (plus 10% penalty if Entrepreneur is under age 59½) on the entire balance, and using what's left over to start his business. Instead, greedy Entrepreneur does the following. He forms a new "C" corporation, which authorizes but does not yet issue some stock. The corporation adopts a plain vanilla off-the-shelf prototype 401(k) plan. The plan permits employees to roll funds over from their IRAs into this plan. The plan either originally or via an amendment authorizes employee rollover accounts to be up to 100% invested in stock of the employer. Entrepreneur becomes the sole employee of the new corporation.

Next, Entrepreneur rolls over his IRA balance to his rollover account in the new 401(k) plan. The money in the 401(k) account is then transferred to the corporation in exchange for all of the corporation's capital stock. Immediately following this transaction, the corporation has only one shareholder (the 401(k) plan—specifically, Entrepreneur's rollover account in the 401(k) plan), and the corporation has in its bank account all the cash that formerly resided in Entrepreneur's IRA. The corporation uses that cash to buy a franchise, buy equipment, rent space, hire employees, pay a fee to the promoter who arranged the transaction, and open for business. In many cases, no other plan participant is ever offered the option to buy employer stock in his plan account.

The IRS memo describes ROBS as "a retirement plan design that appears to operate primarily to transact in employer stock, resulting in the avoidance of taxes otherwise applicable to distributions from tax-deferred accumulation accounts." The Director then proceeds to analyze every issue he can think of as a tool to defeat the ROBS plan.

III. Nothing illegal "per se" here, so the IRS will examine operation

The IRS concedes that the new business's 401(k) plan, on its face, is a qualified plan. There is nothing inherently wrong with either the plan document or the transaction whereby the plan acquires the corporation's stock. However even though these transactions "would otherwise serve legitimate tax and business planning needs," they are still "questionable," because "they may serve solely to enable one individual's exchange of tax-deferred assets for currently available funds," using a qualified plan's investment in employer stock as a medium. The "primary purpose appears to be to provide funding for the establishment of a business." ROBS are designed to allow a business to "retrieve" tax-exempt funds in exchange for stock, "simultaneously avoiding" otherwise applicable taxes "that would ordinarily apply to the transaction."

Since the form of the transaction is not necessarily "non-compliant per se," the Director says if we're going to knock these plans off, it will have to be through some defect in the operation or administration of the plan, on a case-by-case basis. The Director gives his troops a list of defects to look for and "develop" in their audits of these transactions. The memo recipients are directed to "cascade this memorandum" to IRS case managers and technical staff "as appropriate."

Despite listing several potential anti-ROBS lines of attack, the Director concedes that most of them are weak…but adds, hopefully, that the Service is cooperating with the Department of Labor on this project. Perhaps DOL will succeed in destroying these new businesses, even if IRS fails.

The Service has "opened a specific examination project" on ROBS plans, "and found *significant disqualifying operational* defects in most." Emphasis added. Despite this bold statement, the memo in fact discusses only minor or arguable operational defects in some ROBS plans. Let's see what the IRS thinks it has here.

IV. Plan operation: Low-hanging fruit

Some of the businesses started using the IRA rollover plan neglected basic rules of retirement plan operation. The IRS will not have much trouble fining and/or disqualifying these plans. However, that would be true of *any* plan that made these mistakes—whether initially funded with an IRA rollover used to buy company stock or funded in a more conventional manner. The defects the IRS mentions that I would put in this category are:

- Employees are never notified of the existence of the plan, thus causing a violation of the rule that a retirement plan must "be a definite, written program communicated to employees."

- Although the form of the plan is a 401(k) plan, in some cases it appears that employees were not offered salary reduction elections, thus violating § 401(k)(2)(D).

- Plan assets are used for personal expenses. E.g., under one plan, some of the money the corporation received in exchange for its stock was used to buy an RV for the Entrepreneur.

- Some plans may have failed to file Form 5500 or 5500EZ.

But if the plan properly notified all employees and offered them the salary reduction option, filed its reports on time, and didn't use plan funds to buy personal recreational vehicles, the IRS will get onto some thin ice in trying to take these plans down.

V. IRS's procedural difficulties

The IRS admits it is late getting about this project. Not being an ERISA maven myself, I don't understand all of the IRS's procedural problems or strategies, but it seems that the IRS is hamstrung in going after some of the plans because they were adopted under a pre-approved "Master & Prototype" arrangement. Apparently the IRS has to wait two years after approving an "M&P" plan before it can revoke its approval. So while waiting for that clock to run out, it is collecting the names of ROBS promoters from the internet and its own records. The Director is "confident" that the IRS will have a list of most if not all of one promoter's clients "once the two-year window closes on April 30, 2010." That gives the Service plenty of time to fine tune its weapons for destroying these entrepreneurs, their businesses, their retirement plans, and the promoter in what will apparently be the bloody spring of 2010.

Another problem the IRS has is that the statute of limitations has run or may soon run on the stock/assets swap deals of some early ROBS arrangements. Under the IRS's rules, there can be one-

time violations and continuing or ongoing violations. The statute of limitations doesn't start to run on an ongoing violation until it stops being "ongoing."

But the rollover account's purchase of corporate stock would be considered a one-time type of violation (if it *is* a violation), no longer attack-able after the applicable statute of limitations has run. Accordingly, the Director urges his troops to ferret out these cases as soon as possible; to pounce quickly on those that are close to the end of the three-year statute period; and to figure out how to get the six-year statute to apply (based on nondisclosure of the stock transaction) rather than the three-year statute if the three-year statute has already run.

