

**DISTRIBUTIONS FROM RETIREMENT PLANS:
NEW DEVELOPMENTS
AND
PLANNING OPPORTUNITIES**

**Marcia Chadwick Holt
Davis Graham & Stubbs LLP
Attorneys at Law
Denver, Colorado**

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MARCIA CHADWICK HOLT

Marcia Chadwick Holt joined Davis Graham & Stubbs, LLP in 1974 and is an attorney in the firm's Income Tax, Employee Benefits & Estates group. She has extensive experience in ERISA-related work including drafting a regional prototype deferred contribution plan. She also drafts welfare benefit plans and deferred compensation plans for corporations and partnerships and their executives. She advises clients on the impact of the Internal Revenue Code and ERISA on the administration of employee benefit plans. Ms. Holt also advises clients on ERISA issues in mergers and acquisitions and the attendant required due diligence.

In addition, Ms. Holt is a nationally-recognized expert on estate planning, estate administration and on advising individuals regarding planning for distributions from retirement plans and IRAs. Ms. Holt has been a frequent lecturer locally and nationally and has published several articles in Estate Planning for Trusts & Estates Magazine, CCH and other publications.

Ms. Holt is a Fellow, former Regent and former Member of the Executive Committee of the American College of Trust and Estate Counsel, and is the former chair of its Employee Benefits Committee. She is a former member of the Adjunct Faculty of the University of Miami School of Law Graduate Program in Estate Planning where she taught a week-long course on distributions from qualified plans and IRAs for seven years. She is a member of the Advisory Committee of the Heckerling Institute on Estate Planning at the University of Miami. She is an Academician and former member of the Executive Committee of the International Academy of Estate and Trust Law. She has been named in "Best Lawyers in America" by Woodward/White, Inc. in the fields of Tax, Employee Benefits, Trust and Estate Law since 1989, as one of "Denver's Top Lawyers" in Employee Benefits, Trust and Estate Law and as one of Colorado 2006 and 2007 Super Lawyers.

Ms. Holt received a J.D. from the University of Denver College of Law where she was a member of the *University of Denver Law Review*. She received an A.M.T. from Harvard University and an A.B., *magna cum laude*, from Radcliffe College.

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by
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I. DIRECT ROLLOVERS OR TRUSTEE-TO- TRUSTEE TRANSFERS BY CHILDREN OR OTHER NONSPOUSE BENEFICIARIES.

- A. Prior to 2007.** Between 1984 and 2007, there was *no* tax-free rollover for any amount received from an “inherited IRA” by a beneficiary who was not a surviving spouse. An IRA is treated as inherited if the individual for whose benefit the IRA is maintained acquired it because of the death of the IRA owner. Internal Revenue Code (“Code”) § 408(d)(3)(C); Private Letter Ruling (“PLR”) 200228023 (April 15, 2003). Note: Only the taxpayer who received the PLR is entitled to rely upon it.
- B. 2007 and Thereafter.**
1. In General. Effective for distributions in 2007 and thereafter, a nonspouse beneficiary can transfer a distribution from a decedent's eligible retirement plan by means of a direct rollover or trustee-to-trustee transfer to a nonspouse's beneficiary IRA or Individual Retirement Annuity if the plan offers such a transfer. The plan is not required to offer such a transfer. An eligible retirement plan includes a Qualified Plan, a Code § 403(a) Annuity, a Code § 403(b) Plan, an IRA under Code § 408(a), an Individual Retirement Annuity under Code § 408(b), and a Code § 457 Governmental Plan. The rollover is treated as an eligible rollover distribution.
 2. RMD Rules. Distributions from the beneficiary's IRA or Annuity are subject to the required minimum distribution (“RMD”) rules that apply to inherited IRAs of a nonspouse beneficiary. There are two rules. Distributions can be paid over: (1) the longer of the life expectancy of the designated beneficiary or the decedent if the decedent died after his or her required beginning date (“RBD”) or, (2) over the life expectancy of the designated beneficiary or under the five-year rule if the decedent died prior to his or her RBD except as provided under Notice 2007-7 (see below). Code § 402(c)(11)(A).
 3. Decedent as Owner. The decedent remains the owner and the nonspouse beneficiary has only a beneficial interest in the new account. That means that the RMDs must continue to be made based on the RMDs of the of the original nonspouse beneficiary. However, the nonspouse beneficiary can name successor beneficiaries.

C. **A Notice and a Clarification.**

1. Notice 2007-7. Notice 2007-7, 2007-5 IRB was issued on January 10, 2007 and discusses rules for transfers from eligible retirement plans to IRAs.
2. Clarification. A clarification of Notice 2007-7 was issued by the IRS in a Special Edition Employee Plans News Letter on February 13, 2007. It indicated that both the life expectancy and the five-year rule applied in the case of distributions from an IRA of a decedent who died before his or her RBD regardless of the plan provisions. Under regulations, the RMDs must begin by December 31st of the year following the death of the decedent if the life expectancy rule applies. In the alternative if the five-year rule applies, distribution of the entire account must be made by December 31st of the year containing the fifth anniversary of the decedent's death. The clarification indicated that if a beneficiary did not begin to take RMDs by December 31st of the year following the year of the owner's death, only the five-year rule would apply in the case of a decedent dying before RBD. It also stated the rule that RMDs cannot be rolled over to an IRA.
3. An Example. If a decedent dies in 2007 prior to his or her RBD, a designated beneficiary who is a child can rollover the *entire* decedent's account in the Qualified Plan by a direct rollover or trustee-to-trustee transfer to an IRA. If no rollover is made in 2007, the beneficiary can rollover the entire account in 2008 *less* the RMD required for 2008. In 2009, 2010 and 2011, the life-expectancy rule cannot apply. The beneficiary can rollover the entire account in each of these years but must take RMDs from the IRA under the five-year rule, that is, must withdraw the entire account on or before December 31st, 2012. No rollover is allowed after 2011 because the entire account would be an RMD in 2012.

