# Retirement Account Beneficiary Designation Planning
## - Before and After the SECURE Act -

**March 2020**

**by**

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## I. Introduction.

Retirement accounts are often the most significant asset in an estate, yet in most cases, these assets pass outside the terms of our clients' testamentary documents. As a result, planners must take particular care to coordinate beneficiary designations with overall estate plans. This article discusses planning options for maximizing estate and income tax minimization and deferral benefits that remain available after enactment of Pub.L. 116–94, "Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019," (the "SECURE Act").[1]

## II. Pre-SECURE Act Retirement Planning.

### a. Popularity of Retirement Accounts

Due to their popularity and the impact of income tax-free compounding, retirement accounts[2] have experienced enormous growth. According to a report released by the Investment Company Institute (ICI), total US retirement assets reached $29.1 trillion as of the end of the first quarter of 2019, constituting a 7.4% increase from the end of 2018. The study found that retirement assets accounted for a third of total U.S. household financial assets, with the largest segment of retirement assets, totaling $9.4 trillion, residing in individual retirement accounts (IRAs).[3] According to the study, defined contribution (DC) plan assets reached $8.2 trillion, with $5.7 trillion held in 401(k) plans.

Retirement accounts (including IRAs) have thus become an increasingly large percentage of many American estates, in some cases *the* single largest asset. As a result, financial advisors must be mindful that such accounts very often hold the key to maximizing overall tax-saving benefits under current law.

### b. Inherited Accounts - "Stretch IRAs"

Inherited individual retirement accounts have long been a method to enable non-spousal beneficiaries to inherit an IRA account, and then continue to grow the account on a tax-deferred basis over the beneficiary's life-span. The term "stretch IRA" did not refer to a specific type of retirement account. Rather, it was a financial strategy that allowed account owners and beneficiaries to postpone, or stretch out, the duration of the account.[4] Stretching out an IRA allowed more time for the funds in the account to compound on a tax-deferred basis within the account for future generations. A very young beneficiary, for example a grandchild, could stretch distributions of retirement fund for decades. The stretch-IRA method also could reduce the overall

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[1] This article does not provide a comprehensive discussion of the procedural mechanics of beneficiary designation planning, i.e. specific election and paperwork due dates, etc.

[2] The terms "retirement account" and "qualified retirement account" are used interchangeably herein to only refer to assets contributed to accounts that qualify for income-tax favored status under the Internal Revenue Code.

[3] National Association of Plan Advisors, "Retirement assets top $29 trillion, while plan fees continue downward trend," Ted Godbout, June 27, 2019. https://www.napa-net.org/news-info/daily-news/retirement-assets-top-29-trillion-while-plan-fees-continue-downward-trend

[4] Due to its common usage, the term "Stretch-IRA" is used herein to refer to the technique of maximizing income tax deferral to any applicable retirement account In 2007 the rules were expanded to allow non-spousal beneficiaries of 401(k) and other defined-contribution retirement plans to treat these accounts in a similar fashion. Even though not all defined contribution plans allow all types of long-term payouts to beneficiaries following the participant's death, these plans can be rolled over tax-free following death to an "inherited IRA." Accordingly, these materials generally discuss IRAs and other types of non-Roth retirement plans interchangeably.

income tax due on the RMD from a traditional IRA if the younger beneficiaries were income-taxed in lower tax brackets.

### c. Required Minimum Distributions:

The rules governing the required minimum distributions ("RMDs") for inherited IRAs or inherited 401(k)s used to depend upon two primary factors: (1) the age of the original account holder at the time of death, and (2) the age of the beneficiary. If the account holder had not reached the age at which he or she was required to begin taking RMDs (the "required beginning date"),[5] then the non-spouse beneficiary who did not wish to immediately cash out (and pay income tax on) the account had two choices: Withdraw the entire amount by the end of the fifth calendar year after the account owner's calendar year of death (generally, the "five-year rule" ), or stretch out the account based on their life span based on the Internal Revenue Service table in effect for their age at the time. If the original account holder had reached their required beginning date and was taking RMDs prior to death, then the non-spouse beneficiary had the option of continuing to receive distributions based upon the account owner's age or creating a stretch IRA to base the RMDs upon the non-spouse beneficiary's age.

With traditional qualified retirement accounts, the RMDs were generally determined by taking the account balance on Dec. 31 of the previous year and dividing that number by the number of years left in the applicable life expectancy (as listed in the IRS's "Uniform Lifetime" table). Each year, the RMD was calculated by dividing the account balance by the remaining life expectancy.

**1.** ***Qualified Trusts:*** For many tax and non-tax reasons, clients often wish to leave valuable assets to trusts for their beneficiaries, rather than leaving those assets to the beneficiaries directly. Trusts generally provide a number of potential benefits, including protection from creditors, centralized asset management, and/or preventing minor, troubled, or irresponsible beneficiaries from receiving substantial unfettered outright gifts. Accordingly, a commonly utilized estate planning technique is to designate a trust as the beneficiary of substantial retirement assets. However, advisers should do so with caution.

If a trust is the designated beneficiary of a qualified account, the underlying beneficiaries of the trust will be considered the designated beneficiaries for RMD purposes so long as the qualified trust rules of Reg. §1.401(a)(9)-4QA5(b) and A-6 are timely met.[6] The requirements are not overly burdensome:

- The trust must be valid under applicable state law;
- The trust instrument identifies the individual underlying beneficiaries;

[5] Previously 70 ½ years of age.

