By Vicki L. Anderson

How to QTIP an IRA – new rules

Drafting a trust to receive IRA benefits and at the same time qualify for a marital deduction always has been complicated. Recently, the IRS has made it more so. Effective as of May 30, 2006, new Revenue Ruling 2006-26 undoes the QTIP-IRA rules we were just beginning to understand and applies new requirements for marital trusts receiving IRAs.[1] In fact, the new rules apply on a state-by-state basis, depending on each state's interpretation of income.

The ordinary QTIP trust format will not work for IRAs. To draft and administer a proper QTIP-IRA trust going forward, not only must we comply with the IRA look-through trust rules and the QTIP marital-deduction rules, but also, as to Indiana, we must draft around our state's Uniform Principal & Income Act regarding fiduciary accounting income.

New road map to QTIP-IRA trust

Let's start with the typical scenario. Your client, Fred, is married to his second wife, Joan. He has two children, Charlie and Lucy, from his first marriage. Fred has a $1 million IRA as well as other assets. Fred wants Joan to benefit from these assets after his death, but also wants to assure something is left for Charlie and Lucy. A QTIP marital trust is the only satisfactory alternative for Fred. So, your job, as Fred's attorney, is to draft the trust so that it qualifies to receive Fred's IRA under the IRA beneficiary designation trust rules and also qualifies for the marital deduction, including the new "income" payment requirements under Rev. Rul. 2006-26.

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Step 1: IRA look-through rules

From an income-tax deferral standpoint, Fred will not want his entire $1 million IRA paid in a lump sum to the QTIP trust after his death. The trust would owe the income taxes due on the IRA in the year received and at the trust's high tax rate. A lump sum payment of the IRA to the trust would cause the trust to pay about $400,000 in federal and state income taxes. Instead, Fred wants the IRA to make only annual distributions to the QTIP trust to permit deferral of the income taxes on amounts not distributed and continued growth within the IRA itself.

The minimum distribution rules controlling IRAs allow such "stretched" payments to individuals only, and trusts are not individuals.[2] In proper cases, though, the rules permit a "look-through" from the trust to its beneficiaries, treating the individual beneficiaries as named directly by the IRA owner.[3] This look-through allows the IRA benefits to be paid over the oldest trust beneficiary's remaining life expectancy, rather than in a lump sum.

In our example, Fred's wife Joan is age 70 when Fred dies and will receive the QTIP trust income for her life. Fred's children are 35 and 34, and are the trust's remainder beneficiaries. Joan is the oldest of the three trust beneficiaries, and if the trust qualifies as a look-through under the minimum distribution rules, the IRA can stretch distributions to the QTIP over Joan's remaining life expectancy, which is 17 years.[4]

For Fred's QTIP trust to qualify to receive IRA distributions stretched over Joan's 17-year life expectancy, the trust must meet four requirements:[5]

1. The trust must be valid under state law.

2. The trust must be irrevocable or become irrevocable at Fred's death.

3. The trust beneficiaries must be identifiable from the trust instrument.

4. Proper documentation must be provided to the IRA custodian.

Requirements 1 and 2 are easy to meet for any good drafter. Requirement 4 is met simply by providing a copy of the trust to the IRA administrator after the decedent's death.[6] But, requirement 3 can be a troublemaker. Identifiable beneficiaries must be actual, living individuals, like Joan, Charlie and Lucy. The IRS is adamant that if an estate, charity or other non-individual is in the mix of trust beneficiaries, the trust will not qualify for look-through.[7]

The problem would arise in our example if Fred designates his revocable trust as the IRA beneficiary rather than the QTIP trust within the revocable trust. The revocable trust might provide that the trustee may pay trust assets (including IRA benefits) to Fred's estate to cover debts, administration expenses or death taxes. The inclusion of these non-individual beneficiaries could cause Fred's revocable trust (and, in turn, the built-in QTIP trust) to fail to qualify for look-through status.[8] This problem can be avoided either by naming the trustee of the QTIP trust directly as the IRA beneficiary or by adding a simple sentence to the revocable trust to state that the retirement benefits will not be used for payment of expenses.