PRACTICE POINTER: Advise a nonspouse beneficiary to rollover the decedent's account in an eligible retirement plan either in the year of the decedent's death or at least on or before December 31st of the year following the decedent's death. The nonspouse beneficiary must establish a *new* rollover IRA as *beneficiary* and take RMDs under the Single Life Table set forth in the regulations. The beneficiary must *not* commingle the inherited IRA with any other IRAs which the beneficiary established as owner. Note that the beneficiary's IRA will still be titled in the name of the *decedent* but the beneficiary's social security number will be used.

II. ROLLOVERS AND CREDITORS.

- A. The Bankruptcy Code.** The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“the Bankruptcy Act”) amended the Bankruptcy Code and expanded bankruptcy protection for a debtor’s Retirement Plans and IRAs. The Act took effect on October 17, 2005. P.L. 109-8 (April 20, 2005). Under the Bankruptcy Act, all debtors are entitled to a bankruptcy exemption for retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under: Code § 401 which includes Qualified Plans; Code § 403 which includes Annuity Plans and Tax-Sheltered Annuity Plans; Code § 408 IRAs, SEP-IRAs, and SIMPLE IRAs; Code § 408A Roth IRAs; Code § 414 Governmental Plans; Code § 457 Deferred Compensation Plans of state or local governments or tax-exempt organizations; or Code § 501(a) which exempts specified types of organizations from federal income tax. Bankruptcy Code § 522(b)(3)(C) and (d)(12). This exemption is available regardless of a debtor’s choice of federal or state law bankruptcy exemptions.
- B. Direct Rollovers.** The exemption also applies to retirement funds which are transferred in a direct rollover pursuant to Code § 401(a)(31) or in a trustee-to-trustee transfer to an eligible retirement plan. Bankruptcy Code § 522(b)(4)(C). Eligible retirement plans include Code § 401(a) Qualified Plans, Code § 403(a) Annuity Plans, Code § 403(b) Tax-Sheltered Annuity Plans, Code § 457 Governmental Plans, Code § 402A Roth Accounts, Code § 408 IRAs, and Code § 408A Roth IRAs.
- C. Cap.** There is a \$1 million cap on a debtor’s exempt assets which are held in an annual contributory traditional IRA or a Roth IRA. The assets that are subject to the \$1 million cap do not include amounts attributable to rollover contributions which are made pursuant to Code § 402(c), Code § 402(e)(6), Code § 403(a)(4), Code § 403(a)(5), and Code § 403(b)(8)), or earnings on these rollover amounts. Bankruptcy Code § 522(n). What does this mean? It means that the \$1 million cap does apply to amounts in an IRA which are rolled from one IRA into a second IRA since Code § 408(d)(3) rollovers are not listed in the Bankruptcy Act § 522(n) which excepts certain rollovers from the \$1 million cap. Was this an oversight? Time will tell. The \$1 million cap may be increased if the “interests of justice so require” and for inflation. Bankruptcy Code §§ 522(n), 104(b) 1 and 2.

PRACTICE POINTER: Do *not* commingle rollover IRAs which are completely exempt from bankruptcy with annual contributory IRAs or Roth IRAs which are subject to the \$1 million cap.

III. MARITAL DEDUCTION FUNDING ISSUES

A. Background: Qualification for the Marital Deduction.

1. QJSA and QPSA. The QJSA and QPSA will qualify automatically for the marital deduction. The interest of a surviving spouse in a survivor annuity in which only the surviving spouse has the right to receive payments before his or her death qualifies as Qualified Terminable Interest Property (“QTIP”). Code §§ 2056(b)(7)(C) and 2523(f)(6). If the executor of the first spouse to die does not make an election under Code § 2056(b)(7)(C)(iii) electing out of QTIP treatment, any interest remaining in the payments is includable in the surviving spouse’s estate under Code § 2044.

PRACTICE POINTER: Should the executor of the first spouse to die elect out of QTIP treatment for the QJSA or QPSA? Perhaps, if there is a term certain feature to the QJSA or QPSA but only to the extent that the estate of the first to die is less than the exemption equivalent and the survivor’s estate exceeds the exemption equivalent.