VI. Arguments the IRS mostly concedes in advance

Here are two arguments the Director suggests might be used on a "case by case" basis to destroy particular plans, but which he concedes are generally not going to be useful in the anti-ROBS campaign:

Permanence: One of the thirty-plus requirements a qualified retirement plan must meet to stay "qualified" is permanence. Theoretically, a plan that receives only one contribution (Entrepreneur's IRA rollover) in its entire history would appear very vulnerable on the "permanency" test. It would certainly seem advisable for entrepreneurs using this program to make sure the corporation contributes to the plan for at least a couple of years.

But the IRS concedes that it just about never goes after plans on this issue. Plans are usually started, or dropped, for legitimate business reasons, and it's tough for the IRS to develop a case on such a subjective criterion. Furthermore, if the plan is strictly a "cash or deferred arrangement" (CODA), to be funded solely by employees' voluntary salary reduction contributions, the IRS can't argue lack of permanence simply because the employees choose not to make contributions; in such cases "the issue of permanence is resolvable in favor of the employer."

Exclusive benefit: A qualified plan must be operated for the "exclusive benefit" of the employees and beneficiaries. The IRS does not see any line of attack here, as long as the money paid to the corporation from the plan is "in fact used to purchase legitimate business [sic] or franchises, plus attendant start-up costs." The Service concedes that "the typical ROBS design does not violate the exclusive benefit requirement in form," and therefore suggests that this weapon be used against the few ROBS plans where the funds transferred to the corporation were used for "purely non-business expenses," or were used to finance a business not for the participant himself but for someone else (e.g. his spouse).

VII. Prohibited transactions: Stock sale

The Director wants to say that the plan's purchase of stock from the employer corporation is a prohibited transaction (PT). ERISA exempts a plan's acquisition of employer stock from the PT rules, but *only if* (among other requirements) the sale is for "adequate consideration." Is the ROBS stock sale transaction for "adequate consideration?"

The Director's "aha, gotcha!" finding on this subject is that, in every ROBS transaction, the sale price for the stock of the new corporation is always, coincidentally, *exactly equal to the amount of the rollover account that is being exchanged for the stock*! "An appraisal may be created to

substantiate this value, but it is often devoid of supportive analysis." Somehow, the IRS thinks, the stock cannot possibly be worth exactly what the plan paid for it *every single time*!

This argument will prove a dry hole for the IRS. When a start-up company issues its first and only shares of capital stock for cash, the only possible conclusion is that the stock and the cash are equal in value. Right after the transaction the corporation holds all the cash that five minutes ago was in the retirement plan, and the retirement plan owns all the stock. It's not like there is some other stockholder who might be indirectly benefitting from the infusion of cash; the plan is the sole stockholder. It's not like the corporation has some other assets or liabilities that might affect the valuation of the newly-issued stock—the proceeds of the stock sale to the retirement plan are the only assets in the corporation. I don't see the IRS convincing any court that the IRS can come up with a better appraisal of a start-up company's initial issue of stock than "the stock is worth whatever was paid for it."

VIII. Prohibited transaction: Promoter fees

Under the standard ROBS transaction, the corporation will use part of the cash it raises from the stock sale to pay a fee to the promoter. The promoter sold the Entrepreneur on the idea, provided the prototype plan and other paperwork, and generally shepherded the transaction through all its steps. Is the indirect use of plan assets to pay the promoter's fee a PT? "Specialists will need to ascertain whether this is discernable from the facts presented on their examination," says the IRS Director. I leave it to the ERISA experts to analyze whether the IRS may have a winner with this argument, but I'm guessing this argument too is weak in view of the IRS's own language: "*If* the promoter meets these requirements, his status *may* rise to that of plan fiduciary," in which case "this payment *may* be a violation" of the PT rules.

IX. Discriminatory in benefits, rights, & features (BRF)

The IRS has apparently not found that these plans typically discriminate against rank and file employees in coverage or contributions; the employer may never make any contributions, but apparently when contributions *are* made they are allocated properly among all employees. So instead the IRS turns to whether the plan is discriminating in favor of "highly-compensated employees" (HCEs) through its failure to provide "benefits, rights, and features" (BRFs) in a nondiscriminatory manner. Such discrimination would be grounds for disqualifying the plan.

This is the IRS's "best" argument, and it is useful only against plans that have employees other than Entrepreneur himself and that do not in fact offer employer stock to rank and file employees.

In most (apparently not all) of the ROBS plans examined, the IRS finds that only Entrepreneur ever gets any employer stock allocated to his account. Other employees are never offered the opportunity to invest their rollover accounts in employer stock. In some cases, the plan amendment that was adopted permitting investment of rollover accounts in employer stock was deleted from the plan immediately after Entrepreneur's rollover account purchased all the capital stock of the corporation.

Though this looks fishy, the IRS faces obstacles in pursuing this line of attack:

- All the authorized stock has already been issued, so there is no stock left to sell to rank and file employees. It's not that the employer is denying stock to the employees; there just is no stock to sell them. But the IRS says its agents must examine "whether the transaction was structured to intentionally avoid BRF testing issues."

- Another problem for the IRS is the definition of HCE, which is basically a five-percent owner or someone who receives a certain level of compensation (minimum $80,000). In determining who is a five-percent owner, the Code provides that stock held in a qualified plan is *not* attributed to the participant in whose account it sits. So in the ROBS transaction, the corporation has no five-percent owners! It has no owners at all for this purpose, under the Code's definition. And, the IRS concedes, "in most of our cases, the amount of compensation being paid" to Entrepreneur "is *ostensibly* below" the $80,000 minimum level for an HCE, "at least for initial years." Emphasis added. So in many ROBS cases there are no HCEs to discriminate in favor of!

In its discussion of the HCE issue, the IRS hints darkly that these Entrepreneurs may be concealing their true compensation; maybe they really are earning more than $80,000. In other words, the IRS is suggesting that entrepreneurs who use ROBS must all be tax criminals. At this point, we begin to realize that the IRS simply hates these business owners and the promoters who helped them start their businesses.