In some cases, though, the IRA funds may be needed to cover expenses before the QTIP trust is funded. The minimum distribution regulations provide a "shake" period, until Sept. 30 of the year following the year of that IRA owner's death to cash-out or eliminate

improper beneficiaries.[9] So, a trust that provides for payments to non-individuals also could include a restriction preventing the trustee from making such payments after the Sept. 30 deadline.[10] This effectively should eliminate the non-individual beneficiaries from consideration.

Step 2: QTIP marital deduction

Assuming you have followed Step 1 above and drafted Fred's QTIP trust to qualify as a look-through trust under the IRA minimum distribution rules, you also must draft the trust to meet the QTIP deduction rules for a marital deduction. Using the marital deduction to eliminate federal estate tax on the estate of the first of the two spouses to die is a popular and important planning technique. IRC §2056 creates the marital deduction for the value of property "which passed from the decedent to his surviving spouse."[11] However, the marital deduction is denied if the property passing to the surviving spouse is a "life estate or other terminable interest."[12]

A spouse receives a terminable interest in property if she cannot pass it on at her death. With respect to Fred and Joan, Fred wants Joan to benefit from the trust property but not pass it on at her death. Rather, Fred wants to pass it on to his two children. Thus, Joan receives a terminable interest she cannot transfer to others at her death, so the property is not included in Joan's gross estate – unless some special statutory provisions applies to make it taxable.

Section 2056(b)(7) of the marital deduction statute does that.[13] While no marital deduction generally is given for a terminable interest, this section allows the deduction if the terminable interest qualifies, *i.e.,* is qualified terminable interest property.

Property qualifies for the estate tax marital deduction as QTIP if:

- the spouse is entitled for life to all the income from the property, payable at least annually;[14]
- no other person has the power to appoint the property to someone other than the spouse;[15]
- the decedent irrevocably elects on the decedent's estate tax return to treat the property as QTIP;[16]
- the surviving spouse's taxable estate includes the QTIP property at her death;[17] and,
- to make the spouse's entitlement to income meaningful, the spouse must have the power to force the trust assets to be productive so income is, in fact, generated by the trust.[18]

If the QTIP trust is to receive IRA benefits, two additional requirements exist to qualify the trust for the marital deduction. First, the personal representative must make the QTIP election for the IRA, as well as for the QTIP trust. The IRS is clear that this double election is required.[19]

Second, in prior Revenue Ruling 2002-2, the IRS ruled that the spouse in a QTIP trust receiving an IRA must have the power, exercisable annually, to require the trustee to withdraw all of the income earned on the IRA assets and to distribute that income (along with the income earned on the QTIP trust assets) to the spouse. If the IRA distributions exceed the IRA income, the excess distribution is reinvested in the trust.[20] Revenue Ruling 2006-26 modifies this requirement by placing a "reasonable apportionment" burden on the trustee.

Step 3: Rev. Rul. 2006-26

The final step for drafting a proper QTIP-IRA is to comply with new Revenue Ruling 2006-26 with respect to the reasonable apportionment analysis of "income" generated by QTIP assets.

The facts of the Ruling

The facts in Revenue Ruling 2006-26 were simple. An IRA owner died, leaving his IRA payable

(continued on page 30)

to a QTIP trust for the benefit of his surviving spouse. The trust provided that at the surviving spouse's death, the trust was to be distributed to the IRA owner's children. The trust complied with the IRA look-through rules because no other person other than the spouse and the children had any interest in the trust. The trust became irrevocable when the IRA owner died, and it was valid under local law.

The IRA was invested in productive assets, and the spouse had the right to compel the investment of the IRA in assets that would produce reasonable income. As required by Section 2056(b), under the terms of the trust, all income was payable to the spouse for her life, and no person had the power to appoint any part of the principal.

Importantly and as required by Rev. Rul. 2002-2, the spouse had the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all income earned by the IRA during the year. If the spouse exercised her IRA income withdrawal power, the trustee was obligated to withdraw the greater of the IRA income or the annual minimum required distribution from the IRA and distribute to the spouse at least the income from the IRA.