2. Lump Sum Payment. A lump sum payment made to a surviving spouse or QTIP Trust qualifies for the marital deduction. Code § 2056(b)(5) and (7); PLR 8351097, Sept 22, 1983 (lump sum payment to QTIP Trust qualifies for marital deduction). But why would the beneficiary choose a lump sum payment? It is immediately subject to income tax unless the spouse is beneficiary and causes a direct rollover.
3. Installment Payments.
 - a. Elected by the QTIP Trustee or Surviving Spouse. If the QTIP trustee or surviving spouse has the option to take a lump sum payment at any time but instead chooses to take installment payments, the distribution should qualify for the marital deduction. Reg § 20.2056(b)-5(f)(6); Rev Rul 82-184, 1982-2 CB 215.
 - b. Elected by Decedent. If the decedent elected installment payments and the QTIP trustee or surviving spouse has no option to take a lump sum payment, does the distribution qualify for the marital deduction? Under TAM 9220007, Jan 30, 1992, the participant selected distribution options from an IRA for his surviving spouse. The QTIP trustee could postpone distribution for five years under one option and had to postpone distributions under the other two options until the participant would have been 70½ years old. The QTIP trustee added a provision to “arguably” conform to Rev Rul 89-89, 1989-27 IRB 11 (now superceded). But, the options did not provide the spouse with all the income from the IRA

distributed at least annually for her entire life. The IRA is not QTIP under Code 2056(b)(7).

- c. Installment Payments Qualify as an Annuity and QTIP. Under PLR 9204017, Jan 24, 1992, a marital trust received installment payments from Qualified Plans and IRAs and was required to serve as a conduit and distribute all such installment payments to or for the benefit of the surviving spouse within the calendar year received. The payments qualified as an annuity for purposes of Code § 2056(b)(7), that is, they qualified for an automatic QTIP election. If the executor of the first spouse to die does not make an election under Code § 2056(b)(7)(C)(ii) electing out of QTIP treatment, any interest remaining in the payments are includable in the surviving spouse's estate under Code § 2044.
- d. Payments from an Unfunded Plan Qualify as QTIP. Under PLR 9040029, July 6, 1990, installment distributions payable over 15 years to a trust pursuant to an unfunded deferred compensation agreement did not disqualify trust from QTIP treatment.
- e. QTIP Regulations. Look at the QTIP regulations, specifically examples 10 and 11 of Reg § 20.2056(b)-7(h). Under example 10, a spouse's right to all the income and remaining installment payments qualifies for the marital deduction even though the balance remaining at the spouse's death passes to the participant's children. Under example 11, if a spouse is entitled to income, the portion of principal needed to generate the income may be entitled to a marital deduction. But see, PLR 9409005, Oct 29, 1993 (spouse's annuity interest in a trust does not qualify as QTIP).
- f. Qualified Domestic Trust. If the spouse is not a citizen, a special Qualified Domestic Trust should be the beneficiary. Code § 2056A. Income can be distributed free of estate tax but distribution of trust principal triggers an estate tax. Code § 2056A(b)(3). In PLR 9623063 (Mar 13, 1996), a non-citizen spouse was named beneficiary of the decedent's IRAs. The spouse created an irrevocable qualified domestic trust ("QDOT"). The trustee of the QDOT served as custodian of the rollover IRAs. The IRS ruled the spouse would be the deemed account holder for minimum distribution purposes. Furthermore, the QDOT did not need to meet any marital deduction requirements since the spouse as beneficiary of the IRAs created it. Hence, all income earned on the IRAs need not be distributed to the surviving spouse.

B. Revenue Ruling 2006-26: What is Income for QTIP Purposes?

1. Background. Revenue Ruling 2006-26 (the “Ruling”) superceded Revenue Ruling 2000-2 and dealt with the issue: What is income? 2006-22 IRB 939 (05/04/2006). The Ruling applies to both IRAs and Retirement Plans which are defined contribution plans. The Ruling presented three different factual situations involving the Uniform Principal and Income Act (“UPIA”) and qualification of a spousal interest in a trust as QTIP and, hence, eligible for the marital deduction pursuant to Code § 2056(b)(7).
2. Holding. The bottom line is that to qualify a QTIP trust for the marital deduction, the trustees may not solely rely upon a provision of state law which provides that only 10% of an RMD must be allocated to income to qualify for the marital deduction. Instead, the spouse must have the power to unilaterally access all the income of the IRA or Retirement Plan and all the income of the trust payable at least annually. Income for these purposes must be determined either (1) under a state law power to adjust or unitrust regime that complies with the requirements of the Regulations, or (2) under the traditional definition of fiduciary accounting income such as interest and dividends. Reg § 1.643(b)-1.
3. Significance. If you have already included in your trust agreements language to comply with Revenue Ruling 2000-2, additional language should *not* be necessary to comply with Revenue Ruling 2006-26. However, if the QTIP trust is relying only upon the distribution requirements of UPIA § 409(d) wherein only 10% of an RMD is allocated to income, the trust would *not* qualify for QTIP treatment unless amended to provide that the spouse has the power to unilaterally access all the income of the IRA or Retirement Plan and all the income of the trust payable at least annually.

C. New Developments in Funding Issues.

1. Using a Fractional rather than a Pecuniary Share for the Trust.
Remember: The distribution of the right to receive income in respect of a decedent (“IRD”) such as installment or term-certain annuity distributions from a Qualified Plan or IRA in satisfaction of a pecuniary bequest may accelerate the recognition of income for income tax purposes for the distributing estate or trust. If a specific pecuniary amount is funded by the right to receive IRD, the estate or trust must recognize gain on the transfer since the transfer is treated as a sale or exchange. Code 691(a)(2). Treas Reg § 1.661(a)-2(f)(1). Kenan v. Commissioner, 114 F.2d 217 (2d Cir 1940). The distribution of a pecuniary amount ascertainable only under a formula clause results in taxable income to the entity to the extent the value of the property on the date of distribution exceeds the entity’s basis in the property. If the formula clause involves a fractional share, the

estate's obligation is not a specific pecuniary amount and hence the transfer is not a sale or exchange. Rev Rul 60-87, 1960-1 CB 286.