[6] Generally speaking, the qualified trust rules do not need to be complied with until September 30 of the calendar year after the participant's calendar year of death. Reg. §1.401(a)(9)-(4)QA6(b).

- The trust is irrevocable or will become irrevocable upon the participant's death and.

- The trust documentation is provided to the account custodian or plan administrator within a reasonable time.

If a trust designated beneficiary did not meet the qualified rust rules, then there would be no "designated person" to be used for calculating RMDs. Reg. §1.401(a)(9)-4QA3. If so, distribution of the plan or account was required to occur over the *participant's* lifespan, or if the participant had not yet reached his or her required beginning date, then all amounts were subject to the five-year rule. Reg. §1.401(a)(9)-3A(b)QA2. Accordingly, in cases where stretching the account was a primary planning goal, it was critical to meet the (fairly simple) qualified trust rules

**2**. ***Conduit Trusts.*** If the qualified trust rules were satisfied, the measuring life for RMD purposes was that of the *oldest* potential beneficiary. Reg § 1.401(a)(9)-5, Q&A-7(a)(1). In making this determination, both current and *remainder* beneficiaries were considered. For example, in Private Letter Ruling 200228025, a trust for a minor grandchild was named as the beneficiary of qualified retirement assets. However, if the minor died before reaching age thirty and had no living descendants at death, the trust would pass to a 67 year old relative. The IRS determined that the 67 year old relative (rather than the then-minor grandchild) was the measuring life for the trust. Because many practitioners feared how far the IRS might look for remainder beneficiaries, the "conduit trust" safe harbor was commonly utilized in order to maximize the account stretch out. Under Reg. §1.401(a)(9)-5QA7(c)(3)(Ex. 2), the income beneficiary of the trust was deemed to be the sole beneficiary for purposes of determining minimum distributions if the trustee was directed to immediately distribute all amounts withdrawn from the account to the beneficiary (free of trust). As a result, the trust was a mere conduit for amounts passing from the retirement account to the beneficiary.[7]

**d.** **Spousal Rollover:** A spousal beneficiary rollover is the transfer of the deceased spouse's retirement fund assets to the surviving spouse beneficiary of a retirement account. However, instead of treating the account as an inherited IRA (as is the case with a non-spousal beneficiary, discussed above), the surviving spouse can elect to transfer (i.e., roll-over) the account to a qualified retirement account in his or her name. The amounts in the inherited IRA thus become subject to tax rules as if the inheriting spouse had established the account for him or herself. No distributions are required from the inherited IRA by reason of the prior owner's death. Instead, distributions are based on the rules for the surviving spouse, including establishing a new required beginning date. The spouse could then name new beneficiaries to further continue deferral.

**e.** **Summary of Pre-SECURE Act Stretch-IRA Planning .** Prior to the enactment of the SECURE Act, surviving spouses were commonly designated as the primary account beneficiary, with younger persons (e.g., children) designated as contingent beneficiaries. Due to the favorable tax rules described above, the surviving spouse (particularly if he or she was younger[8]) would typically roll over the account into his or her name to

[7] As a result, conduit trusts were often a poor strategy for troubled beneficiaries.

[8] If an account owner was married to a spouse-sole beneficiary more than 10 years younger, a special life-expectancy table to calculate RMDs was required. Rather than using life-expectancy table III, the Uniform Lifetime Table, in

accomplish the first level of extended deferral. The children (or trusts for the children) would then be re-named as the surviving spouse's primary beneficiaries to accomplish a second level of deferral.

## III. Estate Tax Planning

Although designating the surviving spouse has typically been the most flexible approach for purposes of income-tax deferral maximization, doing so can be problematic from an estate-tax minimization standpoint. Fortunately, due to the intersection of Washington State's community property laws, planning methods are available to accomplish both income tax and estate tax goals.

**a. Marital Deduction Gifts**. The value of property passing to a surviving spouse as the result of the death of the other spouse reduces the value of the deceased spouse's estate (the "taxable estate") on a dollar-for-dollar basis for estate tax purposes. See, e.g., IRC § 2056(a). Gifts in trust for the benefit of the surviving spouse (generally those described in IRC §§ 2056(b)(5) and 2056(b)(7)) may also qualify for the estate tax marital deduction.[9] As a result, if a surviving spouse is the sole or a principal beneficiary of a taxable estate, it is common for the combined Washington State and federal estate tax liability to be zero at the time the first spouse dies.

**b. "Exemption" Gifts**. Due to changes in federal tax law enacted under the Trump administration, the federal estate tax currently applies only to estates over $11.58 million (or $23.16 million per married couple) at a 40% maximum rate. This exemption amount is reduced by lifetime taxable gifts (which also are granted the $11.58 million per-person exemption). The changes in law also increased the generation-skipping transfer tax ("GSTT") exemption to a level equal to the federal gift and estate tax exemption. These exemptions are tied to inflation and continue to increase until they sunset at the end of 2025 at which time they return to pre-change levels (generally $5 million per spouse subject to inflation). For convenience, these materials refer to the federal gift and estate tax exemption as "the federal exemption," and the GSTT exemption as "the GSTT exemption."

