IRS Letter Rulings Provide Insight Into Planning for IRAs

Because IRAs represent an increasing portion of many clients' estates, careful planning for these assets is crucial to avoid costly mistakes. This article explains how recent letter rulings relating to IRAs can often resolve planning uncertainties.

CHRISTOPHER P. BRAY, CPA

Estate planners are frequently required to incorporate advanced planning for IRAs into a client's estate plan. For practitioners, a thorough understanding of the opportunities and pitfalls specific to planning for IRAs is critical. Because the Proposed Regulations under Section 401(a)(9)[1] (sometimes referred to here as the "Proposed Regulations")—which are the most comprehensive source of authority on this topic—leave many important questions unresolved and have languished in proposed form for over a decade, practitioners are often left to guess how to resolve ambiguities in various planning situations.

By closely analyzing IRS private letter rulings, advisors can gain greater confidence in planning for IRAs. Additionally, there are a number of myths surrounding the answers to questions not clearly addressed in the Section 401(a)(9) Proposed Regulations. A review of these myths and an analysis of the existing authorities dispelling them will also help in planning for clients with IRAs.

CHRISTOPHER P. BRAY, CPA, is Senior Vice President and National Director of Estate and Succession Planning at National City Bank in Cleveland, Ohio. He is also an adjunct professor in the graduate program in taxation at the University of Akron. Mr. Bray is a frequent author and lecturer on estate planning.

RECENT DEVELOPMENTS

Multiple designated beneficiaries: Life expectancy planning

Generally, when multiple designated beneficiaries (DBs) are named to a singe IRA, the life expectancy of the oldest DB is used to calculate the required minimum distributions (RMDs) from the IRA after the owner's death.[2] This can reduce the favorable tax-deferred compounding that would otherwise have been available if the IRA owner had segregated the IRA into multiple IRAs, or multiple accounts, for each DB.

For example, IRA owner who names her two children, ages 40 and 20, as the DBs of her IRA would generally bind her children to a distribution pattern that would require the entire IRA to be distributed upon her death to her two children over the life expectancy of the 40-year-old child. If IRA owner instead split her IRA into two separate IRAs, with each child as the DB of each IRA, only half of the total IRA assets would have to be distributed over the life expectancy of the older child. The other half could be preserved longer in the tax shelter of an IRA because these assets would be required to be distributed over the longer life expectancy of the younger child.

A recent letter ruling illustrates the circumstances when multiple beneficiaries of a single IRA may use their own individual life expectancies to calculate the RMDs from the IRA instead of using the shortest life expectancy. Apparently, if the IRA owner dies before her required beginning date (RBD) for taking IRA distributions, multiple beneficiaries of the IRA may treat their interests in the IRA as separate accounts. As a result, the life expectancy of each beneficiary will be used for computing the RMDs of their shares of the IRA, provided they begin taking the RMDs before December 31 of the year following the IRA owner's death.

In Ltr. Rul. 199931049, an IRA owner died in 1997, leaving her

IRA to her 93-year-old husband. Later in 1997, husband rolled over wife's IRA into his own new IRA, and named his six children as equal DBs of the new IRA. Husband died in 1998.

Although husband had long passed age 70½, his normal RBD, he had not reached his RBD with respect to the new IRA. Because husband did not own the new IRA as of 12/31/96, no RMD had to be made from the new IRA in 1997. The first RMD from the new IRA had to be made on or before 12/31/98, based on the new IRA's account balance on 12/31/97.

Shortly after husband's death and before 12/31/98 (i.e., husband's RBD with respect to the new IRA), the children directed the IRA custodian to transfer the new IRA into six equal IRAs in the name of decedent husband, but for the benefit of each individual child.[3] The establishment of these separate accounts by the children prior to husband's RBD enabled the children to take advantage of the "separate accounts" exception to the general rule that the shortest life expectancy among multiple DBs is used to calculate the RMDs from the IRA after the death of the owner.[4]

The Proposed Regulations provide the definition of "separate accounts" for RMD purposes.[5] The Proposed Regs. also provide that if, as of the IRA owner's RBD or as of the IRA owner's date of death if earlier, the beneficiaries with respect to a separate account differ from the beneficiaries with respect to the other separate accounts, that account need not be aggregated with other separate accounts in order to determine whether the distributions from that separate account satisfy Section 401(a)(9). Rather, the RMD rules may be applied separately to each separate account.[6]