2. Little Guidance. Until November 2006, there was little guidance in the area of distributions from a Qualified Plan or IRA. Some practitioners took (and still take) the position that the taxation of these distributions is governed by Code §§ 72, 402 and 408 exclusively and that until an actual distribution is made from the Qualified Plan or IRA, there is no recognition of income even under the principles of Code § 691(a).
3. Some Rulings. In one ruling, the IRS failed to discuss the issue of whether funding a pecuniary marital formula trust with an IRA constituted a taxable sale of the assets for income tax purposes. A widow withdrew the entire marital trust and rolled it into her own IRA within 60 days. The IRS ruled that the withdrawal and rollover constituted a valid spousal rollover without any discussion of whether the IRA would be taxable as of the date of its allocation to the marital trust. Practitioners asked: Is the funding of a pecuniary trust by an IRA perhaps not an issue? PLR 9623056 (Mar 12, 1996). In another ruling, an estate was the beneficiary of three IRAs. The decedent's will provided for the residue to pass to a QTIP trust. The spouse disclaimed a pecuniary interest in the trust based on a fraction. As personal representative, the spouse allocated the IRAs to herself in satisfaction of her intestate interest. The IRS did not discuss whether a pecuniary disclaimer funded by an IRA would cause acceleration of income for federal income tax purposes. Again: Is the funding of a pecuniary interest by an IRA perhaps not an issue? PLR 9623064 (Mar 14, 1996).
4. PLR 200608032 (Nov 30, 2005): Dodging the Issue. This PLR dealt with pecuniary gifts to charities which were beneficiaries under a trust and which were satisfied by allocating a portion of an IRA payable to the trust to each of the charities equal to the sum of money to which each was entitled. The PLR states: "[T]he letter ruling does not address issues, if any, that arise under sections 691(a) and 642(c)(1) of the [Internal Revenue] Code. In that regard, this letter ruling does not address the issue of whether Trust T realized income when portions of IRA X (now IRA Y) were transferred to charities." Some thought "so much for the Kenan case." Practitioners have long wondered whether such an allocation would lead to acceleration of income. The IRS seemed to have dodged the issue.
5. Contrary Chief Counsel Advice. CCA 200644020 (Nov 3, 2006) addressed the issue apparently dodged by the IRS in PLR 200608032 discussed immediately above. The CCA is quoted at length to give you a flavor of how strongly the advice is stated. However, the CCA "may not be used or cited as precedent." *Id.* The CCA posed two issues and drew two conclusions as follows:

a. Issues and Conclusion.

Q: “Did Trust have gross income under § 691(a)(2) on the assignment of a portion of Decedent’s IRA to the Charities in satisfaction of a pecuniary legacy?”

A: “Trust had gross income under § 691(a)(2) on the assignment of a portion of Decedent’s IRA to the Charities.”

Q: “If Trust had gross income under § 691(a)(2), was it entitled to a deduction under § 642(c)(1) for the portion of the Decedent’s IRA assigned to the Charities?”

A: “Trust was not entitled to a deduction under § 642(c)(1) for the portion of the Decedent’s IRA assigned to the Charities.”

b. The Reasoning.

The CCA stated:

“The amount of the balance in IRA at Decedent’s death, less any nondeductible contributions, is IRD under § 691(a)(1). If an estate or trust satisfies a pecuniary legacy with property, the payment is treated as a sale or exchange. See *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940). Because Trust used IRA to satisfy its pecuniary legacies, Trust must treat the payments as sales or exchanges. Therefore, under § 691(a)(2), the payments are transfers of the rights to receive the IRD and the Trust must include in its gross income the value of the portion of IRA which is IRD to the extent IRA was used to satisfy the pecuniary legacies.

The terms of the Trust do not direct or require that the trustee pay the pecuniary legacies from Trust’s gross income. Accordingly, the transfer of a portion of IRA in satisfaction of the pecuniary legacies does not entitle Trust to a deduction under § 642(c)(1).”

c. The Result. The trust was taxable on IRD with no corresponding charitable deduction!

d. The Taxpayer’s Response? The CCA stated that the taxpayer “does not agree that the partial assignment of IRA to the Charities results in a sale or exchange of the IRD element of IRA (and thus gross income under § 691(a)(2), with no allowable § 642(c) deduction for the reasons described above). The taxpayer argues that this conclusion is preempted by the application of § 408(d)(1), which provides that ‘any amount paid or distributed out of an IRA shall be included in gross income by the payee or distributee.

The taxpayer maintains that this rule, requiring actual payment or distribution, prevents the application of the Kenan principle and § 691(a)(2) to currently tax Trust since it has not received payments or distributions from IRA.”

- e. The CCA Response. “We disagree with this interpretation. We believe that under Kenan, Trust has received an immediate economic benefit by satisfying its pecuniary obligation to the Charities with property on which neither Trust nor Decedent have previously paid income tax which is a disposition for § 691(a)(2) purposes. We further believe that the language of § 408(d)(1) simply prevents the immediate taxation of IRA recipients on amounts in an IRA which are not currently payable under a theory of ‘constructive receipt.’ T:EP:RA, which has jurisdiction over § 408, does not object to our conclusion on this issue.”