However, Washington state imposes its own estate tax on estates over $2.193 million at a maximum 20% rate. This amount is also subject to inflationary increases. Accordingly, if a Washington state resident dies in 2020 with assets in excess of $2.193 million, such excess will be subject to Washington state estate tax at his or her death. A common Washington state estate planning strategy is thus for a spouse to give the $2.193 exemption amount ("exemption gift") at death to a beneficiary other than the surviving spouse individually, such as a trust for the spouse, and to give only the part of the estate that exceeds the $2.193 million exemption gift to the surviving spouse ("marital gift"). This makes it possible not only to achieve a zero estate tax at the first death, but also to take full advantage of the married couple's combined estate tax

Appendix B of IRS Publication 590-B to calculate their required minimum distribution, such persons needed to use life-expectancy table II, the Joint Life and Last Survivor Expectancy, to determine the RMD. The general result was that the owner would not be required to withdraw as much money each year as he or she would if the spouse were older.

[9] The married persons referred to in these materials are assumed to be United States citizens. Only a gift meeting the requirements of the IRC § 2056(d) "qualified domestic trust" rules qualify a gift to a non-United States citizen for the estate tax marital deduction. Non-citizen spouse planning is outside the scope of these materials.

exemptions by excluding the $2.193 million exemption gift of the first spouse from the taxable estate of the surviving spouse.

For example, if a married couple with $4.386 million owned jointly as community property dies without utilizing the first spouse's exemption, the surviving spouse will own that full amount at death, with only a single $2.193 million exemption. The result will be estate tax in excess of $250,000. However, at the first spouse's death, a $2.193 million exemption bequest can instead be made to the children of the deceased spouse, or to a trust (sometimes referred to as a "bypass" trust or "credit shelter" trust) that may provide benefits to the surviving spouse and/or other family members. Assuming the gift to the bypass trust does not result in an estate tax marital deduction because the requirements of IRC § 2056(b)(5) or 2056(b)(7) are not met, and also assuming the application of § 2041 (in connection with powers of appointment that may be granted to the surviving spouse) is avoided, then the trust is not subject to estate tax at *either* spouse's death. IRC § 2044(b). The surviving spouse's $2.193 million Washington state (and $11.58 million federal) exemption remain fully available to shelter other assets from tax, and no estate tax is due at the first or second death. Accordingly, use of a bypass trust generally doubles the amount of assets that can be shielded from estate tax for married persons.

**c. Non-Pro Rata Partition Of Community Property Among The Estate and Surviving Spouse**. Absent a provision in the governing instrument prohibiting non-pro rata distributions of the decedent's assets, RCW 11.68.090 and RCW 11.98.070(15) authorize a personal representative acting under non-intervention powers, or a trustee, to select any part of the probate estate or trust in satisfaction of any partition or distribution, in kind, in money or both, to make non-pro rata distributions of property in kind, and to allocate particular assets or portions of them or undivided interests in them to any one or more of the beneficiaries without regard to the income tax basis of specific property allocated to any beneficiary and without any obligation to make an equitable adjustment. Estate of Ehlers, 80 Wn. App. 751 (Div. III, 1996). Most Wills do not contain a prohibition against the non-pro rata distribution of the decedent's assets among the shares established under the Will, since such a prohibition would make the Will too inflexible in the vast majority of cases. Rather, the more customary approach is for the Will to contain an express discretionary power to make non-pro rata distributions among the shares.

Additionally, RCW 11.02.070 grants the personal representative the power to administer the whole of the community property during the administration of the estate, and RCW 11.28.030 grants the surviving spouse the right to administer the community property, even if the Will provides to the contrary. RCW 6.15.020 confirms that the non-participant spouse's interest in an IRA is subject to disposition by Will, and therefore is subject to administration under the statutes referenced in the preceding paragraph in the same manner as other assets that pass by Will.

Thus, the surviving spouse serving as sole personal representative with non-intervention powers has the specific, exclusive fiduciary authority under Washington law to make non-pro rata distributions of the community assets, including an interest in an IRA that is subject to administration (whether as part of an equal partition of the entire community estate, or a division of property between different shares of the decedent's estate). This exclusive authority of the surviving spouse is, according to the IRS letter rulings below, all that is necessary to qualify an IRA for the spousal rollover when the estate or revocable living trust (instead of the spouse) is the named beneficiary.

For example, if an estate passing in two equal shares consists of a $1 million cash account, and a $1 million parcel of real estate, the Personal Representative is not required to distribute 50% of each asset to each beneficiary. Rather, the Personal Representative may distribute 100% of the cash to one beneficiary, and 100% of the real estate to the other. This procedure may be used, for example, to accomplish the distribution to the surviving spouse of the entire former community interest in the personal residence to preserve the ability of the surviving spouse to exclude post-death gain resulting from future sale under IRC §121,[10] or to allocate the decedent's interest in closely held corporation stock to the survivor to preserve the S election.[11]

**d. <u>Non-Pro Rata Distributions of Community Property Retirement Account Interests.</u>**

**1. *Example*:** Consider the following hypothetical scenario:

A. A $4,386,000 exclusively community property estate is comprised of $2,193,000 cash and a $2,193,000 IRA.

B. Both spouses are 60 years old when the first death occurs in 2020. The surviving spouse is named the IRA beneficiary by the deceased participant spouse, and the estate is the contingent IRA beneficiary in the event of disclaimer by the surviving spouse. The full $2,193,000 Washington State and $11.58 federal exemptions are available to the decedent's estate, at least $1,096,500 of which will be wasted if the decedent's $1,096,500 community interest in the IRA passes directly to the survivor as provided in the beneficiary designation, and is consequently unavailable for distribution to the bypass trust established under the Will.