Consequently, in Ltr. Rul. 199931049, each child was permitted to use her own life expectancy in computing the RMD of her separate IRA (i.e., her separate account of husband's IRA), as long as such distributions commenced on or before December 31 of the year following husband's death (12/31/99). As a result, five-sixths of husband's IRA was able to compound tax-free longer than if the RMDs had been calculated under the general rule using the life expectancy of the eldest child. Practitioners should therefore be aware of the opportunity to use the separate accounts rule of the Proposed Regulations.[7]

More planning opportunities using 'separate accounts'

The "separate accounts" exception to the general rule that the age of the eldest DB must be used to determine RMDs after the death of the IRA owner was also illustrated in Ltr. Rul. 199903050. This ruling suggests that it may be possible to take advantage of the life expectancies of the beneficiaries of different sub-trusts (rather than the oldest beneficiary of all the sub-trusts) to which a single IRA may be payable, by using separate account planning within the IRA's beneficiary designation.

In the ruling, a profit-sharing plan participant who died before her RBD designated her revocable trust as the beneficiary of her plan benefits. The revocable trust was to be divided into three trusts at her death: a general power of appointment marital trust (Trust A), a QTIP trust (Trust B), and a credit shelter trust (Trust C). The revocable trust was considered the DB under the requirements of the Proposed Regulations;[8] therefore, all the beneficiaries of the trusts created under the revocable trust were treated as DBs of the plan for purposes of determining the RMDs of the plan benefits.

Husband was entitled to all the income of Trust A as well as invasions of principal. He was also entitled to all the income of Trust B, plus invasions of principal based on an ascertainable standard. Trust C required distribution to participant's children or their issue after husband's death.

The Service considered whether the plan benefit consisted of separate accounts allocable to each of these sub-trusts, and concluded that in order to satisfy the separate account rule, plan benefits must be divided into separate accounts in the governing beneficiary instruments. The Service ruled that because the separation of plan benefits among Trusts A, B, and C occurred under the terms of the revocable trust, rather than under the beneficiary designation form, the separate account rule could not be used.

Because the plan benefits could not be allocated to separate accounts for each of the sub-trusts, all the beneficiaries of all the sub-trusts created under the revocable trust had

---

1 Section 408(a)(6) applies the minimum distribution rules of Section 401(a)(9) to IRAs.

2 Prop. Reg. 1.401(a)(9)-1, Q&A E-5(a)(1) and E-5(a)(2).

3 See Rev. Rul. 78-406, 1978-2 CB 157.

4 See generally Prop. Reg. 1.401(a)(9)-1, Q&A H-2.

5 Prop. Reg. 1.401(a)(9)-1, Q&A H-2A(a).

6 Prop. Reg. 1.401(a)(9)-1, Q&A H-2(b).

7 One commentator has noted that the "separate accounts" provision of the Proposed Regulations probably represents "the most overlooked estate planning technique for qualified plans and IRAs." See Wilf, "'Separate Accounts': An Overlooked Estate Planning Technique for Qualified Plans and IRAs," 24 Est. Planner's Alert 17 (Mar 1999).

8 The requirements for a trust to be a DB for RMD purposes generally include the following: (1) the trust must be valid under state law; (2) the trust must be irrevocable, or must become irrevocable upon the death of the employee; (3) the trust beneficiaries must be individuals identifiable from the trust instrument; and (4) information regarding the trust beneficiaries, or a copy of the trust instrument, must be provided to the plan administrator. Prop. Reg. 1.401(a)(9)-1, Q&A D-5(b).

to be considered in determining the life expectancy over which the plan benefits would be payable in order to satisfy the RMD requirements. Because husband was the oldest beneficiary of all the sub-trusts created by the revocable trust (and the beneficiary with the shortest life expectancy), his life alone was considered in determining the RMDs for the plan benefit.

Had the sub-trusts been able to use the separate account rules (and if only the children were the beneficiaries of the credit shelter trust (Trust C)), the plan benefit would have profited from longer tax deferral with regard to a separate account allocable to Trust C. That account could have been paid out over the life expectancy of the eldest child. Instead, because the separate account provisions were not available, the RMDs of the plan benefit were limited to the life expectancy of the husband, which was most likely considerably shorter than the life expectancy of the eldest child.