> The suggestion on page 7 of the IRS Memorandum, without any apparent evidence, that business owners who use ROBS must be under-reporting their incomes is outrageous!

The IRS thinks discrimination-in-BRFs is its strongest argument. And this leads us to the conclusion of the memo, which, if anyone had stood back and read it unhindered by the blind anti-entrepreneurial prejudice of the bureaucrat, would have stopped the anti-ROBS project in its tracks: There can obviously be no "discrimination" problem if the Entrepreneur is the sole employee of the corporation. So IRS agents are instructed to "develop" the BRF-discrimination argument in ROBS cases *if there are other employees in the plan*, but not to bother pursuing it if the Entrepreneur is the sole employee!

In other words, if you use ROBS to start a business that actually *hires other people* and *creates jobs*, you will be crucified for not offering your employees the "opportunity" to invest their retirement accounts in employer stock. But if you used it to start a business that hires *only yourself*, that created no other new jobs for our nation and our economy, the IRS will let you alone!

HELLO-O-O-O-O?????

X. The problem with the IRS's approach

The IRS's approach is fundamentally flawed. The Director simply assumes that it is illegitimate to use an IRA rollover to finance a start-up business—that IRA funds must first be taxed

before they can properly be used for this purpose, and therefor his only task is to identify which particular Code sections can be used to hobble ROBS.

But rollovers are *supposed* to be tax-free. That's the whole *point* of rollovers: to allow "portability" of tax-deferred funds. And nowhere in the Code or anywhere else is it written that rollovers are ok only if they go to a plan that invests in marketable securities, and not ok if they are go to a plan that invests in employer stock.

The investment of 401(k) funds in employer stock is equally legitimate. That's the whole point of all the Code sections encouraging such investments and exempting them from the usual fiduciary and prohibited transaction rules.

Admittedly, ROBS represents a new use of the rollover and 401(k) plan. Traditionally, ESOPs have been used to spread ownership of the employer among all the employees; this use is seen at large companies such as Procter & Gamble. In contrast, with ROBS, the rank and file employees do not typically get any stock. Traditionally, also, ESOPs have been used to "cash out" the founder of the company, who sells his stock to the employees through the ESOP upon retirement. In contrast, with ROBS, the ESOP is being used to finance the *startup* of the business, not the owner's retirement.

But nowhere is it written that ESOPs MUST be so used, and nowhere is it written that a new business MUST be funded only with after-tax funds.

The IRS is trying to make up a new rule out of whole cloth because for some unknown reason it does not approve of this use of the IRA rollover or of the 401(k) plan, *even though* the transaction follows the Code's rules to the letter. ROBS is not an abusive use of retirement plan funds. If the IRS doesn't like ROBS, it should ask Congress to outlaw them. However, it seems unlikely that Congress would do so at a time when the use of retirement plan funds to start a new enterprise must be seen as a blessing to the nation.

The IRS needs to rethink its attitude to these plans. Instead of viewing them as ROBS, how about calling them J-O-B-S? I don't know what that stands for, but the point is we should applaud the promoters who have facilitated so many business startups with IRA rollovers and put the tax Code to good use for the economy. The Director of Employee Plans should come out and admit that there is nothing inherently wrong with this idea, and instruct his agents to audit these plans for the same issues as any other plan, rather than singling them out for special attack.

2009: Assorted New Developments Involving the Premature Distributions Penalty (§ 72(t))

Several new cases and IRS pronouncements shed light on the ever-fascinating 10 percent penalty ("extra tax") on retirement plan distributions taken before age 59½. The pattern? The IRS reaching and over-reaching to collect this penalty; confused taxpayers nailed by their own technical errors; and some long-awaited clarification.

A. What constitutes a "modification" of a SOSEPP?

One of the 13 (+/-) exceptions to the penalty is for payments that are part of a "series of substantially equal periodic payments" (SOSEPP). See ¶ 9.2 of *Life and Death Planning for Retirement Benefits* for the requirements of a valid SOSEPP, including how to set one up. The SOSEPP exception is lost if there is a "modification" of the series (other than by reason of death or

disability) before the later of the participant's reaching age 59½ and the fifth anniversary of the first payment in the series. See ¶ 9.3.01.

Another exception (applicable to IRAs only) is for distributions to pay higher education expenses. Can you combine two exceptions?

"Yes," says the Tax Court in *G.T. Benz v. Commissioner*, Dec. 57,810, 132 TC ***. In *Benz*, the participant was taking a SOSEPP. One year (during the no-modifications period) she *also* withdrew (in addition to her SOSEPP payment) additional distributions totaling $22,500 which were used to pay qualified higher education expenses for her son. The IRS (reaching and over-reaching) went after her, claiming that this was a modification of her SOSEPP.

The result of modifying a SOSEPP is that all payments in the series retroactively lose their qualification for the exception. Had the IRS prevailed, this woman would have owed the 10 percent penalty on all SOSEPP payments she had taken, though it appears in this case that the IRS was demanding the penalty with respect to only one year's SOSEPP payment. But the court said in effect that distributions that qualify for some other exception are *not* modifications of a SOSEPP, so Ms. Benz did not owe any penalty. This question has long had practitioners scratching their heads and it's nice to finally get an answer.

Other developments continue past trends:

In **PLR 2009-30053 (7/24/09)**, the participant ("P") was taking a SOSEPP and having income taxes withheld. One year the financial institution (IRA provider) failed to withhold the normal amount, then later made a "makeup" distribution to P to correct its error. The IRS ruled that this financial institution error and "makeup distribution" did NOT constitute a modification of the SOSEPP.