The reference to T:EP:RA is to the Director, Employee Plans Rulings, and Agreements. Apparently, even the Employee Plans area goes along with the advice!

PRACTICE POINTER: The CCA is a *warning* to those estates and trusts which fund pecuniary devises with Retirement Plan or IRA assets. They may be in for a fight. Drafting fractional share devises rather than pecuniary devises will avoid the problem. Naming the charity or pecuniary devisee as beneficiary on a Retirement Plan or IRA beneficiary designation form will also avoid the problem.

IV. SOME TAX AND DISTRIBUTION ISSUES.

A. Can the Taxpayer Obtain An Estate Tax Discount for Income Tax Payable? No.

1. A Case.

- a. Facts. In Estate of Smith v. United States, SD Tex, No H-02-2046 (Jan 16, 2004), the estate contended that the value of the retirement accounts in the decedent’s estate should have been discounted to reflect the federal income tax liability resulting upon distribution to beneficiaries. The estate filed a lawsuit following disallowance of its refund claim. The government maintained that no discount should apply. The government argued that the court must apply the willing buyer/willing seller test to the retirement accounts at the date of decedent’s death and that a willing buyer would pay the value of the securities as determined by applicable securities exchange rates, and a willing seller would accept the same. It argued that the potential tax to be incurred by the seller, while significant to the seller, would not affect the sales price of the

securities and would not factor into negotiations between the hypothetical buyer and seller. It also noted that the beneficiaries are allowed an offsetting income tax deduction for the estate tax attributable to the retirement accounts under Code § 691(c).

- b. The Holding. The government's motion for summary judgment was granted. Decedent's estate was not entitled to discount the decedent's retirement accounts to reflect the potential federal income tax liabilities of the accounts' beneficiaries.

2. Another Case.

- a. Facts. In Estate of Kahn v. Commissioner, T.C., No. 12551-04, 125 T.C. No. 11, (Nov 17, 2005), at the time of her death, the decedent owned two IRAs. Both IRA trust agreements provided that the interests in the IRAs were not transferable, but both IRAs allow the underlying marketable securities to be sold. On the estate tax return, the estate reduced the net asset value of one IRA by 21 percent and the NAV of the other IRA by 22.5 percent to reflect the expected income tax liability resulting from the distribution of the IRAs' assets to the beneficiaries under Code § 408(d)(1). The commissioner issued a notice of deficiency disallowing the reduction in value of the IRAs, and asserted a deficiency in estate tax liability of \$843,892. The parties filed cross-motions for summary judgment.
- b. The Holding. Summary judgment was granted for the government. In computing the gross estate value, the value of the assets held in the IRAs could *not* be reduced by the anticipated income tax liability following the distribution of the IRAs. The court stated that a hypothetical sale between a willing buyer and a willing seller would not trigger the tax liability of distributing the assets in the IRAs because the subject matter of a hypothetical sale would be the underlying assets of the IRAs (marketable securities), not the IRAs themselves. A discount for lack of marketability was *not* warranted because the assets in the IRAs are publicly traded securities. Payment of the tax upon the distribution of the assets in the IRA is not a prerequisite to making the assets in the IRAs marketable. Thus, the court ruled that there is no basis for a discount and that Code § 691(c) already addresses the potential double tax issue. Accordingly, the court held that the valuation of the IRAs were dependent upon their respective net aggregate assets values.

PRACTICE POINTER: No discount is allowed in valuing retirement benefits for estate tax purposes for the anticipated income tax liability upon distribution of those benefits.

B. What Are the Rules for Taxation of Distributions from IRAs?

1. Rules. Distributions from Traditional IRAs (whether to the owner or to a beneficiary of the owner) are taxable to the distributee except to the extent of any basis in the account. Code § 72(e). The following rules apply:
 - a. Single Contract. All Traditional IRAs of an individual (including SEPs and SIMPLE accounts) are treated as a single contract.
 - b. One Distribution. All distributions during the individual's tax year are treated as one distribution.
 - c. Calculation. The value of the contract, the income on the contract, and the investment in the contract are calculated (after adding back distributions made during the year) as of the close of the calendar year in which the tax year of the distribution begins.
 - d. Withdrawals. Total withdrawals excludable from income in all tax years cannot exceed the taxpayer's investment in the contract in all tax years. The individual's investment in the contract is made up of the aggregate nondeductible contributions to the Traditional IRAs. Code §§ 408(d)(1), (2).
 - e. Separate Treatment. Traditional IRAs and Roth IRAs are treated separately for purposes of these rules. Code § 408A(d)(4)(A).
2. Example: Joe owns two Traditional IRAs. Before 2006, Joe did not make any nondeductible contributions to either Traditional IRA. During his 2006 tax year, Joe made a deductible contribution of \$1,000 to Traditional IRA 1 and a nondeductible contribution of \$500 to Traditional IRA 2. During his 2007 tax year, Joe withdrew \$1,500 from Traditional IRA 1 and made a \$2,000 nondeductible contribution to Traditional IRA 2. Joe's total nondeductible contributions were \$2,500 and his total withdrawals were \$1,500. Joe's \$2,500 in nondeductible contributions represents his basis in the contract. At the time of the withdrawal of \$1,500, the account balance of Traditional IRA 1 was \$10,000, and the value of the account balance of Traditional IRA 2 was \$5,000. The portion of the \$1,500 distribution which is excludable from income is a pro rata share of his investment in the contract determined as follows: $\$2,500/\$15,000 \times \$1,500$, or \$250. The balance of the distribution or \$1,250 is includable in Joe's gross income for 2003.

