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Tax opinion: Transferring an IRA out of trust

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This *Study* explains the federal tax law regarding the transfer of a retirement plan out of a terminating trust, and also illustrates how the author complies with IRS Circular 230 when providing written tax advice.

The trustee of the Richard Roe Trust has asked my advice regarding the tax treatment of a proposed transfer of an individual retirement account from the trust to the trust's charitable residuary beneficiaries. The following "tax advice letter" is my response. Exhibits referred to in the "letter" are not reproduced.

____________, 2008

To: Jane Doe, Trustee
Richard Roe Trust
Number Street
City, State, Zip Code

Re: Tax Advice Regarding Transfer of Individual Retirement Account

Dear Trustee Doe:

I have reviewed the 18-page document entitled "Restated Agreement of Trust" dated [date], a copy of which is attached hereto as Exhibit A ("the Trust Instrument"), establishing the "Richard Roe Trust" (the "Trust"). You have requested my advice regarding the tax treatment of a proposed transfer of a certain retirement plan from the Trust to certain beneficiaries of the Trust.

In this letter, references to sections ("§") refer to sections of the Internal Revenue Code of 1986, as amended through date, unless otherwise specified. References to "Reg." refer to Treasury Regulations, unless otherwise specified. "PLR" stands for IRS private letter ruling.

References to "Circ. 230" refer to IRS Circular 230, 31 C.F.R. 10, T.D. 9165 (12/17/04),

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as amended through 9/26/07, "Regulations Governing Practice Before the Internal Revenue Service." Circular 230 sets out certain requirements applicable to the provision of written tax advice. Recitals in this letter that are specifically responsive to such requirements contain references to the applicable sections of Circular 230 in which such requirements appear.

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I. FACTS AND ASSUMPTIONS ON WHICH THIS LETTER IS BASED

The tax advice in this letter is based on the following facts and assumptions. In my opinion the factual and legal assumptions recited here are not unreasonable.

A. Facts and factual assumptions

The facts listed here are all of the facts that are relevant to the tax advice in this letter. These facts are as represented to me by you. It is reasonable for me to rely upon your representations in this matter because you are, or should be, familiar with the matters involved. Circ. 230, Sec. 10.37(a). You understand and agree that the advice in this letter cannot be relied upon if, and to the extent that, any of the facts and assumptions listed here are false.

The Trust Instrument recites that it is an amended and restated version of an earlier trust instrument. I have not reviewed any earlier version. I assume, based on your representation, that the Trust Instrument is the only document establishing the terms of the trust that is named as beneficiary of the IRA. I assume that all factual representations contained in the Trust Instrument are true.

The creator of the Trust is Richard Roe (hereinafter called "the donor" or "the participant"). You represent that Mr. Roe owned an individual retirement account at [name of IRA provider firm] ("the IRA"); that the value of the IRA on the date of his death was approximately $1 million; that Mr. Roe died on [date], 2008, at the age of 81; and that his date of birth was [date], 1926. Accordingly, he died after his "required beginning date." § 401(a)(9)(C), § 408(a)(6).

The beneficiary that he designated for his IRA was "Richard Roe Trust U/A DTD [date], Jane Doe Trustee." See copy of beneficiary designation form attached hereto as Exhibit B. You represent that the Trust is the trust that is named as beneficiary in Exhibit B; that this beneficiary designation form was in effect for the IRA as of the date of Richard Roe's death; that you are the sole trustee of the Trust; and that the Trust has not disclaimed and will not disclaim the IRA.

B. Legal assumption

I assume, and do not opine: that the IRA is qualified under § 408; that the Trust is a valid trust under applicable state law, enforceable in accordance with its terms; and that the two charitable residuary beneficiaries [see Section III (B) of this letter] are tax-exempt charitable organizations under §501(c)(3). See further assumptions in the body of this letter.

II. TAX MATTERS CONSIDERED; MATTERS NOT CONSIDERED

A. Tax question considered

This opinion addresses a federal tax issue regarding the "existence or absence of a taxable transfer of property." Circ. 230, Sec. 10.35(b)(3). Specifically, the following tax question is addressed in this opinion:

Transfer of Benefits to Beneficiaries: To the extent the Trust Instrument provides for the distribution of assets to charitable residuary beneficiaries, will the transfer or assignment of the IRA or portions of the IRA by the Trust to such beneficiaries be a taxable event for federal income tax purposes or not?