The IRS ruled in **PLR 2009-25044 (6/19/09)** that a participant's trustee-to-trustee transfer of her SOSEPP-supporting IRAs from one financial institution to another, solely for the purpose of changing the investments in the account, was a modification of the series. In this ruling, the SOSEPP-supporting IRA (IRA X) was commingled with funds from another IRA (IRA Y), not involved in the SOSEPP, when both were transferred into a new combined IRA, IRA Z, at the new financial institution. The ruling stated that the problem could not be corrected by unmingling the IRA Y funds and sending them back to IRA Y. It is not clear whether it was only the commingling that caused the IRS to rule this a modification; they base the ruling on the provision in Rev. Rul. 2002-62 prohibiting *any* nontaxable transfers in or out of the SOSEPP-supporting IRA.

However, in other PLRs the IRS *allowed* nontaxable transfers of the entire SOSEPP-supporting IRA to a different IRA at another financial institution (for investment reasons) *without* treating such transfers as a modification of the SOSEPP. See PLRs 2006-16046, 2006-31025. So is PLR 2009-25044 just another IRS flip-flop? Or was the negative holding in PLR 2009-25044 "really" based on the commingling, not the transfer, though it doesn't say so? We'll never know. That's the beauty of depending on bureaucratic whims for the safe conduct of your financial affairs. I can't wait until these guys are ruling on what treatment I can get for cancer!

B. GOTCHA! Typical taxpayer technical fouls

Is this any way to run an economy (or a tax system)? A major source of airline revenue is ticket change fees, when various circumstances force hapless customers to change their travel plans. The IRS gets big revenue from penalties when hapless taxpayers mis-step the ridiculously complicated and pointless rules surrounding the 10 percent penalty.

Withdrawing for the right reason *but from the wrong type of plan* is a perennial favorite technical foul. In *R.T. Bailey*, T.C. Summary 2009-37, a woman withdrew money from her 401(k) plan to finance a "first time home purchase." GOTCHA!!!! That exception is *only* for IRAs, not qualified plans! We don't want taxpayers using their qualified plans to finance home purchases; that would be terrible! This is a distinction only a Congressman could love.

Another favorite: Withdrawing for the right reason *but at the wrong time*. In *Evers v. Commissioner*, T.C. Summ. Op. 2008-140 (11/3/08), a husband and wife borrowed money to pay medical expenses in 2003. In 2004, while still both under the age of 59½, they withdrew money from their QRP to pay off the 2003 loan. GOTCHA!!!! In order to qualify for the medical expense exception, the distribution must be matched to deductible medical expenses paid *in the same year as the distribution*. While the couple's medical expenses in 2003 may have been deductible (if and to the extent such expenses exceeded 7.5% of their 2003 AGI), the couple had no deductible medical expenses in 2004, and paying off the loan in 2004 doesn't count as a medical expense even if the loan proceeds were used in a prior year to pay deductible medical expenses! Hey, Mr. and Mrs. Evers, too bad about those big medical bills: Penalty owed: $1,625.

C. Clarification on health insurance for self employed

An unemployed individual can take penalty-free distributions from his IRA (but NOT from a qualified plan or 403(b) arrangement!) to pay health insurance premiums. § 72(t)(2)(D). The test of being unemployed is being eligible for unemployment benefits for certain specified periods. Though this exception is supposed to apply to the self-employed as well as to "common law" employees, there was no guidance until this year regarding how a self-employed person could qualify for the exception, since the self-employed never qualify for unemployment compensation.

The IRS has stepped into the breach. CCA 2009-20052 says that: "A self-employed individual shall be treated as having satisfied the requirement of section 72(t)(2)(D)(i)(I)…) if, under Federal or State law, the individual would have received unemployment compensation but for the fact that the individual was self-employed. Sec. 72(t)(2)(D)(iii). Thus, if the taxpayer is self-employed, the taxpayer has to present evidence that he would have been eligible to receive any Federal or State unemployment compensation, but for the fact that the taxpayer was self employed."

D. The disability exception

Why do taxpayers keep litigating these questions when there is no hope?

There is an exception to the 10 percent penalty for total and permanent disability…it's well settled that this exception does not apply to a temporary condition. And the court confirmed this for *S.E. Machlay* (T.C. Summary 2009-21) who was fired in 1993, received medical treatment, was reinstated in her job, was frequently absent from work "due to her condition," quit the job in 2005, withdrew all the money from her pension plan ($85,557), and found new employment in 2006. There was a "lack of evidence" that she suffered from any *permanent irremediable* medical condition and she had to pay the penalty.

No case or ruling has found depression a sufficiently disabling condition to qualify for the exception, and *Kowsh v. Commissioner*, T.C. Memo 2008-204 (8/28/08) continues that trend. Mr. Kowsh's case was particularly weak because he offered no documentary evidence to corroborate that he even had depression.

So no surprises there. Now for the ULTIMATE in IRS greed and over-reaching. Early in 2005 Edward Dart ceased working due to disability (his wife was already disabled). He applied for Social Security disability benefits in April 2005. On Nov. 11, 2005, he withdrew $38,888 from his QRP to pay mounting bills. The Social Security Administration approved his application, sending a letter with the statement “We found that you became disabled under our rules on December 2, 2005.” Note that 12/2/05 is a few weeks after the date of the retirement plan distribution. Passing the Social Security test for “disability” automatically qualifies you for the disability exception under § 72(t). But the IRS went after Mr. Dart claiming that his disability didn’t start until 12/2/05, three weeks after the plan distribution! The court gave the IRS the raspberry on this one, because the evidence showed that Mr. Dart’s disability began long before 11/11/05, and the Social Security Administration approval was based on the facts as they existed when he had applied, back in April 2005.

Doesn’t the IRS collect enough penalties based on technical fouls and innocent mistakes by taxpayers, without having to invent some new ones? The idea that being disabled within the meaning of the Social Security guidelines depends on the date your application is approved, not the date your condition begins, is simply outrageous.