C. The surviving spouse (who is also the sole personal representative of the decedent's estate) disclaims the decedent's interest in the IRA in order to ensure that $2,193,000 of total assets will be subject to administration in the decedent's half of the community estate and available for distribution to the bypass trust established under the Will. The decedent's estate is thereafter comprised of a $1,096,500 half interest in the cash account, and a $1,096,500 half interest in the IRA. The written disclaimer document is unconditional and does not contain any direction by the surviving spouse as to the disposition of the disclaimed property. However, the surviving spouse does not resign as personal representative, nor disclaim any of the normal powers of the personal representative.

D. In a later equal, non-pro rata partition of the community property estate, the decedent's $1,096,500 half interest in the community IRA is allocated by the surviving spouse/personal representative to the survivor's 50% share of the community estate, and

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[10] An equal non-pro rata partition of community property incident to divorce is a non-taxable event independent of the application of IRC § 1041. Rev. Rul. 76-83, 1976-1 C.B. 213, <u>Jean C. Carrieres</u>, 64 T.C. 959 (1975). The <u>Carrieres</u> principle has been applied by the IRS in private letter rulings when community property is voluntarily partitioned by married persons, and when a marital community is terminated and partitioned as a result of death. Thus, equal non-pro rata distributions of assets of the former community estate may generally be made income-tax free between the surviving spouse's one-half share and the one-half share of the deceased spouse. The specific issue of allocating retirement accounts in this manner is discussed below.

[11] Distribution of S corporation stock to a testamentary trust that does not constitute a "qualified subchapter S trust" as defined in IRC § 1361(d)(3), or an "electing small business trust" as defined in IRC § 1361(e), will terminate the S election after sixty days under IRC § 1361(c)(2)(A)(iii).

the survivor's $1,096,500 half interest in the community cash is allocated to the decedent's 50% share of the community estate. This leaves the decedent's estate with $2,193,000 cash, and the survivor with the entire $2,193,000 IRA as his/her separate property.

E. The decedent's entire estate ($2,193,000 cash) is then distributed to the bypass trust established under the Will.

F. Distributions from the IRA are not made thereafter until after the survivor reaches the applicable required beginning date.

The hypothetical presents at least two issues. First, is the disclaimer a qualified disclaimer under IRC § 2518? Second, is the non-pro rata distribution of the decedent's interest in the IRA income-tax free, or is it an income-taxable disposition of income in respect of a decedent (IRD) under IRC §§ 1001 and 691(a)(2)?

**2. *Is The Disclaimer Qualified?***

**A**. **Treas. Reg. § 2518-2(e)(2)**. The IRS ruled in Private Letter Ruling that the surviving spouse can make a qualified disclaimer of the deceased spouse's interest in a community property IRA. However, that ruling did not address the following pertinent question: subsequent to the disclaimer, does the non-pro rata distribution to the surviving spouse of the same interest in the IRA he or she previously disclaimed (unconditionally, without any direction at the time the disclaimer was made as to the disposition of the disclaimed property) prevent the disclaimer from being qualified under IRC § 2518?

No cases or rulings appear to specifically address this issue in the IRA context, perhaps making an advance letter ruling advisable. However, IRC § 2518(b)(4)(A) and the corresponding regulations indicate that the disclaimer will most likely be qualified. Treas. Reg. § 2518-2(e)(2), entitled "Disclaimer By Surviving Spouse," provides that a surviving spouse may make a qualified disclaimer of property if:

> ...the interest passes as a result of the disclaimer without direction on the part of the surviving spouse either to the surviving spouse or to another person. If the surviving spouse, however, retains the right to direct the beneficial enjoyment of the disclaimed property in a transfer that is not subject to Federal estate and gift tax (whether as trustee or otherwise), such spouse will be treated as directing the beneficial enjoyment of the disclaimed property, unless such power is limited by an ascertainable standard. See examples 4, 5 and 6 in paragraph (e) (5) of this section [emphasis added].

The referenced example 5 provides that if the disclaiming surviving spouse retains with respect to the disclaimed property a "testamentary non-general power to appoint among designated beneficiaries" which is not limited by an ascertainable standard, then the disclaimer is not qualified unless the power of appointment is also disclaimed. The referenced example 6 conversely provides that if the disclaiming surviving spouse retains with respect to the disclaimed property, a "power to invade corpus if needed for [the surviving spouse's] health or maintenance," then the disclaimer is qualified even though the surviving spouse does not also disclaim the retained power.

Even in the unlikely event that the statutory power to make non-pro rata distributions from an estate constitutes a power of appointment for purposes of the rule above, the requirement of the regulation that the power must be limited by an ascertainable standard is nevertheless expressly satisfied under Washington law. RCW 11.95.100 provides that, unless a contrary intention is clearly indicated, the holder of any lifetime or testamentary power of appointment may exercise the power in his or her favor only for his or her "health, education, support or maintenance as described in section 2041 or 2514 of the Internal Revenue Code..."