The most important lesson of this ruling is that the Service takes the position that if the division of plan or IRA assets into various sub-trusts occurs within the context of the beneficiary designation, rather than under the terms of a revocable trust, the life expectancies of each of the sub-trusts may be available as the measuring lives from which to compute RMDs from the plan or IRA under the separate account provisions. This may result in substantial tax deferral if, for example, only children or grandchildren are the beneficiaries of the credit shelter trust.

Postmortem IRA transfers

The planning flexibility of IRAs after the death of the owner has been demonstrated in a number of letter rulings, including the ones previously discussed, which reveal the portability of these accounts. Ltr. Rul. 9810031 illustrates the postmortem planning flexibility of IRAs persuasively.

There, three sons were the equal DBs of their decedent mother's IRA. Apparently, the sons did not agree on the investment management style for the IRA. They each wanted to transfer their one-third interest in the IRA to a separate IRA (i.e., a separate sub-account) for their individual benefit at a financial institution different from the one where the mother's IRA was maintained. Each son would then be able to invest the IRA in accordance with his own investment preferences, and each could select different distribution options for his own portion of the IRA.

The Service ruled that the sons could implement their plan as requested, and that the transfers to the three separate IRA sub-accounts at different financial institutions would not be characterized as rollover contributions. Additionally, the Service based its ruling on the fact that all three subsequent IRA sub-accounts would be maintained in the name of the decedent mother for the benefit of each individual DB son and that each IRA would be subject to a RMD pattern based on the remaining life expectancy of the eldest son.[9]

The other crucial requirement set forth in these letter rulings is that the newly established IRAs be formed as "(name of deceased IRA owner), deceased (date of death); (name of designated beneficiary), beneficiary."[10] As a practical matter, it may be very difficult to persuade some financial institutions to open an IRA in the name of a deceased individual. An official in the general counsel's office of a large mutual fund company recently bemoaned this dilemma, "[t]he legal problem that you run into if you want to move (the IRA of a deceased owner) to anther institution is how can a decedent open an account."[11] Regardless of the dilemma, the letter rulings show that it can and has been done.

Practitioners should be aware of the opportunity to move assets from the IRA of a decedent at one financial institution to an IRA for the benefit of the DB at another. This could enable the practitioner to assist the beneficiaries of an estate resolve disputes about investment strategies and distribution options relating to an IRA. This opportunity can also give beneficiaries leverage with the original financial institution to improve service and negotiate fees.

The A/B trust IRA estate plan

How can an A/B trust estate plan be implemented for a client whose assets include a large IRA? Ltr. Rul. 199918065 offers a helpful answer to this question. There, a husband named his revocable trust as the DB of his IRA. Husband died at age 60, and his revocable trust required his estate to be divided into a credit shelter trust (Trust No. 2) for the benefit of his wife and children, and a marital trust (Trust No. 1) over which his

[9] The limitation on RMDs over the remaining life expectancy of the eldest son in this letter ruling can be distinguished from the conclusion in Ltr. Rul. 199931049 (discussed earlier), that the life expectancies of each individual DB could be used in calculating the RMDs from each IRA. The difference in the conclusions results from the beneficiary designations and from the fact that the father in Ltr. Rul. 199931049 died before his RBD with respect to the IRA in question. The mother in this letter ruling died after her RBD. Because separate accounts had not been established prior to her death, the sons were required to continue to use the remaining life expectancy of the eldest son after their mother's death.

[10] Ltr. Rul. 9802046.

[11] Hansard, "Parties of First Part Try to Ensure Dough for Parties of the Second," 3 Investment News 3 (10/11/99).

wife had a general power of appointment. The trustees intended to fund the credit shelter trust with assets not obtained from the IRA.

The Service ruled that the wife, as co-trustee, could direct that assets in the IRA, in excess of the husband's unused applicable credit amount (described as the "Base Amount"), be distributed to the DB trust. Wife could then, as co-trustee, direct the distribution to be allocated to Trust No. 1 (the marital trust), from which she would withdraw the entire amount as beneficiary. The Service ruled that wife would then be able to roll over the withdrawn amount into her own IRA, provided that the rollover took place within 60 days of distribution from the IRA, as required by Section 408(d)(3)(A)(i). Because the Trust No. 1 amount would subsequently be rolled over into wife's own IRA, wife could name her own DB for the IRA, and RMDs would not need to be made until she reached her RBD.