B. Matters not considered

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This letter does not address any aspect of the income tax treatment of any trust or IRA other than the income tax treatment of transfers of portions of the IRA as described in Section IV. This letter does not address any estate tax issues or any state tax issues.

This letter is based on the law as it now exists. Changes occurring after this date could render the advice in this letter invalid. I do not undertake any obligation to inform you of any such change in the law.

This letter deals only with the tax aspects of the proposed transfers. Some IRA providers do not permit post-death transfers of IRAs. This letter does not cover the legality of such transfers under applicable state law, or whether such transfers are permissible under the terms of the agreement establishing the IRA.

Because Mr. Roe died after his "required beginning date," a distribution must be taken from the IRA for the calendar year 2008. Reg. § 1.401(a)(9)-5, A-4(a). This letter does not advise regarding the amount of such distribution or who is required to take it.

III. Summary of Trust Instrument

In this Section of the letter, I am reviewing the provisions of the Trust Instrument and, where applicable, commenting on such provisions with respect to the matters covered in this letter.

A. Introductory matter

In parts 1-4 of the Trust Instrument, the donor states that he is unmarried, and that this trust may be referred to as the "Richard Roe Trust dated [date]," and deals with other matters regarding the administration of the Trust during his life and at his death. After his death, part 4 states that the Trust is to pay certain obligations of the donor's estate upon his death, including fulfillment of certain bequests under his will. This letter assumes that neither the IRA nor any distribution therefrom will become subject to these provisions; all such payments will be made out of other assets. This assumption is based on your representation that the IRA will pass as part of the "residue" of the Trust.

B. Disposition on donor's death

Part 5 of the Trust Instrument provides that the residue of the Trust shall be paid to the following beneficiaries in the following amounts: The trustee is to distribute one-quarter of such property to each of two charities, Charity X and Charity Y. The balance of the net trust property (half of the residue) is to be distributed to the donor's nephew, Thomas Roe, if living. You represent that Thomas Roe survived Richard Roe and does not intend to disclaim this gift. Accordingly, I will ignore the provisions of the Trust Instrument dealing with disposition of the trust assets if Thomas had predeceased Richard or disclaimed this gift, as these provisions are irrelevant to the matter discussed in this letter.

C. Other provisions

Part 9 recites that the Trust Instrument shall be interpreted according to, and the administration of the Trust shall be governed by, the law of [name of state].

Part 10 provides that, in the administration of the Trust, "the trustee, except as otherwise provided in this instrument, shall have the following powers and rights and all others granted by law." Among the powers granted under this part is the following: "(j) to divide, segregate, allocate or distribute trust property in undivided interests, non-pro rata or wholly or partly in kind at fair market value." There is no other provision in the Trust Instrument that would limit or deny application of this provision. Accordingly, the trustee has the power (sometimes referred to as a "pick and choose funding" power) under the Trust Instrument to transfer assets to beneficiaries in kind. The trustee is excused from any duty of making pro rata distributions to beneficiaries. Thus, it is within the trustee's discretion to pick and choose which assets will be transferred to which residuary beneficiaries, so long as each residuary beneficiary receives assets having the appropriate value to which that beneficiary is entitled under the terms of the Trust Instrument.

You have determined, and are satisfied, based on opinions of other counsel, that the Trust is valid under applicable state law and can be carried out according to its terms. In particular, you have determined that subparagraph (j) of part 10 of the Trust

Instrument does not violate and is not countermanded by any provision of law applicable to this trust. I am relying upon your and your counsel's determination in that matter. I am not familiar with the law of [name of state] in respect of trust matters, or any other matters, and your other counsel is familiar with such law and matters, so it is reasonable to rely upon your other counsel's opinion on this point.

IV. TRANSFERS OF IRA TO CHARITABLE BENEFICIARIES

A. Proposed transfer

You have determined that the value of the IRA is less than the total amount of the residuary bequests to the two charitable beneficiaries. Accordingly, you propose to transfer partial interests in the IRA to the respective charitable beneficiaries by the following means.