**B**. **Private Letter Ruling 9707008.** PLR 9707008 t addresses the impact of a retained fiduciary power to make non-pro rata distributions in the qualified disclaimer context. In this ruling, the surviving spouse was the named beneficiary under a life insurance policy and was also the executrix with a power to make non-pro rata distributions of estate assets to estate beneficiaries. The decedent had also granted her the power, in her capacity as a beneficiary, to select the estate assets in satisfaction of the marital deduction gift made to her under the Will.

The surviving spouse proposed to disclaim the right to receive the life insurance proceeds, in which case they would become payable to the estate. She further proposed to retain her power as executrix to make non-pro rata distributions of the estate assets in satisfaction of the various gifts (including her marital deduction gift). In ruling that the proposed disclaimers were qualified, the IRS specifically concluded that the retained fiduciary power was not the type of prohibited retained power described in the regulations, because it was simply an administrative power:

> Spouse's fiduciary discretion to select assets to fund the various bequests is administrative in nature and not a power to allocate enjoyment of the disclaimed property or to effect a redistribution of the property.

This strongly suggests that the surviving spouse may make a qualified disclaimer of the deceased participant spouse's community property IRA interest, even though he or she retains the fiduciary power to later distribute the disclaimed IRA interest back to himself or herself as part of his or her share of the estate.

**3. *Is the Partitioning and Allocation of Community Property to separate shares Income Tax Free*?**

The equal partition of jointly owned property is not a taxable sale or disposition under § 1001 where the co-owners sever their interests but do not acquire a new or additional interest as a result of the severance. Rev. Rul. 56-437, 1956-2 C.B. 507. Silverstein v. U.S., 419 F.2d 999 (7th Cir. 1969). Similarly, an equal, non-pro rata partition of community property, incident to a divorce, was ruled (prior to, and completely independent of, the enactment of IRC § 1041) to be a non-income taxable event in Rev. Rul. 76-83. This ruling is consistent with Jean C. Carrieres, 64 T.C. 959 (1975) and Clifford v. Wren, 24 T.C.M. 290 (1965). As a result of an equal, non-pro rata partition of community property, both parties end up only with an interest in some of the same assets in which they already had an interest prior to the partition, and the post-partition interest is equal in value to the previously held interest. Accordingly, such a partition of community property as a result of the termination of a marriage does not constitute an "exchange of property for other property differing materially either in kind or in extent" within the meaning of Treas. Reg. § 1.1001-1(a).[12]

There are numerous IRS technical advice memorandums and private letter rulings also providing that the non-pro rata lifetime or post-death partition of community property, or non-pro rata distribution of the assets of an estate or trust, can be accomplished income-tax free.

A. **Private Letter Ruling 8003109**. Relying on Rev. Rul. 76-83, this ruling concludes that an approximately equal, non-pro rata division of four community property pension/retirement accounts by married persons into four separate property accounts (three for him, one for her), is not income taxable under IRC § 1001. Although Rev. Rul 76-83 involved a partition of community property incident to divorce, the division referred to in this private ruling was apparently not divorce-related (the partition was motivated by moving to a separate property state).

B. **Private Letter Ruling 8037124**. The IRS again ruled that an approximately equal non-pro rata partition of community property by a married couple is not an income taxable event. The purpose for the non-pro rata partition was to provide liquidity "for estate taxes," and was again unrelated to divorce.

C. **Private Letter Ruling 8016050**. The IRS extended Rev. Rul. 76-83 to similar equal, non-pro rata divisions of community property following the death of the first spouse. The basis for the ruling is that, under the applicable state law, the survivor's one-half ownership interest in all the community property, as an entity, continues during the administration of the deceased spouse's estate, until a severance or partition occurs. The IRS relied in part on U.S. v. Merrill, 211 F.2d 297 (9th Cir. 1954), a case construing Washington law, and concluded that California law was the same as Washington law in this respect.

D. **TAM 8505006**. The IRS again approved of the Rev. Rul. 76-83 principle that the equal, non-pro rata division of community property that occurs following the death of the first spouse may be accomplished income-tax free. This was a part of its ruling that such a division nevertheless does not affect the IRC § 2032 alternate valuation, which must be applied to the decedent's assets as initially constituted at the time of death, prior to the division.[13]

E **Private Letter Ruling 9537011**. This ruling approves the non-income taxable, non-pro rata distribution of IRD assets from a decedent's estate (savings bonds with an untaxed interest component that accrued prior to the date of death) among the fractional residuary shares of the estate. The ruling specifically concludes that the non-pro rata

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[12] These materials assume that the governing instrument divides estate residue property by use of a fractional share formula as opposed to pecuniary (i.e. an interest measured in dollars) bequests. Although the distribution of property as a specific or residuary gift is not a taxable sale or exchange, the distribution of property in satisfaction of a pecuniary gift is. Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935). Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940). Treas. Reg. § 1.661(a)-2(f)(1). The complexities of pecuniary versus fractional share formulae are outside the scope of this article.

[13] See also Private Letter Ruling 199925033, obtained for a client by Alan Montgomery of Montgomery, Purdue, Blankinship & Austin, PLLC, discussed at subparagraph F below, which also applied the non-recognition rule of Rev. Rul. 76-83 to a post-death, equal partition of community property.

distribution of the IRD among the fractional shares is not taxable under IRC § 691(a)(2), since the executor had the authority to make non-pro rata distributions under the state law that was incorporated by reference into the governing instrument.