The Service also addressed the "Base Amount" (i.e., an amount equal to husband's applicable credit amount), which was to remain in husband's IRA. The Service concluded that wife would be considered the DB of the Base Amount in husband's IRA. As a result, Section 401(a)(9)(B)(iv) applied, allowing RMDs to be delayed until the date on which husband would have attained age 70½. Ltr. Rul. 199918065 was subsequently modified by Ltr. Rul. 200008048, which preserved all of the original rulings, but further clarified the Service's reasoning with regard to this issue. Hence, the amount remaining in husband's IRA could grow tax-deferred for another ten years. RMDs would then be required to be made, based on wife's remaining life expectancy.

For practitioners who work with clients with large IRAs, Ltr. Rul. 199918065 represents a helpful guide in using a revocable trust as the DB of the IRA. Such planning may allow the surviving spouse to roll over the marital deduction amount drawn from the decedent's IRA into her own IRA.

Getting out of the recalculation trap

For purposes of calculating the distribution period of an IRA during the owner's life and after the owner's RBD, the DB is generally determined as of the employee's RBD. If, as of that date, there is no DB for the IRA (i.e., the beneficiary is the owner's estate, a trust not meeting the requirements of Prop. Reg. 1.401(a)(9)-1, Q&A D-5(b), or any other entity which is not an individual), then the distribution period is limited to a period not extending beyond the owner's life expectancy.

In determining the life expectancy of the IRA owner for RMD purposes, the owner is required to recalculate his or her life expectancy annually unless the IRA agreement provides otherwise and the IRA owner chooses a method other than recalculation.[12] Upon the death of the IRA owner, the recalculated life expectancy will be reduced to zero in the calendar year after the year of the IRA owner's death.[13] Based on this calculation, the RMD of the IRA owner using a recalculated life expectancy will be equal to the full balance of the assets in the IRA the year after the owner's death, resulting in full income taxation of the IRA. A distribution method (either recalculation or no recalculation of life expectancy) elected by the owner for the IRA for RMD purposes becomes irrevocable as of the owner's RBD.[14]

In Ltr. Rul. 199915063, IRA owner named two individuals, neither of whom was his spouse, as the DBs of his IRA. Although the IRA agreement allowed owner to choose whether or not to recalculate his life expectancy in computing his RMDs, the agreement required his life expectancy to be recalculated unless otherwise elected. Upon reaching his RBD, owner made no election with respect to computing the RMDs for his IRA. Accordingly, owner received his RMDs during his lifetime based on his life expectancy alone, as recalculated each year.

At IRA owner's death, the DBs were concerned that the Proposed Regulations would require that the IRA be completely distributed to them before December 31 of the year after the year of owner's death. Although the DBs had been named by owner during his life and before his RBD, the DBs were concerned that since owner had constructively elected to compute his RMDs based on his life expectancy alone as recalculated, rather than based on the joint life expectancies of himself and the oldest DB, they would have no choice but to distribute the entire IRA before the end of the calendar year following owner's death.

The DBs hoped that since they had been named as DBs before owner's RBD, they might be able to begin using their life expectancies to defer distribution of the IRA after owner's death. The Service ruled that because the DBs had been named as beneficiaries before owner's RBD, this fact would allow the IRA to be distributed over the remaining life expectancy of the oldest DB. The Service allowed this result regardless of the fact that owner had computed RMDs based on his life alone, as recalculated during his life.

When faced with the possibility of having to distribute an entire IRA before the end of the year follow-

[12] Prop. Reg. 1.401(a)(9)-1, Q&A E-7(a).
[13] Prop. Reg. 1.401(a)(9)-1, Q&A E-8(a).
[14] Prop. Reg. 1.401(a)(9)-1, Q&E E-7(c).

ing a client's year of death, practitioners should examine every opportunity to argue that the distribution of the IRA should be deferred over a longer period of time. Ltr. Rul. 199915063 demonstrates that prolonged deferral may be obtained even if a client has passed her RBD and has elected a RMD pattern based on her single recalculated life expectancy. As long as the practitioner can determine that an individual DB of the IRA was named before the client reached her RBD, it may be possible to defer distribution of the IRA over the beneficiary's remaining life expectancy.