Currently, the IRA, which is an inherited IRA within the meaning of § 408(d)(3)(C)(ii), is titled in the name "Richard Roe, deceased, IRA, payable to the Richard Roe Trust as beneficiary." The taxpayer identification number associated with the account is the employer identification number of the Trust.

You, as Trustee, propose to instruct the IRA provider to divide the inherited IRA into two separate inherited IRAs of equal value. Following such division, you, as Trustee, will instruct the IRA provider to change the titling of these two accounts. One will be retitled "Richard Roe, deceased, IRA, payable to Charity X as beneficiary" (or as "successor beneficiary," depending on the preference of the IRA provider), or similarly. The other will be retitled "Richard Roe, deceased, IRA, payable to Charity Y, as beneficiary" (or as "successor beneficiary"), or similarly. The taxpayer identification number associated with each such account will thenceforth be the employer identification number of the charity that owns such account as beneficiary. In effect, you, as Trustee, will divide the IRA into two separate inherited IRAs, and transfer these two inherited IRAs to the charitable beneficiaries in partial fulfillment of their fractional residuary bequests, thus terminating the Trust with respect to the IRA. Following such transfers, each charitable beneficiary will liquidate the inherited IRA payable to it and take full distribution of the account.

B. Law

Amounts paid to a beneficiary from an IRA after the death of the IRA owner are taxable to the beneficiary as income in respect of a decedent (IRD) under § 691, to the same extent such amounts would have been taxable to the owner if paid to him or her during life. *Rev. Rul. 92-47*, 1992-1 C.B. 198; Reg. § 1.663(c)-5, Example 9. A retirement plan or IRA when it is inherited by the beneficiary, but prior to distribution of the benefits out of the plan or IRA, is a "right to receive IRD." See *PLRs 2002-34019, 2005-20004, 2005-26010, 2006-17020, 2006-20025, 2006-33009, 2006-44020* and *2006-52028*.

Generally, the transfer of a right to receive IRD, whether by gift or by sale, triggers immediate taxation of the embedded IRD to the transferor. § 691(a)(2), first sentence. However, this general rule does not apply to a "transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent." Instead, in the case of such a transfer, the transferee is taxable on the IRD as and when it is paid to such transferee (or upon a further transfer of the right to receive the IRD by such transferee, if such further transfer is not itself excepted). § 691(a)(2), second sentence; Reg. § 1.691(a)-2(a)(3); (b), Example 1.

Thus, for example, when an estate assigns, to a charitable residuary beneficiary of the estate, an IRA that is payable to the estate, the assignment is not a taxable transfer because it qualifies for the exception under § 691(a)(2). See *PLRs 2002-34019, 2005-20004, 2006-17020, 2006-33009. PLR 2004-52004* rules similarly, though, unlike the other rulings cited here, it does not mention § 691.

The exception, not the general rule, also applies when a trust that is named as beneficiary of a retirement plan transfers the Trust's interest in the plan to the Trust's residuary beneficiaries. Reg. § 1.691(a)-4(b)(3). Although the Regulation refers to a trust that "terminates," the exception applies to any properly authorized transfer from a trust to its residuary beneficiaries, which is, in effect, a

termination of the trust with respect to such asset. See *PLRs 2005-26010, 2006-52028, 2008-03002.* Thus, the transfer of an inherited IRA payable to a trust, from the trust to one or more of the trust's residuary beneficiaries, is not a taxable event.

The IRS Chief Counsel has opined that a trustee's transfer of retirement benefits in fulfillment of a pecuniary (fixed dollar amount) gift (in contrast to a fractional or percentage gift) is treated as a "sale" of such benefits, triggering immediate realization of income to the funding trust under § 691(a)(2). *PLR 2006-44020.*

C. Tax advice: Transfer is nontaxable

The proposed transfers described in subsection A above are not in fulfillment of a pecuniary gift. Such proposed transfers qualify for the exception to the general rule of § 691(a)(2). Accordingly, neither of such transfers would be treated as a sale of the IRA or as a sale of the right to receive IRD, and neither of such transfers would be taxable. Following such transfers, distributions from each IRA will be made to, and includible in the gross income of, only the transferee of such IRA. Reg. § 1.691(a)-4(b)(2). If such transferee is exempt from income tax under § 501(a), the distribution will, in effect, be nontaxable.