All these rulings are distinguished from Rev. Rul. 69-486, 1969-2 C.B. 159, in which the IRS concluded that if a trustee is not independently authorized under the governing instrument or state law to make a non-pro rata distribution of property in-kind, but does so only as a result of the mutual agreement of the beneficiaries, then the non-pro rata distribution is equivalent to a pro rata distribution followed by an income-taxable exchange between the beneficiaries. Rev. Rul. 69-486 only requires gain recognition when a trustee makes non-pro rata distributions to residuary beneficiaries and no authority to do so exists under state law or the governing instrument. See Private Letter Rulings 9429012 and 9424026..[14]

F. **Reconciling the Rulings With the "Item Theory" of Community Property**. Washington State has adopted what is often called an "item" theory of community property. As a result, one-half of each community property item belongs to each spouse, and thus, the deceased spouse has no power to control the disposition of the surviving spouse's interest in the deceased spouse's Will.[15] It thus might be suggested that the non-pro rata allocation method described above (and IRS rulings supporting it) is inconsistent with the "item theory" of community property law. However, a closer reading indicates that this is not the case.

In Estate of Patton, 6 Wn. App. 464, 494 P.2d 238 (1972), the court ruled that the deceased spouse cannot impose in his or her Will a non-pro rata partition of the community property on an unwilling surviving spouse, since the deceased spouse only has the testamentary power to dispose of his or her one-half interest in each individual community property asset (in each "item" of community property). California also follows the item theory of community property. Estate of Resler, 278 P.2d 1 (Cal. 1954). However, the rule of Estate of Patton has no bearing on the *executor's* statutory authority to make such a non-pro rata partition, and it is upon this statutory authority (or authority granted in the governing instrument) that the IRS rulings are based.

Accordingly, under Washington law, both of the income non-recognition principles of Rev. Rul. 76-83 and Rev. Rul. 69-486 are applicable when retirement accounts are distributed as part of an equal, non-pro rata partition of community property following the death of the first spouse. The available authorities indicate that these principles should apply in every state which subjects the entire community property estate, as an otherwise indivisible entity, to the post-death administration by the executor or trustee up until the time of final partition. This should be true

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[14] Private Letter Ruling 9537011 is one of a long series of letter rulings (see, e.g., 200112031, 200103049, 200103003, 200103002, 200103001, 200045028, 200013014, 199951028, 199933027, 199930036, 199930011, 199930010, 199929021, 199922030, 199912040, 199912034, 199951028, 199933027, 199930036, 199930011, 199930010, 199929021, 199922030, 199912040 (discussed at subparagraph F below), 199912034, 9830017, 9801014, 9737017, 9731041, 9717012, 9717030, 9715024, 9709028, 9649015, 9625020, 9523029, 9422052, 9411033, 9410030, 9324015, 8119040, 8145026, and 8029054) providing that non-pro rata distributions between fractional shares of a decedent's estate or a trust are not income taxable if done pursuant to authority contained in the governing instrument or state law.

[15] In contrast, the "aggregate" theory of community property considers each spouse as owning one-half of all the couple's assets taken together.

regardless of whether that state follows the "item theory" of community property as described in Patton and Resler.

4. ***The Community Property IRA "Spousal Rollover" Rulings Under IRC § 408.***

The IRS has issued private letter rulings that appear to resolve any doubts about its position on the income-tax impact of making non-pro rata distributions of community property IRA interests from estates and trusts.

A. **Private Letter Ruling 199925033**. Alan Montgomery, a partner with the law firm of Montgomery Purdue Blankinship & Austin, obtained a favorable private letter ruling on behalf of a client from the IRS on March 25, 1999 (made available to the public June 25, 1999). Private Letter Ruling 199925033 confirms that the IRS does not consider the equal non-pro rata partition of the former community property estate (in this case held in a revocable living trust) following the death of one spouse to be an income-taxable event under either IRC Sec. 1001 or Sec. 691(a)(2). The IRS so ruled even though 100% of a community property IRA was allocated fully to the share of the surviving spouse (the "Survivor's Trust" under the revocable living trust agreement), and other community assets of equivalent value were allocated to the decedent's share for further non-pro rata distribution to the QTIP and bypass trusts. The IRS cited Rev. Rul. 76-83, 1976-1 C.B. 213 as the governing authority:

> Rev. Rul. 76-83, 1976-1 C.B. 213, holds that no gain or loss will be recognized from the approximately equal division of the fair market value of community property in a community property state under a divorce settlement agreement that provides for transfer of some assets in their entirety to one spouse or the other.
>
> The non-pro rata partition into equal shares of A and B's community property pursuant to the terms of the Trust is in substance the same as the division of the community property described in Rev. Rul. 76-83. Accordingly, the non-pro rata partition of A and B's community property in Trust and the allocation of B's share (the IRA X) to the Survivor's Trust is neither a sale or exchange for purposes of section 1001, nor a transfer for purposes of section 69 1(a)(2).