2008–2009: IRS Private Letter Rulings of Interest

Private Letter Rulings (PLRs) related to estate and distribution planning for retirement benefits continue to flow from the IRS. “P” means the participant. “S” means the participant’s spouse.

I. INVESTMENT ISSUES FOR IRAS

A. PLRs 2008-52034 (12/26/08), 2008-50054 (12/12/08), 2009-21039 (5/22/09): Punitive damages and hypothetical interest may not be contributed to IRA

When investment losses inside an IRA are caused by the malfeasance of a financial advisor or institution, and the participant wins a financial judgment or settlement from the advisor or institution, the participant can contribute the money he/she won back into the IRA without having such contribution be subject to the normal limits on IRA contributions—provided IRS requirements are met. The IRS will treat the contribution as a “replacement payment” (rather than as a new contribution, subject to the limits of § 219) “only if the payments are made in order to restore some or all of the IRA losses resulting from breach of fiduciary duty, fraud, or federal or state securities violations (such as payments made pursuant to a court-approved settlement or independent third-party arbitration or mediation award).” Payments to an IRA made to make up for losses due to market fluctuations or poor investment returns do not qualify for this favorable treatment.

PLR 2008-52034 illustrates this concept. The participant’s IRA experienced losses of 50 percent due to the breach of fiduciary duty by a financial advisor, who “arbitrarily” changed the investment objective of the IRA and invested it (without authority) in “some of the most volatile and speculative securities created,” then engaged in “day-trading” to try to recover some of the losses. PLR 2008-50054 appears to be identical. In each case, the advisor’s actions led to an arbitration award which granted the participant the following amounts:

A Compensatory damages (compensating P for the losses caused by the FA's violations)
B Punitive damages
C Costs of litigation
D Attorneys' fees

N Total award

The total award (amount N) was paid to P's attorney H. The actual costs and attorney's fees exceeded amounts C plus D by amount E, so Attorney H transmitted to P amount "F," which was equal to amount N minus amounts C, D and E. P placed amount F in an IRA within 60 days after receiving it from Attorney H.

The IRS ruled that P was NOT entitled to roll over the punitive damages (or the amounts awarded for attorneys' fees and costs). So in order to grant a favorable ruling on the rollover, the IRS required P to remove from the rollover IRA everything *except* "Amount A" (compensatory damages), minus "the pro-rata portion of the difference between the actual and awarded attorneys' fees and costs attributable thereto," plus income thereon. What's clear here is that only compensatory damages (not punitive damages, and not any portion of the award attributable to attorneys' fees and costs) may be rolled over as "replacement contribution" to an IRA. It's also clear that P was not required to remove from the IRA the income attributable to the amount that he was entitled to contribute.

What is not so clear is why P could not roll over what might be called the "excess" attorneys' fees attributable to his recovery (Amount E). The ruling says this fee "is part of Taxpayer A's costs of recovery, and, as such, may not be contributed to IRA X as a replacement payment."

PLR 2009-21039 (5/22/09) also dealt with the "rollover" contribution of a restorative payment. Due to an employee's malfeasance, unauthorized distributions were taken from P's IRA. The employee's firm entered into a settlement with P, whereby the firm would pay P "amount D," the "result of an arm's length settlement of a good faith claim." As such, the IRS would allow P to roll Amount D back into the IRA as a "restorative payment." However, P was not allowed to add to the rollover "a reasonable amount of interest accrued" during the "distributive period," because "restorative payments" are limited to the amount of the loss caused by breach of fiduciary duty.

B. IRAs owning stock in S Corporations

An IRA is not legally prohibited from owning stock in an "S" corporation; holding such stock in an IRA will not disqualify the IRA! However, an S corporation is prohibited from having an IRA as a stockholder…so holding S stock inside an IRA would disqualify the S corporation! (There is one exception to that rule, applicable to certain banks, for S stock held since prior to October 22, 2004; § 1361(c)(2)(A)(vi).) Unfortunately, some businesses aren't aware of this rule, and issue S corp. stock to IRAs. Fortunately for them, there is a procedure for remedying the problem when it happened by mistake; the corrective procedure involves applying to the IRS for mercy, and undergoing elaborate consequences whereby the individual IRA owners pick up their IRAs' shares of the S corp.'s income (but don't get to deduct the losses), and the stock is removed from the IRAs. For examples of these corrective procedures, see PLRs 2008-02008 (1/11/08), 2007-07002 (2/15/08), 2008-17013 (4/25/08), 2008-25029 (6/20/08), **2009-06015 (2/6/09)** and **2009-17008 (4/24/09)**.

C. Nontraditional IRA investments

Like I've said all along, owning real estate (or other nonvanilla investments) inside an IRA is not illegal…it just carries a high risk of unwanted complications.

One of the most common mistakes that turns up in private letter rulings: Participant wants to invest his IRA in a hedge fund, private equity fund, real estate or other nontraditional IRA investments. So he takes money out of his IRA and sends a check *to the partnership*, thinking (based on misleading advice from a financial advisor) this was how to roll over to a new "self-directed" IRA. But IRA funds must be held by a bank as custodian or trustee. The *bank* can invest the funds in a partnership, but title must be held in the name of "*Bank* as custodian for John Doe IRA."

If there is no bank custodian or trustee involved, and the partnership simply holds the funds for the account of "John Doe IRA," the funds are not in an IRA, and the "rolled" distribution is in fact taxable. That's pretty much what happened in **PLRs 2009-19066 (5/8/09)** and **2009-21038 (5/22/09).** The IRS allowed the participants in these rulings to roll their money back into an IRA, waiving the 60-day deadline, due to their financial advisors' mistakes.