Postmortem IRA rollovers

In early 1997, this author was working with a 65-year-old client who survived his 50-year-old wife who had just passed away unexpectedly. Wife was a participant in her employer's profit-sharing plan; her account had a very large balance of which client was the DB. Wife was also the owner of a modest IRA of which client was the DB.

The plan administrator wanted to distribute wife's benefit directly to client. In order to avoid income taxation, client would have to roll over the distribution into his own IRA, from which he would be required to begin taking distributions in five years when he reached his RBD of age 70½. Client had no current financial need for wife's plan benefit, and would not need it upon reaching his RBD.

The author proposed that the plan administrator make a distribution of wife's plan benefit to wife's IRA (of which client was the sole DB) in a trustee-to-trustee transfer, instead of making a distribution directly to client. If wife's plan benefit were distributed to her IRA, then client—as the surviving spouse and the DB of the IRA—could delay distributions from the IRA until the date on which wife would have attained age 70½, pursuant to Section 401(a)(9)(B)(iv). The large plan benefit could therefore compound tax-deferred for an additional 15 years before any distributions would be required.

The plan administrator rejected the author's proposal on the ground that because wife was deceased, a trustee-to-trustee transfer of her plan benefit to her IRA would result in an "excess contribution" to the IRA under Section 4973(b)(1). When the author suggested that the plan administrator seek a ruling from the Service with regard to this issue (a ruling that the client would pay for), the plan administrator refused and soon thereafter distributed wife's entire plan benefit directly to client.

Later that year, Ltr. Rul. 9745033 was published. There, the Service permitted the surviving spouse of a deceased participant in two employee benefit plans to transfer his benefit directly to an IRA owned by the deceased participant of which the surviving spouse was the sole DB. The Service ruled that this transfer would not result in an excess contribution under Section 4973. It was soon obvious that in the case of the author's client, the plan administrator's refusal had cost the client 15 years of valuable tax deferral.

Practitioners should be mindful of Ltr. Rul. 9745033, which can be useful in a situation like the above. The older spouse is not always the first to predecease. When the predeceasing spouse is significantly younger and has died with assets in an employee benefit plan, Ltr. Rul. 9745033 can assist the practitioner in arranging for a trustee-to-trustee transfer of the plan benefit to an IRA of the predeceasing spouse.

STALE MYTHS

The pecuniary bequest myth

Generally, practitioners cannot read commentary on the subject of RMD planning without being warned that the use of a pecuniary formula to fund a trust in a client's estate plan will result in accelerated income taxation of an IRA or qualified plan of which such trust is a DB. The warning is repeated so often that there are probably practitioners who have counseled clients to pay income taxes prematurely when the DB of the decedent's IRA is a trust with a pecuniary funding formula.

The warning stems from the following analysis: If a pecuniary bequest is funded with income in respect of a decedent (IRD), the estate or trust through which such pecuniary amount was paid must recognize gain on the transfer since the pecuniary nature of the bequest causes the transfer to be characterized as a sale or exchange.[15] This result will not occur if a bequest is funded under a fractional share formula.[16]

Despite the anxiety caused by this analysis, the Service consistently ignores its suggested effect when issuing rulings to taxpayers dealing with IRA or qualified plan benefits passing through pecuniary funding formulas.[17] In its rulings, the Service does not address the matter of a pecuniary bequest and acceleration of tax on IRD, because it's not an issue; funding formulas have nothing to do with the income taxation of IRA and qualified plan benefits. Pursuant to Section 408(d)(1), only amounts "distributed out of an [IRA]" are included in the gross income of the DB.

[15] Section 691(a)(2); Reg. 1.661(a)-2(f)(1). Kenan, 114 F.2d 217, 25 AFTR 607 (CA-2, 1940).

[16] Rev. Rul. 60-87, 1960-1 CB 286.

[17] See Ltr. Ruls. 199912040, 9808043, 9744024, 9623064, 9623056, 9608036, 9537030, 9524040, 9510049, 9451059, 9450041, 9442032, and 9350040.