The IRS further ruled that the revocation of the Survivor's Trust by the surviving spouse and resulting distribution of the IRA directly to the surviving spouse will qualify for the spousal rollover under IRC §408, since the surviving spouse possessed the sole and exclusive authority to make the non-pro rata partition, revocation and distribution:

> In this case, B, the surviving spouse of A, has the power under the provisions of Trust to allocate IRA X to Survivor's Trust. B intends to exercise that power. Upon allocation, B will terminate Survivor's Trust which will result in IRA X passing to B. B will then request a distribution of IRA X and roll over the IRA X proceeds into an IRA set up and maintained in her name. Thus, in this case, control over the assets of IRA X will at all times lie exclusively with B. As a result, the general rule does not apply.
>
> Based on the foregoing, we hold that, for purposes of section 408(d)(3) of

> the Code, B will be treated as the beneficiary of IRA X. Thus, B will be treated, for purposes section 408(d)(3), as receiving the IRA funds from the decedent and not from the decedent's estate.

B **Private Letter Ruling 199912040**. The IRS reached a similar conclusion in Private Letter Ruling 199912040, which also dealt with a revocable living trust containing exclusively community property including an IRA interest. The deceased spouse IRA owner had survived the required IRA distribution beginning date (he was age seventy-two at his death) and named the revocable living trust as beneficiary of the IRA. The surviving spouse was the sole successor trustee and proposed to allocate 100% of the community property IRA to the Survivor's Trust, and other community property assets of equivalent value to the Bypass Trust. Unlike Private Letter Ruling 199925033, there was no QTIP trust to receive the marital deduction gift, and the marital deduction gift therefore was added to the Survivor's Trust along with the survivor's share of the community property. Thus, it is not clear from the language of the ruling whether all of the IRA "fit" into the survivor's one-half community interest share, or whether some of it had to be allocated to the marital deduction gift. The fact that Rev. Rul.76-83 was not cited in the ruling as the governing authority suggests perhaps it was the latter.

The IRS again ruled that the non-pro rata distribution of the IRA to the Survivor's trust was not income taxable under IRC Sec. 1001, but this time cited Rev. Rul 69-486 (upon which the numerous rulings described above are based) as the governing authority.

> In addition, the present case is distinguishable from Rev. Rul69-486 because it has been represented that Trust X and the applicable state law authorize the Trustee to make a non-pro rata distribution of property. Thus, the By-Pass Trust and Survivor's Trust are not required to receive pro rata distributions for each asset of Trust X. Accordingly, the proposed transaction will not be treated as a pro rata distribution followed by an exchange of assets between the ByPass Trust and Survivor's Trust.
>
> We conclude that the proposed distribution, whereby Individual A, as sole Trustee of Trust X, makes a non-pro rata allocation of the IRA to the Survivor's Trust, is not a taxable event under section1001 of the Code.

The IRS again ruled that the resulting distribution of the IRA to the surviving spouse qualifies for the spousal rollover under IRC §408, since the surviving spouse possessed the sole and exclusive authority to accomplish the non-pro rata distribution of the IRA to herself:

> However, in a situation where the surviving spouse has the power to allocate the assets as well as the power to revoke the trust, and cause the assets of the trust to revert to himself or herself, then, for purposes of section 408(d)(3) of the Code, the Service will treat the surviving spouse as having acquired the IRA proceeds from the decedent and not from the trust….
>
> Under these circumstances, we do not believe that the general rule above should apply. In such a situation, for purposes of section 408(d)(3) of the Code, the Service will treat the surviving spouse as having acquired the IRA from the decedent and not from the trust.

**5.** ***<u>Retirement Accounts Subject to ERISA.</u>*** So long as the participant spouse dies first (i.e., the scenario discussed in these materials), the principles described above apply generally to all retirement accounts, including those subject to ERISA. If, however, the non-participant spouse dies first, the analysis is more complex, involves federal preemption statutes, and is outside the scope of these materials.

**6.** ***<u>Summary of Pre-SECURE Act Spousal Beneficiary Designation Planning:</u>*** Private Letter Ruling 199925033 suggests it is highly likely that the designated beneficiary/surviving spouse can make a qualified disclaimer of the deceased spouse's community property IRA interest, and retain a fiduciary power to later distribute the disclaimed IRA interest back to himself or herself as part of his or her share of the estate or trust which received the disclaimed interest. This further suggests that the approach of naming the surviving spouse as primary beneficiary and the bypass trust as secondary beneficiary may not be the best choice. It may be preferable in circumstances where the surviving spouse will be the sole fiduciary, and where there will probably be sufficient other community property to accomplish the desired non-pro rata partition or distribution, to consider a different recommendation. The spouse should be named as the primary IRA beneficiary, the estate or revocable living trust as the first alternate beneficiary in the event the surviving spouse executes a qualified disclaimer, and the bypass trust (or its remainder beneficiaries individually) as the second alternate beneficiary in the event the estate or revocable living trust also disclaims the IRA (or there is no surviving spouse).

## IV. <u>Post -SECURE Act Retirement Planning</u>

### A. <u>The SECURE Act</u>.

On December 20, 2019, President Trump signed into law the "Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019," Pub.L. 116–94. The Act implemented many changes to tax-favored savings accounts, including raising the minimum age for RMDs from 70 ½ years of age to 72 years of age; allowing workers to contribute to traditional IRAs after turning 70 ½ years of age; and allowing taxpayers to use 529 education savings plan funds to repay student loans. However, the most significant impact of SECURE was on the stretch-IRA technique discussed above. Taxpayers older than 70 ½ as of December 31, 2019 could continue to take advantage of the old rules described in detail above. For others, all but a limited class of beneficiaries are now required to take the distribution of their benefits under qualified plans and IRAs within 10 years of the account owner's death. Accordingly, the SECURE Act has significantly limited beneficiaries' ability to continue tax-deferred growth (effectively killing the stretch IRA technique for most taxpayers).