D. Tax advice: No "DNI" deduction

In some cases, a trust is entitled to a "distributable net income" (DNI) tax deduction for a distribution from the trust to a residuary beneficiary of the trust. § 661(a). Although the proposed transfer of the IRA to Charities X and Y will be a distribution of trust assets to those beneficiaries, the Trust will not be entitled to a "DNI" deduction with respect to such transfer, for two reasons.

First, the § 691 and § 661–§ 662 systems of income taxation are mutually exclusive. The transfer of a right-to-receive-IRD is governed by § 691, which "overrules" § 661 when it applies.[1] The "transfer by an estate of section 691 property is treated as a neutral event, and is not subject to the distribution rules of section 661 and 662."[2] As one source put it, "the general distribution rules of subchapter J . . . do not apply to distributions of rights to [IRD] . . . [the DNI] scheme is antagonistic to the rules of section 691 . . . Section 691 . . . prevails over the rules relating generally to distributions, and a transfer to a beneficiary of property representing [IRD] is treated as a neutral event."[3]

Second, a DNI deduction is never allowed for a distribution from an estate or trust to a charity. § 651(a)(2), § 663(a)(2). A distribution to a charity from an estate or trust is deductible, if at all, only as a charitable deduction under § 642(c). Apparently, all the DNI rules other than the DNI deduction itself do apply to a distribution to a charitable beneficiary; thus, the DNI rules are used to determine how much of a trust's income is distributed to a charitable beneficiary. See Reg. § 1.663(c)-5, Example 11. The deductibility of such distribution is then determined under § 642(c) rather than § 661.

E. Comment: Alternative method of fulfilling these gifts

The proposed transfer of the inherited IRA to the charitable residuary beneficiaries is not the only means by which you, as trustee, could fulfill their residuary bequests. Another alternative would be for you as trustee to request and receive distribution to the Trust of the entire IRA. Following receipt of the IRA proceeds of approximately $1 million, you, as trustee, could then transfer all or part of these cash proceeds to the charitable residuary beneficiaries in partial fulfilment of their bequests.

However, use of this alternative method could result in higher income taxes. The IRA distribution would be includible in the Trust's gross income as IRD under § 691(a). Because the Trust is payable proportionately to three residuary beneficiaries (Charity X, Charity Y, and nephew Thomas Roe), the three beneficiaries' respective interests would be treated as separate shares under § 663(c), which mandates that "substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts" for purposes of applying the DNI rules of § 661–§ 662. This is sometimes called the "separate share rule."

When the separate share rule applies to a trust, and such trust receives an IRD distribution that is treated as principal for trust accounting purposes, the gross income resulting from such distribution "is allocated among the separate shares that could potentially be funded with these amounts irrespec-

tive of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts." Reg. § 1.663(c)-2(b)(3), § 1.663(c)-5, Example 9.

The Trust Instrument does not mandate allocation of IRD to the shares of the charitable residuary beneficiaries. Instead, as explained above, the Trust Instrument allows the trustee to pick and choose which assets shall be allocated to each beneficiary's share. However, the above Regulation appears to override the trustee's "pick and choose funding" power. Thus, even if you as trustee chose to allocate an IRA distribution received by the Trust to the shares of the charitable residuary beneficiaries, the Regulation may have the effect of allocating the gross income resulting from such distribution proportionately to all of the beneficiaries whose shares had not been paid to them in full prior to the Trust's receipt of such distribution, to the extent such distribution constituted "principal" for trust accounting purposes under Reg. § 1.643(b)-1.

Although § 642(c) allows an estate or trust "a deduction in computing its taxable income…[for] any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a" permitted charitable purpose, a deemed allocation to the residuary share of the noncharitable beneficiary of part of the gross income resulting from the IRA distribution would cause a loss of a substantial portion of any otherwise permissible charitable deduction. As a result, the Trust and/or the Trust beneficiary(ies) could incur income tax on all or a portion of any distribution from the IRA to the trust, depending on: the sequence of distributions from the IRA to the Trust and from the Trust to the various residuary beneficiaries; the trust accounting treatment of such IRA distributions; and the interpretation of Reg. § 1.663(c)-2(b)(3).