II. CLEANING THINGS UP AFTER THE PARTICIPANT'S DEATH

A. Reformations and other state court proceedings

There have now been five PLRs involving beneficiary designation forms that were reformed by state court action after the death of the participant, PLRs 2006-16039 and 2006-16040 (both dealing with the same beneficiary designation form), 2006-52028, 2007-07158, and 2007-42026. Only three of these (2006-16039, 2006-16040, and 2007-42026) dealt with the *minimum distribution* effects of the reformation, and unfortunately the newest of these three may cancel out the favorable language of the first two.

The first two were **PLRs 2006-16039** and **2006-16040** (Jan. 25, 2006), in which the participant had had an IRA which 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 mistakenly did not insert the name of any contingent beneficiary and apparently the participant didn't notice this mistake when he signed the form. He died; his wife survived him for only a short time, and her estate disclaimed the benefits. A court reformed the beneficiary designation form to name the daughters as contingent beneficiaries, and the IRS ruled that the daughters would be treated as the decedent's "designated beneficiaries" for minimum distribution purposes.

In **PLR 2007-42026** (10/19/07), however, the IRS refused to honor a post-death reformation for RMD purposes. The participant (P) 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 P's death. Unlike in PLRs 2006-16039 and 16040, where the financial institution testified that its own error had caused the contingent beneficiary line to be left blank, in PLR 2007-42026 the IRA provider had actually mailed P a new form to name his daughter as beneficiary of the IRA after P's wife died, but P never signed it. Because there was no named beneficiary, the IRA would pass to P's estate as beneficiary; however, two years after P's death a court order was obtained reforming the beneficiary designation

to name the daughter as beneficiary. The daughter sought, but the IRS refused to grant, a ruling that she should be treated as P's "designated beneficiary" for minimum distribution purposes.

One could say that this negative ruling simply reflects the fact difference between the Jan. 2006 PLRs and the Oct. 2007 PLR. In the 2006 rulings, there was admitted financial institution error; in the 2007 ruling there was no financial institution error. In the 2006 rulings, there was testimony that P intended to name his daughters as contingent beneficiary; in the 2007 rulings, there does not seem to have been any evidence that P intended to name his daughter as contingent beneficiary (at least the PLR doesn't mention any). In the 2006 rulings, there was an apparently speedier court action in reforming the B.D. form; in the 2007 ruling, the court action seems to have come rather late in the game (though the IRS has twice blessed delayed *trust* reformations, occurring in one case two years after P's death in another three years; see PLRs 2007-04033 and 2007-03047, discussed at IV(D), below). But is the IRS then second-guessing the court, and saying it shouldn't have granted the reformation? That's not what the ruling says. The language of the ruling suggests rather that the IRS is closing the door on post-death reformations as a way to improve the designated beneficiary situation for RMD purposes. From the PLR:

"We believe that the Code and regulations are clear as to the requirements of naming a designated beneficiary and the timing of the beneficiary designation and do not permit the exception sought here. Section 1.401(a)(9)-4, Q&A-1 of the Regulations provides that a designated beneficiary is an individual designated as a beneficiary under the terms of the IRA or by an affirmative election of the IRA owner. Moreover, '[t]he fact that an [IRA owner's] interest passes to a certain individual under a will or under otherwise applicable state law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the [IRA]'. Under Q&A-4 of section 1.401(a)(9)-4 of the Regulations, only individuals who are beneficiaries under the IRA on the IRA owner's death, and who remain beneficiaries as of September 30 of the following year, can be 'designated beneficiaries' for purposes of section 401(a)(9). As described in the Preamble to these regulations, '[t]he period between death and the beneficiary determination date is a period during which beneficiaries can be eliminated but not replaced with a beneficiary not designated under the [IRA] as of the date of death'. Preamble to section 1.401(a)(9) of the Regulations, T.D. 8987 (04/16/2002) ('Determination of the Designated Beneficiary')....

"Thus, the statute and applicable regulations clearly describe the method to determine the designated beneficiary and provide a specific mechanism to achieve a post-required beginning date payout period longer than the IRA owners remaining life expectancy - the IRA owner merely has to ensure that at least one individual is designated as beneficiary under the IRA as of his date of death. In this case, no living person was named, as either primary or contingent beneficiary, on that date. Accordingly, under the foregoing rules, Taxpayer A must be treated as having no designated beneficiary as of his death under section 401(a)(9) and the timing of distributions under the IRA must reflect this...."

This ruling interrupts the prior longstanding trend of the IRS's apparent strong approval of post-death "cleanup" actions; see (in addition to the Jan. 2006 PLRs discussed above) earlier rulings approving trust reformations to create "see-through trusts" out of trusts that might not otherwise qualify as such or to permit spousal rollover, such as: PLRs 2006-08032; 2007-03047 and 2007-04033; and 2007-40018 (discussed at III(B), below).

Though the outlook is cloudy for reformation of a beneficiary designation form as a way to improve the minimum distribution results, it still can be useful for other "cleanup" jobs, such as undoing a designation signed under "undue influence" (PLR 2007-07158) or redirecting benefits

from an estate (the named beneficiary) to a trust (that was the residuary beneficiary of the estate) (see PLR 2006-52028, 9/13/06).

PLR 2008-46028 (11/14/08) involved a state court's interpretation of a beneficiary designation form rather than a reformation. The decedent's IRA beneficiary designation form said only, in the space provided for the name of the beneficiary, "as stated in wills." P's will left all of P's estate (aside from some specific bequests of tangible personal property) to "Trust T". This form of beneficiary designation suggests that the benefits should be paid to the beneficiary(ies) named in the decedent's duly probated will (i.e., in this case, "Trust T") but prudence would suggest that a state court order be obtained confirming this meaning. P's executor sought and obtained a state court order.