Limited exceptions remain to the SECURE Act's sweeping RMD change. Life expectancy RMD calculations and distributions remain available only to beneficiaries who qualify as an "eligible designated beneficiary." Eligible designated beneficiary is defined to only include the following:

1. a surviving spouse;

2. a child of the retirement account owner (but only until that child reaches eighteen)[16];

3.. a "disabled" individual;

4. a "chronically ill" individual; or

5. an individual (other than above EDBs) not more than ten years younger.

**B. Impact:**

**1.** ***Spousal Beneficiaries.*** As noted immediately above, the SECURE Act left one major beneficiary class unaffected: the account owner's spouse. As a result, surviving spouses may still use their life expectancies for calculating RMD's. Moreover, the spouse's ability to roll the account over into a new IRA is unchanged. This means that all of the pre-SECURE Act spousal planning discussed above remains viable.

**2.** ***Non-Spouse Individual Beneficiaries***: Unless they qualify as an eligible designated beneficiary, non-spouse individual beneficiaries may no longer use their life expectancies to calculate their RMD's. Rather, a strict 10 year rule applies, within which all account funds must be withdrawn.

**3.** ***Non-Individual Beneficiaries other than Qualified Trusts.*** As noted above, a former consequence of naming a beneficiary without a life span (e.g., an estate) was that all funds were required to be distributed in five years (the five-year rule). Now, the five-year rule has been extended to ten-years, which is a benefit (only) in the context of non-individual beneficiaries other than qualified trusts. Unfortunately, the ten-year rule also applies to nearly everyone else.

**4.** ***Non-Conduit Qualified Trusts.*** As discussed above, a popular technique under prior law was to designate a Qualified Trust as a beneficiary. If that trust did not qualify as a Conduit Trust, then the RMDs were calculated based upon the oldest beneficiary's life-span. Now, the ten-year rule simply replaces the lifespan of the oldest beneficiary.

**5.** ***(Qualified) Conduit Trusts.*** If a Qualified Trust did qualify as a Conduit Trust, then each particular beneficiary's life span could be used. However, the trade-off for the certainty of conduit treatment was that the annual RMD had to be distributed out of the trust to the beneficiary each year as it was received. Many clients implemented Conduit Trust planning as part of an overall estate plan favoring trusts for creditor protection and proper management purposes since, generally speaking, the undistributed assets remain protected from the beneficiary's creditors and/or from the beneficiary's irresponsible decision making. The Conduit Trust method was in many cases thought to be consistent with that approach since the beneficiary's lifespan would presumably be long, so the relatively small RMD amounts required to be distributed did not present too great a risk to the creditor protection/prudent management purposes of the trust. Moreover, most clients (right or wrong) like to believe their beneficiaries will become more mature (and less of a creditor-risk) as they age.

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[16] This exception does not apply to grandchildren or other beneficiaries under 18.

Now, however, these assumptions are no longer valid. Due to the SECURE Act changes, substantial retirement accounts may be forced out of Conduit Trusts in ten-years or less, which may entirely frustrate the creditor protection purpose of the planning. As a result, any clients who have implemented Conduit Trust planning should review their beneficiary designation and trust planning to determine if changes are warranted.

**6. *Potential Changes to Conduit Trust Planning*.** If a client wishes to remove Conduit Trust planning from their estate plan, they have the following general options for their non-spousal retirement account beneficiary designations:

**A. Simply name an individual(s) as beneficiary.** The individual will be subject to the ten-year rule and will receive (and pay tax-on) the full account in ten years. This may be the favored approach for smaller retirement accounts, and/or in cases where beneficiary creditor claims or immaturity is not an issue.

**B. Name a *Non*-Conduit Qualified Trust.** As discussed, the major difference between Conduit Qualified Trusts and Non-Conduit Qualified Trusts (NCQTs) is that NCQTs are permitted to accumulate the RMDs within the trust. In other words, the trustee of an NCQT is not required to distribute such funds out to the beneficiary immediately upon receipt. Thus, so long as clients ensure that Conduit Trust language has been removed from their estate planning, Qualified Trusts may still be used for retirement beneficiary designation planning. The downside of accumulating income in such a trust is the potential for increased income taxes compared to if the beneficiary received the retirement account outright due to the higher income tax brackets applying to trust income at much lower levels.[17]

## V. Conclusion.

The most significant change implemented by the SECURE Act was to prohibit the immensely popular practice of stretching required minimum distributions over the lifespan of non-spousal beneficiaries. Now, almost all non-spouse beneficiaries will be required to withdraw all funds from qualified retirement plans within ten years of the account owner's death. Advisors should pay particular attention to clients who have designated trusts as account beneficiaries, as these estate plans may need revision. However, the SECURE Act has not changed the spousal beneficiary designation planning techniques discussed above. As a result, advisors may still implement and employ these non-pro rata allocation and roll over techniques to best maximize the estate tax minimization and income tax deferral benefits available under current law.

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[17] For example, the highest 2020 income tax bracket of 37% does not apply to an unmarried individual until the total taxable income exceeds $518,401, whereas that rate applies to trust income in excess of $12,750.