Practitioners shouldn't focus on the funding formula of a trust that is named as the DB of an IRA to determine the income tax consequences of the IRA after the death of the owner. Practitioners should instead focus on the issues of importance under Section 401(a)(9) and the accompanying Proposed Regulations, including whether the owner died before or after the RBD, whether the trust qualifies as a DB, or whether the trust has more than one individual beneficiary and which beneficiary has the shortest life expectancy. These factors alone are relevant in determining the income taxation of an IRA after the owner's death.

The charitable IRA myth

Another prevalent myth is that qualified plan or IRA assets are the best assets to use in funding charitable bequests in an estate plan. This myth stems from the belief that IRA assets are inherently bad assets to die with because they don't enjoy an income tax step-up in basis under Section 1014.

Proponents of this myth often rely on the following analysis: The IRA will be subject to a 55% estate tax and a 39.6% income tax at the death of the owner; therefore, only about 5% of the IRA will be left for family members. On the other hand, non-IRA assets will be subject only to a 55% estate tax, leaving 45% of these assets available for family members. Consequently, when given a choice to use IRA or non-IRA assets to fund a charitable bequest, clients should use IRA assets because the charity will receive the same amount either way, but the family will receive less if they are left the IRA.

Unfortunately, the analysis ignores two substantial realities. First, IRAs are rarely required to be subject to immediate income taxation at the death of the owner. Second, what's good for the goose is good for the gander. In other words, if the IRA was valuable for the owner, it should be valuable for the owner's family as well.

If the DB of an IRA is an individual, the IRA is not required to be distributed immediately at the death of the IRA owner, but may instead be distributed over the life expectancy of the DB. If IRA owner died leaving her 21-year-old granddaughter as the DB, the IRA could be distributed over the next 60 years![18]

The IRA is a tax shelter—that is why the owner enjoyed it. All the assets within the IRA compound at a pre-tax rate of return. Assets that grow at a compounded pre-tax rate of return increase significantly faster than assets left to grow at a compounded after-tax rate of return. As long as the IRA can be deferred over an extended period of time for the benefit of the DB, the impact of the pre-tax compounding will cause the total wealth generated by the IRA to eclipse the total wealth that would be produced by non-IRA assets left to the beneficiary.[19]

Practitioners should be cautious about advising clients to leave IRA assets to charity without first performing a quantitative analysis of the alternatives. A knee-jerk conclusion that IRA assets should be used to fund the charitable goals in a client's estate plan may prove to be exceedingly costly to the client's family.

The creditor beneficiary myth

Only individuals and certain trusts may be DBs of an IRA for purposes of the RMD provisions. Because an IRA owner's estate is not an individual, it does not qualify as a DB. Similarly, if an IRA owner's estate is a beneficiary of a trust which is named as the beneficiary of an IRA, such trust will not qualify as a DB under the Proposed Regulations.

This myth holds that if a trust with only individual beneficiaries contains a provision allowing for the payment of estate taxes, debts, or administration expenses, that provision will result in the trust not qualifying as a DB of an IRA. Because a trust can have only individual beneficiaries to qualify as a DB, any payment allowed for estate taxes, debts, or administration expenses results in a possible payment to an entity other than an individual (i.e., federal or state government in the instance of taxes, partnership or corporation in the instance of debts or expenses). Consequently, the trust is deemed to have non-individual beneficiaries, and cannot qualify as a DB.

This notion seems to be based on the interpretation of two letter rulings. In Ltr. Rul. 9809059, the Service included the following sentence in its statement of the taxpayer's representations:

> Trust [DB] does not provide that trust assets shall be used to pay the funeral costs and expenses of Grantor's last illness, costs of administering her (sic) probate estate, any estate and inheritance taxes and generation-skipping taxes on direct skips imposed by reason of the Grantor's death and attributable to the trust estate.

The Service concluded that the trust qualified as a DB for purposes of the Proposed Regulations. The Service did not set forth any explicit analysis indicating that the favor-

[18] As long as (1) adequate GST exemption is allocated to the IRA, (2) estate taxes can be paid from assets other than the IRA, and (3) only required minimum distributions are made for the entire life expectancy, the calculations show that the after-tax value of the IRA exceeds the after-tax value of a similar non-IRA amount left to the granddaughter.

[19] See Wilf, "Qualified Plan or IRA Proceeds to Charities: A Good or Bad Planning Idea?," 23 Est. Planner's Alert 18 (July 1998), for additional discussion, including a case study comparison.

able ruling was predicated on the trust's prohibition of payment for debts and expenses. However, some practitioners believe that the above-quoted sentence—in and of itself—is an indication that the Service might not have reached the same conclusion had the trust allowed trust assets to be used for payment of debts and expenses.