Because of the possibility of unfavorable tax treatment of this alternative approach, you, as trustee, in fulfilment of your fiduciary duty to minimize taxes and other costs for the Trust by legally permissible means, propose to avoid such possible unfavorable tax effects by transferring the inherited IRA directly to the charitable residuary beneficiaries in partial fulfillment of their bequests.

E. Likelihood of audit or settlement

No advice in this letter takes into account the possibility that any tax return will not be audited, that any issue will not be raised on audit, or that any tax issue will be resolved through settlement with the IRS if raised. Circ. 230, Sec. 10.37(a).

F. IRS Circular 230 and other matters

The advice in this letter constitutes "other written advice" under Circular 230. The advice in this letter does not constitute a "covered opinion" because:

1. NOT A LISTED TRANSACTION: The proposed transfer discussed in this letter is not a "listed transaction" under 26 C.F.R. § 1.6011-4(b)(2). Circ. 230, Sec. 10.35(b)(2)(i)(A).

2. NOT A MARKETED OPINION: Although you are not restricted from disclosing the contents of this letter, the advice in this letter is for you and you alone and may not be relied upon by any other taxpayer. You represent that you will not, and that you do not have any reason to believe that any other person will, use or refer to the advice herein "in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to" any taxpayer. Circ. 230, Sec. 10.35(b)(5)(i).

3. NO CONDITIONS OF CONFIDENTIALITY: There is no limitation on your ability to disclose the advice herein or the tax structure of the proposed transaction. Circ. 230, Sec. 10.35(b)(6).

4. NO CONTRACTUAL PROTECTION: The fee you are being charged for the advice in this letter is not contingent on whether you obtain the tax consequences predicted in this letter. You have no right to a full or partial refund of fees paid to me or my firm if all or a part of the intended tax consequences from the matters addressed in the written advice are not sustained. Circ. 230, Sec. 10.35(b)(7).

5. NOT A PRINCIPAL PURPOSE ARRANGEMENT: The tax issues regarding which I have advised you in this letter do not arise from any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement "the principal purpose of which is the avoidance or evasion of any tax imposed by the" Code. Circ. 230, Sec. 10.35(b)(2)(i)(B). Rather, I have advised

you regarding the tax consequences of transactions necessitated by carrying out the terms of an individual's will, trust, beneficiary designation, or other estate planning documents. The purpose of carrying out such terms is to fulfill your duties as trustee. The documents, and the trust created by such documents, involved in this matter have as their primary purpose disposing of the individual's assets upon the individual's death. To the extent such documents and entities have tax reduction as an additional purpose, they represent the taxpayer's claiming tax benefits in a manner consistent with the tax Code and Congressional purpose, for example by utilizing charitable tax incentives, deferring income taxes through a retirement plan, and utilizing the nontaxable transfer of the right to receive IRD to a person entitled to receive it by inheritance from the decedent as provided in § 691(a)(2). Circ. 230, Sec. 10.35(b)(10).

6. NOT A RELIANCE OPINION (INVOLVING SIGNIFICANT PURPOSE, SIGNIFICANT IMPACT, AND SIGNIFICANT TAX ISSUES): There are alternative ways to carry out the terms of the documents involved in the advice in this letter. In fulfillment of your fiduciary duties, you are seeking to use the legally permissible method that will minimize taxes and other costs. Accordingly, tax avoidance is arguably a "significant purpose" of the way the proposed transaction is to occur. Circ. 230, Sec. 10.35(b)(2)(i)(C). Furthermore, if the tax issues discussed in this letter were resolved in a manner contrary to the conclusion contained in this letter, such negative result could have a "significant impact" on the tax treatment of the transaction discussed herein, although "significant impact" has not been defined. Circ. 230, Sec. 10.35(b)(3). However, the advice in this letter does not involve "significant Federal tax issues"; in view of the authorities cited in this letter, the IRS has no reasonable basis for a successful challenge of the advice herein. Circ. 230, Sec. 10.35(b)(3), (4)(i). Accordingly, this is not a "reliance opinion" within the meaning of Circ. 230, Sec. 10.35(b)(4).