C. What Are the Rules for Taxation of Distributions from Roth IRAs?

1. Withdrawal of Contributions are Tax Free. An individual can withdraw his or her contributions tax free anytime subject to the rules below. Distributions from a Roth IRA are treated as made from contributions

first. All of an individual's previous Roth IRA distributions are aggregated for this purpose. Code § 408A(d)(4)(B)(i).

2. RMD Rules. RMD rules do not apply while the owner is living. They do apply to the beneficiary after the owner's death.
3. Qualified Distributions. An individual can withdraw earnings tax-free only if the distribution is a Qualified Distribution. Code § 408A(d). If the distribution is not qualified, earnings are subject to ordinary income tax and penalties for early withdrawal unless an exception applies.
 - a. Five-Taxable-Year Period. The Roth IRA must be held for 5-taxable years before any earnings can be withdrawn tax-free ("Five-Taxable-Year Period"). Code § 408A(d)(2)(B). The 5-taxable years begin with the first-taxable year for which the individual made a contribution to a Roth IRA. Because of the Five-Taxable-Year Period, no Qualified Distributions can occur before taxable years beginning in 2003. In addition, if an amount is rolled over or converted from a Traditional IRA to a Roth IRA and is then distributed within the Five-Taxable-Year Period beginning with the taxable year of the rollover or conversion, a 10% penalty tax applies unless there is an exception.
 - b. Purposes of Distribution. A Qualified Distribution is a distribution which is made:
 - (1) Age 59 ½. To the owner after he or she reaches age 59 ½.
 - (2) Death. To a beneficiary because of the owner's death.
 - (3) Disability. To the owner after he or she is disabled.
 - (4) Home Purchase. To the owner for a qualified first-time home purchase of up to \$10,000 lifetime. The distribution must be used within 120 days of the distribution for the "qualified acquisition costs" of acquiring a "principal residence" for a "first-time home buyer who is the owner, his or her spouse or a descendant or ancestor of either." Code §§ 72(t)(2)(F), 408A(d).

Consequently, if the Roth IRA is withdrawn at the death of the owner, earnings will not be taxable so long as the Roth IRA has been held for the Five-Taxable-Year Period.

4. Treated Separately. Roth IRAs and Traditional IRAs are treated separately for purposes of the rules requiring that all IRAs be treated as one contract, all distributions during any one year be treated as a single

distribution and that the value of the contract be computed as of the close of the calendar year. Code § 408A(d)(4)(A).

5. Income Acceleration. If a taxpayer dies before the full amount is includable in income, any remaining amount must be included in taxpayer's gross income for the taxable year that includes the date of death. However, if the surviving spouse is the sole beneficiary of all the decedent's Roth IRAs, the spouse can elect to continue income taxation under the four-year rule. Reg § 1.408A-4, Q&A 11.

6. Ordering Rules. Amounts withdrawn from a Roth IRA are treated as made in the following order:

a. From regular contributions.

b. From conversion contributions. Distributions allocated to a qualified rollover or conversion contribution are treated on a first-in first-out basis and as coming first from the taxable portion of the contribution or conversion.

c. From earnings.

Code § 408A(d)(4)(B). Reg § 1.408A-6 Q&A 8. The 10% penalty applies to income withdrawn unless an exception applies. Code § 408A(d)(4)(B).

Note: Distributions which are not qualified distributions may be withdrawn tax-free up to the aggregate amount of contributions to Roth IRAs. Excess amounts are includable in income.

D. What are the Rules for Taxation of Distributions from Roth 401(k) Accounts?

1. The Law. Code § 401(k) Plans and Code § 403(b) Tax-Sheltered Annuity Plans may allow participants to elect that all or part of their pre-tax salary deferral contributions instead be designated as after-tax Roth Contributions. TD 9237, 12/30/2005; Reg § 1.401(k)-1(f), 2 and 6; Reg § 1.401(m)-2 and 5; Prop Reg §§ 1.402(g)-1; 1.402A-1 and 2; 1.403(b)-3,5 and 7; 1.408A-10. The rules for distributions from a designated Roth Code § 401(k) or Code § 403(b) account ("Roth Account") differ from the rules explained above for Roth IRAs. These rules are below.

2. No Conversion for Roth Accounts. A pre-tax salary deferral contribution account under a Code § 401(k) Plan or Code § 403(b) Plan *cannot* be converted to a Roth Account. By contrast, a traditional IRA can be converted to a Roth IRA. Code § 402A.

3. RMD Rules Do Apply to Roth Accounts. Roth Accounts *are subject* to the RMD rules in the same way that pre-tax salary deferral contributions are. Code § 401(a)(9)(A) and Code § 401(a)(9)(B). The law does *not* except designated Roth Contributions from the lifetime RMD rules. Code § 402A. Taxpayers must take RMDs from their Roth Accounts no later than their RBDs. By contrast, an owner of a Roth IRA is *not* subject to the lifetime RMD rules. Code § 408A(c)(5).