In Ltr. Rul. 9820021, the Service ruled that a trust did not qualify as the DB of a profit-sharing plan where the trust included charitable beneficiaries. The Service also noted that the trust was required to pay estate taxes and administration expenses, and the trustee actually used proceeds from the profit-sharing plan to pay taxes and expenses. After concluding that the existence of charitable beneficiaries in the trust precluded it from qualifying as a DB, the Service included the following sentence:

> This ruling does not address whether or not there are other provisions in Trust [DB] that result in [spouse] not being the designated beneficiary, as defined in section 401(a)(9) of the Code, of [decedent's] account under [profit-sharing plan].

As in the case of Ltr. Rul. 9809059, some practitioners believe that this sentence is an indication that the Service might have reached the same conclusion regardless of whether or not there were charitable beneficiaries of the trust. To these practitioners, this sentence represents the Service's implicit conclusion that payments for debts and expenses result in the trust having non-individual beneficiaries, thus precluding the trust from being a DB under the Proposed Regulations. If an amount is paid from the trust to a creditor for debts or administration expenses, the argument is that the estate is the beneficiary of that payment (and an estate cannot be a DB). The rationale is that if an amount is paid for debts or administration expenses on behalf of the estate to a creditor, the estate is the beneficiary of that payment. Practitioners generally don't believe that there is any basis for concluding that the payment of taxes (attributable solely to the IRA) from a trust will result in that trust being deemed to have non-individual beneficiaries.

The Proposed Regulations permit a trust to be a DB as long as the trust meets the requirements of Prop. Reg. 1.401(a)(9)-1, Q&A D-5. If those requirements are met, distributions made to the trust will be treated as paid to the "beneficiaries of the trust" with respect to the trust's interest in the IRA, and the "beneficiaries of the trust" will be treated as the actual DBs of the IRA for purposes of Section 401(a)(9).

If a decedent's estate or a charity is a beneficiary of the trust, the trust will not qualify as a DB because of the prohibition against non-individual DBs found in Prop. Reg. 1.401(a)(9)-1, Q&A D-2A. However, if a trust authorizes payment for estate taxes, debts or administration expenses, will the payees be considered "beneficiaries of the trust" for purposes of the Proposed Regulations? The technical answer to this question is unknown. The Proposed Regulations do not define the term "beneficiaries of the trust."

Perhaps the term "beneficiaries of the trust" is not defined because to do so would state the obvious. In order for a trust to exist under state law, it must have beneficiaries. "Beneficiaries of the trust" should therefore be those for whose benefit the trust property is held by the trustee.[20] Not every party who stands to receive payment through operation of a trust is regarded as a trust "beneficiary."[21] Creditors of a trust, for example, "benefit" from trust assets, yet they are not the trust's beneficiaries. The debtor-creditor relationship is one that is legally distinct from the trust-beneficiary relationship.[22]

Accordingly, if a trust authorizes payment for estate taxes, debts or expenses, will the payees be considered "beneficiaries of the trust" for purposes of the Proposed Regulations? The common sense answer to this question would seem to be "no." The non-individual payees of taxes, debts, and expenses are creditors of the trust, not its beneficiaries. Therefore, under this line of reasoning, the existence of provisions in a trust that allow trust assets to be used for payment of taxes, debts, and expenses would not seem to disqualify the trust as a DB.

Nevertheless, practitioners should be forewarned that there currently is no clarity on this issue, and Ltr. Ruls. 9809059 and 9820021 indicate that allowing a trust to pay taxes and creditors could prevent the trust from qualifying as a DB.

Conclusion

Ambiguity in the Proposed Regulations can often be resolved by reviewing the Service's position in letter rulings. Therefore, estate planners should continue to review letter rulings based on the Proposed Regulations in the context of planning with clients. Because IRAs represent an ever-larger portion of many clients' estates, careful planning with IRAs is crucial to avoid costly mistakes. ■

[20] See generally Restatement (Second) of Trusts, § 112.

[21] See Restatement (Second) of Trusts, § 126.

[22] See Restatement (Second) of Trusts, § 12.