Very truly yours,

Natalie B. Choate

Comments on the letter

Circular 230 contemplates three types of written tax advice: the covered opinion, preliminary advice, and "other written tax advice." This letter falls into the last of those categories.

The recitals purporting to demonstrate compliance with Circular 230 are not required. Many advisors would typically not include such recitals in a tax opinion. Including them provides two advantages. First, these recitals serve as a checklist, jogging the advisor to consider every element of the opinion in light of Circular 230: Have I obtained all the facts that are relevant? Why is it reasonable to rely on this person's representations? Does the IRS have any reasonable basis to challenge the conclusion?

Second, the advantage of embedding these recitals in the opinion (rather than, say, using a separate checklist) is that the Circular 230 reasoning and compliance will be apparent on the face of the opinion. The opinion may need to be read years later, when the author is no longer around or doesn't remember her thinking process exactly. The recitals show that Circular 230 compliance was front and center during preparation of the advice, and exactly how Circular 230 was complied with.

This letter details one well-worn path involving the transfer of an inherited IRA by the estate or trust named as beneficiary of the account, namely, the transfer of the account to a charitable residuary beneficiary of the estate or trust. Other occasions when a fiduciary may need to transfer an inherited retirement plan, intact, to a residuary beneficiary include: The division of a single "funding" trust named as beneficiary of a retirement plan into various subtrusts (such as a marital trust and a family trust), with the retirement plan to be allocated to one or both of such subtrusts; the termination of a marital trust upon the death of the surviving spouse, with transfer of the retirement plan and other marital trust assets to the donor's issue as remainder beneficiaries; the transfer of all of an estate's assets to the estate's residuary beneficiary(ies) when the estate is closed; and the transfer of assets in a minor's trust outright to the former minor when he or she reaches majority or other age specified for trust termination in the trust instrument. On all of these occasions, a similar opinion, modified appropriately for the

circumstances, could be issued to the fiduciary and/ or the IRA provider.

Some IRA providers balk at permitting their firms' IRAs to be transferred out of a trust or estate named as beneficiary to the estate's or trust's beneficiaries. These IRA providers may not allow such transfers at all, or may require that an IRS ruling be obtained first. The author has heard of one IRA provider that requires fiduciaries to terminate and distribute the account (incurring immediate income tax on its entire value) upon termination of the trust or closing of the estate, rather than permitting the estate or trust beneficiaries to assume continued ownership of the account. If substantial continued income tax deferral (or tax minimization, as in the above opinion letter) is at stake, a fiduciary faced with this IRA provider policy might consider transferring the account (still in the name of the estate or trust) to an IRA provider that has a different policy on this question.

*Natalie B. Choate practices law in Boston, Massachusetts, with the firm of Nutter, McClennen & Fish LLP. Her practice is limited to consulting on estate planning and retirement benefits matters. Her books, *Life and Death Planning for Retirement Benefits* and *The QPRT Manual*, as well as her Web site, www.ataxplan.com, are leading resources for estate planning professionals. Ms. Choate is a Former Regent of the American College of Trust and Estate Counsel and former Chairman of its Employee Benefits Committee. A frequent writer and lecturer on estate planning topics, she received the "Distinguished Accredited Estate Planner" award from the National Association of Estate Planners and Councils and is listed in *The Best Lawyers in America.*

FOOTNOTES

1. *Edward D. Rollert Residuary Trust*, 80 T.C. 619, 648 (1983), aff'd 752 F2d 1128 (6th Cir. 1985). Note that the *Rollert* holding that § 691 overrides § 661–§ 662 refers only to transfers of the right to receive IRD. Once a retirement plan distribution has been received by a trust or estate, it is includible in the trust's or estate's gross income; it is included in DNI just like any other income; and § 661 does apply to the trust's or estate's distribution of such income. § 643(a); Reg. § 1.663(c)-5, Example 6.

2. *Estate of Jack Dean*, 46 TCM 184 (1983).

3. James J. Freeland, et al., "Estate and Trust Distribution of Property in Kind After the Tax Reform Act of 1984," 38 Tax L. Rev. 449, 463 (1985).

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