PRACTICE POINTER: The inconsistent and contradictory distribution rules create new complexities for taxpayers who choose to own both Roth IRAs and Roth Accounts.

4. Qualified Distributions from a Roth Account. As in the Roth IRA, an owner of a designated Roth Account can withdraw earnings tax-free only if the distribution is qualified. Code § 402A. If the distribution is not qualified, earnings are subject to ordinary income tax and a 10% additional income tax for early withdrawal unless an exception applies. However, unlike the Roth IRA, an owner of a designated Roth Account *cannot* withdraw only contributions. Any withdrawal will be a *combination* of contributions and earnings.

There are two requirements for a Qualified Distribution from a Roth Account. The requirements are similar but *not* the same as those which apply to Roth IRAs.

- a. Five-Taxable-Year Period. Contributions to a Roth Account must be held for 5-taxable years before any earnings can be withdrawn tax-free (“Five-Taxable-Year Period”). The Five-Taxable-Year Period begins on the first day of the taxpayer’s tax year for which the taxpayer first makes contributions to his or her Roth Account and ends when five consecutive tax years have been completed. For example, if the taxpayer first made designated Roth Contributions to a Roth Account beginning July 1, 2006, the Five-Taxable-Year Period would end December 31, 2010.
- b. Purposes of Distribution.
- (1) to the owner after he or she reaches age 59 ½,
 - (2) to a beneficiary because of the owner’s death, or
 - (3) to the owner after he or she is disabled. Note that a distribution for a qualified first-time home purchase is *not* allowed.
5. Rollover of a Roth Account. The Five-Taxable-Year Period for a Roth Account and the Five-Taxable-Year Period for a Roth IRA are determined independently. If a Roth Account is rolled over to a Roth IRA, the period

that the rolled-over funds were in the Roth Account does not count towards the Five-Taxable-Year Period for determining qualified distributions from the Roth IRA. Prop Reg § 1.408A-10, Q&A 4. However, if a participant withdraws from his or her Roth Account in one plan and makes a direct rollover to a Roth Account under another plan, the Five-Taxable-Year Period from the old plan is carried over to the new plan so that it begins on the first day on which the employee made contributions to the Roth Account in the first plan, if earlier. Prop Reg § 1.402A-1, Q&A 4.

6. No Ordering Rules. The ordering rules described in § 3.2.4 for distributions from a Roth IRA do not apply to distributions from a Roth Account. All withdrawals from a Roth Account which are not Qualified Distributions are subject to income tax and the 10% additional income tax on earnings as determined on a pro rata basis. However, if an owner arranges for a partial direct rollover to another Roth Account, the portion that is rolled over is treated as consisting first of the amount of the distribution which is otherwise taxable. Prop Reg § 1.402A-1, Q&A 5. This represents an exception to the pro rata rule.

E. A Comparison Chart: Comparison of Roth IRA and Roth Account		
	Roth IRA	Roth Account
<u>Eligibility</u>		
Age restriction?	No	No
Income restriction?	Yes	No
	2007: Eligibility phases out for joint taxpayers with modified adjusted gross income (MAGI) between \$156,000 and \$166,000 and for single taxpayers with MAGI between \$99,000 and \$114,000	
<u>Contributions</u>		
Maximum allowable from compensation	2007: \$4,000 plus \$1,000 if age 50 or older	2007: \$15,500 plus \$5,000 if age 50 or older (Maximum applies to combination of pre-tax salary deferrals and Roth contributions)
<u>Distributions</u>		
Subject to RMD rules during owner's life?	No	Yes

E. A Comparison Chart: Comparison of Roth IRA and Roth Account		
	Roth IRA	Roth Account
Deductible?	No	No
Ordering Rules	Amounts withdrawn are treated as withdrawn in the following order: (1) from regular contributions; (2) from conversion contributions on a first-in first-out basis with distributions allocated to a qualified rollover or conversion contribution treated as coming first from the portion, if any, that was includible in gross income as a result of the conversion; and (3) from earnings.	The ordering rules for distributions from a Roth IRA do <i>not</i> apply to distributions from a Roth Account. All withdrawals from a Roth Account which are not Qualified Distributions are subject to income tax and the 10% additional income tax on earnings as determined on a <i>pro rata basis</i> unless an exception applies. However, if an owner arranges for a partial direct rollover to another Roth Account, the portion that is rolled over is treated as consisting <i>first</i> of the amount of the distribution which is otherwise taxable.
<u>Qualified Distributions</u> When does the Five-Taxable-Year Period begin?	Begins with the first-taxable year for which the individual makes a contribution to <i>any</i> Roth IRA <i>unless</i> a rollover or conversion is involved. In that case, the Five-Taxable-Year Period begins with the taxable year of the <i>rollover</i> or <i>conversion</i> to a Roth IRA.	Begins on the first day of the taxpayer's tax year for which the taxpayer first makes contributions to his or her Roth Account and ends when five consecutive tax years have been completed.
Reasons for Withdrawals	(1) to the owner after he or she reaches age 59 ½; (2) to a beneficiary because of the owner's death; (3) to the owner after he or she is disabled; or (4) to the owner for a qualified first-time home purchase of up to \$10,000 lifetime.	(1) to the owner after he or she reaches age 59 ½, (2) to a beneficiary because of the owner's death, or (3) to the owner after he or she is disabled. Note that a distribution for a qualified first-time home purchase is <i>not</i> allowed.
<u>Direct Rollover</u> Direct Rollover to Roth Account?	No	Yes, for after-tax contributions if to a Qualified Plan that separately accounts for