Perhaps unfortunately, rather than simply obtaining a state court order confirming that the meaning of the beneficiary designation form was that the beneficiary of the IRA was Trust T, the executor went further. Trust T provided for disposition of the entire trust (other than specific gifts of certain real estate) to eight individuals in specified percentages. P's executor sought and obtained a state court order ruling that the eight individuals should be treated as named directly as beneficiaries by P, that the individuals were "designated beneficiaries" of P's IRA within the meaning of the Code and regulations, and that the "separate accounts" rule was applicable in determining the applicable distribution periods for each beneficiary's share of the benefits!

Not only did this counteract the clear sense of the beneficiary designation form (which pointed to the beneficiary of the WILL, not the beneficiaries of the TRUST), it put the state court in a position of interpreting the minimum distribution regulations (not just the beneficiary designation form and will). Furthermore, it attempted an end-run around the IRS's rule that (even if a trust IS named properly as beneficiary), all trust beneficiaries must use the life expectancy of the OLDEST trust beneficiary—separate accounts don't apply. My sense is the IRS regarded all this as encroaching on IRS turf plus over-reaching, and it got the IRS's back up. The IRS simply refused to accept the state court order in any respect. The IRS put in its own interpretation of the beneficiary designation form, namely, that it failed to indicate ANY beneficiary, therefore the benefits were payable by default to P's estate. The money ended up with the same eight people in the same percentages, but the ADP would be the five-year rule (because P died before his RBD) that applies when there is no "designated beneficiary."

B. Disclaimers

PLR 2008-46003 (11/14/08) provides an example of disastrous post-mortem planning.

P's prenuptial agreement required her to leave her IRA to a QTIP trust (Trust #1) for the life of P's surviving spouse S. The remainder beneficiary of the QTIP trust was a trust (Trust #2) for the benefit of P's children. However, instead, P named her children directly as beneficiaries of her IRA, with no contingent beneficiary specified. Perhaps what the family SHOULD have done when this was discovered at P's death was to go to state court and get the prenuptial agreement enforced and get the beneficiary designation reformed to say what the prenup said it should say.

Instead, the children "disclaimed" the IRA as beneficiaries. The disclaimer caused the IRA to pass to P's estate as beneficiary, whence it would pass to the QTIP trust. However, even though the disclaimer occurred within nine months after P's death and otherwise appeared to be in proper form, it had a fatal defect: The children did NOT disclaim their remainder interests in Trust #2, which was the remainder beneficiary of Trust #1. As a result, the disclaimer was not qualified under

§ 2518. One of the requirements of a qualified disclaimer is that the disclaimed property must pass, as a result of the disclaimer, without any direction on the part of the disclaimant, either to the spouse of the decedent or to someone other than the disclaimant. But this IRA was going to pass right back to the disclaiming children (on S's later death), as beneficiaries of Trust #2.

What is the effect of a nonqualified disclaimer? It is treated as a taxable gift of the entire IRA value by the children to the QTIP trust; and there is no marital deduction for the transfer to the QTIP trust because, as far as the IRS is concerned, the IRA went from P to the children to the QTIP, not directly from P to the QTIP. There is no mention of what the income tax effects of this were, nor of what reduction in value (if any) of their taxable gift the children get for the fact that they have retained a remainder interest in the transferred asset, or whether they get a credit for tax on previously transferred property.

III. TRUSTS AND ESTATES AS BENEFICIARIES

A. Transfer of inherited plan from trust or estate to beneficiary(ies)

PLRs continue to confirm that the transfer of an inherited retirement plan from a trust or estate that was the named beneficiary of such plan to the beneficiaries of the trust or estate is permissible, is not a tax-triggering "assignment of IRD," and is generally a tax-neutral event. See ¶ 2.3.03, ¶ 6.1.05, and ¶ 6.4.07–¶ 6.4.08 of *Life and Death Planning for Retirement Benefits*.

(However, there is one important exception: If the assignment is in fulfilment of a pecuniary gift, the tax-neutral concept does not apply, according to CCM 2006-44020, where the IRS ruled that such an assignment would trigger immediate income tax under § 691(a)(2).)

In **PLR 2008-50058** (12/12/08), P died after his RBD leaving his IRA to S. She disclaimed part of it. The disclaimed part passed to P's estate as default contingent beneficiary. S also disclaimed her interest in the estate. The disclaimed portion passed to P's three children. In this PLR, S (as executrix of P) sought and obtained a ruling that permitted the estate to transfer one-third of the disclaimed IRA to one of the children, C, who would then take minimum distributions based on P's remaining life expectancy as the ADP. Strangely, the ruling does not mention § 691(a)(2).

B. Who are the "beneficiaries" of a trust?

PLR 2008-43042 (10/24/08) is the latest in the series (now up to three) of bad rulings dealing with the question of which beneficiaries of a typical minor's trust "count" for purposes of the rules that all beneficiaries must be individuals and the oldest beneficiary's life expectancy is the Applicable Distribution Period. In this ruling, part of P's IRA was payable to a trust for the benefit of P's child C, who was apparently under 40 years old. The trust was to make various distributions to C until C reached age 40, at which time the trust was to terminate and be distributed outright to C. If C died before reaching age 40, the trust would be paid instead to C's issue if any, otherwise to P's heirs at law. At the time of P's death, C had no issue. Had C died immediately after P, P's only "heir at law" would have been P's spouse, S. So the IRS ruled that the "countable" beneficiaries were C and S—despite the over 95 percent likelihood under the IRS's own actuarial tables that a person under age 40 will survive to age 40. Since both C and S were individuals, the trust passed the rule that all beneficiaries must be individuals. However, since S was the older of the two beneficiaries, the ADP was S's (not C's) life expectancy.