E. A Comparison Chart: Comparison of Roth IRA and Roth Account		
	Roth IRA	Roth Account
		after-tax amounts.
Direct Rollover to Roth IRA	Yes	Yes
<u>Withdrawal and then Rollover Within 60 Days</u> Rollover to Roth Account?	No	Yes, for taxable portion of distribution. No, for after-tax contributions.
Rollover to Roth IRA	Yes	Yes, amount rolled over is deemed to come first from amount includible in income.
<u>Conversion</u> Can pre-tax contributions be converted to a Roth?	Yes Conversion available only if taxpayer's AGI does not exceed \$100,000	No

F. A Planning Opportunity: Advantages of Roth Contributions to Roth 401(k) Accounts.

Roth contributions to a 401(k) Plan can be very appealing. For example, assume a taxpayer makes the maximum allowable contribution to a 401(k) Plan (which was \$15,000 in 2006) and has additional funds available to either save or pay taxes. Assume that any outside taxes earn 8% each year. If the taxpayer's marginal tax bracket is the *same* at contribution and distribution, the taxpayer will have the following results in dollars:

	Before-Tax Contributions to a 401(k) Plan	After-Tax Roth Contributions to a 401(k) Plan		
Annual elective contribution	15,000.00	15,000.00		
Outside savings (i.e. not added to Plan)	5,644.50	0.00		
Immediate tax cost @ 33% rate	0.00	5,644.50		
Cost at contribution	<u>20,644.50</u>	<u>20,644.50</u>		
<u>Distribution after any applicable income taxes @ 33%</u>	<u>Amount Remaining At Distribution</u>			
If continued for 10 years	222,700.00	234,700.00*		
If continued for 20 years	678,800.00	741,300.00*		
If continued for 30 years	1,639,000.00	1,835,200.00*		
If the taxpayer is in a <i>different</i> marginal tax bracket upon distribution:				
	<u>Years in 401(k) Plan</u>			
	10	20	30	
Roth Contribution to 401(k) Plan: Not taxable at distribution (see above)	234,700.00	741,300.00	1,835,200.00	
Before-Tax Contribution to 401(k) Plan: Taxable at distribution	10	20	30	
Amount remaining <i>after</i> taxes at:				
15% rate	270,700.00	842,200.00	2,063,200.00	
25% rate	244,000.00	751,400.00	1,827,500.00*	
30% rate	230,700.00*	706,100.00*	1,709,700.00*	
35% rate	217,400.00*	660,700.00*	1,591,900.00*	
40% rate	204,000.00*	615,300.00*	1,474,100.00*	
* Nontaxable Roth distribution is larger.				
Thanks to Rachel James an attorney with Davis Graham & Stubbs LLP for the calculations.				

The advantage continues if the Designated Roth Account is rolled over to a Roth IRA. No RMDs are required from a Roth IRA so the funds can continue to grow even after the taxpayer reaches his or her RBD.

G. Appeal of a Roth Contribution to a Roth Account?

A Roth Contribution to a Roth Account will appeal to:

1. The taxpayer who will be in as high a tax bracket (or perhaps a slightly lower tax bracket) when he or she takes distributions from the Roth Account or Roth IRA as he or she is when contributions are made.

2. The taxpayer who has separate funds from which to pay the income taxes due because of an after-tax contribution. The taxpayer has a charitable deduction carry forward or other credits which can be used to offset the tax due.
3. The taxpayer who is young and has many years until retirement.
4. The taxpayer who is on Social Security. Qualified Distributions from Roth Accounts are *not* taxable and, hence, would *not* affect the taxability of Social Security payments. The AGI will be less and Social Security may escape taxation.
5. The taxpayer who does not want to take RMDs and will *not* need to withdraw from the Roth IRA when he or she retires. RMDs are required from Roth Accounts but Roth Accounts can be rolled over to Roth IRAs. RMDs are not required from Roth IRAs.
6. The taxpayer who wants a Roth IRA but has too much income to be eligible to contribute to one. The taxpayer prefers to allow the Roth IRA to increase tax-free after his or her retirement and plans to pass it to his or her children. After the taxpayer's death, the Roth IRA can continue to build tax-free subject only to the RMD rules which apply to beneficiaries.

H. Who Gets Hurt by a Roth Contribution to a Roth Account?

A Roth Contribution to a Roth Account will hurt:

1. A taxpayer who needs to withdraw funds for college tuition or other reasons which are not Qualified Distributions. Such a taxpayer gains no benefit from paying income taxes early to contribute to a Roth Account. If the taxes had not been paid to the IRS, the funds could still be earning tax-free for the taxpayer.
2. A taxpayer who needs the funds and who is in a lower tax bracket when the funds are withdrawn from the Roth Account than when they were contributed. The taxpayer gains no benefit from paying the taxes early to contribute to a Roth Account.
3. A taxpayer who wants a deduction for contributing to the plan.

PRACTICE POINTER: The rollover rules are complicated. Plan well. The results can be very beneficial particularly if the goal is to pass a Roth IRA to younger generations at the taxpayer's death.