PLR 2008-43042 confirms two IRS positions that practitioners are unhappy with but can't do anything about: First, that the contingent remainder beneficiary of a minor's trust "counts" even though the minor will be entitled to full outright ownership of all the trust property upon reaching a certain not-very-old-age; second, that, in determining who will be the countable "remainder" beneficiary if the minor fails to reach that age, only now-living people "count." The minor's own unborn future issue don't count.

The trend started in PLR 2002-28025, which involved a trust for the benefit of two minors. The trust was to terminate and be distributed outright to the minors as each reached age 30, but if they both died before reaching that age, the trust would pass to other relatives, the oldest of whom was age 67 at the participant's death. The IRS ruled that the 67-year-old's life expectancy was the ADP because he was the "oldest trust beneficiary." No mention was made of the fact that the actuarial likelihood that a 1-year-old will survive to age 30 is 97.8%. The odds that at least one of two minors will survive to age 30 approaches 100%. The odds that a 67-year-old will survive them both are very slim. Yet the 67-year old is treated as "the" beneficiary for purposes of determining the ADP for the benefits!

PLR 2006-10026 was similar. Benefits were paid to a trust for the benefit of "C," who was under the age of 25. C would be entitled to outright ownership of the benefits when he attained age 25, but if he were to die before age 25 the trust would pass to his heirs at law, who were his parents (B and D). The IRS ruled that B and D counted as beneficiaries of the trust and accordingly the ADP was the life expectancy of the oldest member of the group consisting of B, C, and D. No mention was made of the fact that the actuarial likelihood that a 1-year-old will survive to age 25 is 98.6%. If C was 15 or older, that increases to 99%. (Probability of survival determined using the highly recommended "TigerTables" software, www.tigertables.com.)

IV. HARDSHIP WAIVERS OF THE ROLLOVER DEADLINE

The deadline for completing a rollover is generally 60 days after receipt of the distribution. One exception to this general rule is that, for distributions after 2001, the IRS "may waive the 60-day requirement…where the failure to waive such requirement would be against equity or good conscience…." See § 402(c)(3)(B), § 408(d)(3)(I), and ¶ 2.6.06 of *Life and Death Planning for Retirement Benefits*. The hardship waiver provisions are now a permanent part of the Code, thanks to PPA 2006. In Rev. Proc. 2003-16, 2003-1 C.B. 359, the IRS issued guidance for such hardship waivers.

Following issuance of Rev. Proc. 2003-16, the IRS began issuing a flood of private letter rulings dealing with these deadline waiver requests. In the early days of 2003–2005, the IRS almost never denied a request for a hardship waiver. It seemed the IRS would accept just about any excuse for missing the deadline, even "the cat ate my rollover papers." Now the IRS denies quite a few requests. When they want to deny a request, they recite the mantra that the taxpayer has failed to show any of the justifying factors listed in Rev. Proc. 2003-16. But they rarely mention this "list of factors" when they *grant* a waiver.

Reading dozens of these rulings each year, patterns emerge. What jumps out is that the NUMBER ONE cause of messed-up rollovers is not illness or natural disaster: It is an error by the IRA provider, plan administrator, or professional advisor—typically, putting the rollover money into a taxable account when it was supposed to go into an IRA. The other thing that jumps out is that people don't read their account statements. Even if money went into a taxable account by mistake,

you can fix the problem, in most cases, by rolling the money back into the account it was supposed to go into within 60 days. But in ruling after ruling, NOBODY noticed the error until after the 60-day deadline (typically it's noticed when tax returns are prepared the following year).

For hardship waivers in conjunction with a spousal rollover through an estate or trust, see IV(D), above; in conjunction with a payment to the wrong beneficiary, see II(C), above; of a lawsuit settlement, see I(A), above.

A. The typical successful fact patterns

Most successful waiver requests involve one or more of the following facts:

1. Error (such as depositing an intended tax-free rollover into a taxable account by mistake) or erroneous or incomplete rollover advice, by a professional advisor, plan administrator, or financial institution (FI). To grant these rulings, the IRS seems to now always require a *written admission of error by the FI or advisor*! See **PLR 2008-27035** (7/4/08).

2. Erroneous distribution that the recipient was unaware of or did not request; or

3. Illness, disability, or other trauma impairing the individual's ability to complete the rollover or otherwise deal with financial affairs. In these PLRs, the taxpayers clearly demonstrated their medical conditions or other traumatic circumstances: e.g., in **2008-31026** (8/1/08), "severe mental incapacities" (sufficient to cause a guardian to be appointed after the events involved in the ruling request) impaired P's ability to make sound financial decisions or understand the consequences of her actions.

But the IRS is not exactly a "softie" about these things: In **PLR 2008-29030** (7/18/08), P withdrew money on 7/26/06 from his IRAs, expecting to use the cash to purchase a house on 8/30/06. The purchase fell through several weeks prior to expiration of the 60-day period, and P was intending to complete the rollover, but then on 9/4/06 he learned his father had cancer and was to undergo surgery. On 9/14/06, P flew to where the father was; the father died after the surgery. P tried to complete the rollover in January 2007. The IRS said no, claiming that the "Taxpayer has not presented any evidence to the Service as to how any of the factors [in 2003-16] prevented him from completing the rollover during the" 60-day period! The evidence "did not substantiate his assertion that his father's medical condition precluded him" from timely completing the rollover.

B. No waiver for participant's OWN errors

Here's an ugly development: the IRS will not grant the waiver when the *taxpayer* makes a mistake but did not seek professional advice (and did not suffer from any mental or physical impairment). Here are PLRs where the IRS denied a waiver, apparently because the participant failed to seek professional advice. These continue the trend seen in the similar rulings PLRs 2007-21023, 2007-24039, 2007-36036, 2007-38027, 2008-04025 2008-09043 2008-17059 and 2008-19020.

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