The new requirement

In Rev. Rul. 2006-26, the IRS modifies Rev. Rul. 2000-2 by adding a new income determination requirement for the QTIP qualification of a marital trust that is the designated beneficiary of IRA or qualified plan. The Ruling explains that the trustee must look to state law for the definition of "income" for determining whether or not the trust qualifies as QTIP. The IRS then lays out three situations for defining income depending upon the state. In the first situation, the trust is situated in a state like Indiana that has adopted the Uniform Principal & Income Act ("UPIA") power to adjust. In the second situation, the trust is situated in a state that has a unitrust definition of income. In the third, the trust is situated in a state that has neither the UPIA power to adjust, nor a unitrust definition of income.

As to a state like Indiana, the IRS contemplates the QTIP trust might address the "pay all income to spouse" requirement of Section 2056(b)(7) in one of two ways. First, the trust might say nothing about how much of an IRA distribution into the trust is "income." In fact, this scenario is typical. The QTIP trust simply requires the payment of income of the trust to the spouse, without referencing income from the IRA. In this case, Indiana's UPIA at I.C. §30-2-14-31(e) fills the void to provide that 10 percent of the IRA distribution each year to the trust is trust "income" to be distributed to the QTIP spouse, and 90 percent of the distribution stays in the trust as principal.[21] Additionally, our UPIA statute at I.C. §30-2-14-31(g) provides that the trustee must allocate more than 10 percent of a payment to income if necessary to obtain the marital deduction.

In Rev. Rul. 2006-26, the IRS holds that this 10 percent allocation does **not** satisfy the QTIP marital deduction requirements. The 10 percent income amount does not reflect a reasonable apportionment of the total return between the income and remainder beneficiaries, and the trust flunks as a QTIP. The IRS goes on to say that our statute's requirement of an additional allocation to income if necessary to qualify for the marital deduction will not save the failed QTIP trust because such savings clauses are ineffective to reform an instrument for federal transfer tax purposes. Accordingly, if Fred's QTIP trust says nothing about how

much of the IRA distribution is income, the trust will not qualify for the marital deduction because Indiana's UPIA automatically applies the 10 percent income rule.

A second approach in drafting a QTIP trust is to track Rev. Rul. 2002-2 and provide that the trustee must withdraw "all income" generated by the IRA (even if it is greater than the minimum required distribution) and pay this income to the spouse. This can be a mandatory withdrawal requirement or the result of the spouse exercising a power to compel the withdrawal. In this case, Rev. Rul. 2006-26 applies another section of Indiana's UPIA, I.C. §30-2-14-15, to require the trustee to allocate the total return of all the trust assets, including the IRA, between income and principal in a manner that fulfills the trustee's duty of impartiality. If the trustee makes this reasonable allocation analysis each year between the income and remainder beneficiaries, Rev. Rul. 2006-26 provides that the marital deduction requirements are satisfied. This allocation of income analysis is a burdensome additional step for a trustee imposed by the Ruling.

Applying the Ruling to our example

Using our Fred and Joan example, the first year after Fred's death the trustee of the QTIP trust must direct Fred's IRA to distribute into the QTIP trust at least the minimum required distribution (MRD) based on Joan's 17-year life expectancy as determined under the minimum distribution rules for IRAs. Thus, the trustee must direct that the IRA distribute at least $58,824 ($1 million ÷ by 17) in the first year.

The IRA distributes $58,824 to the QTIP trust. The QTIP trust rules now apply to require that all trust income must be distributed to Joan, but what constitutes trust income? Indiana's UPIA defines income for trusts, including marital trusts. Under I.C. §30-2-14-31(e), trust income is 10 percent of the IRA amount distributed into the trust. Here, the income would be $5,882 (10 percent of $58,824). The $5,882 distribution from a $1 million IRA is paltry, and it is this application of the 10 percent income rule that Rev. Rul. 2006-26 states is insufficient. The trust will not qualify as QTIP for the marital deduction if the trust relies on I.C. §30-2-14-31(e) and distributes only 10 percent to Joan. In fact, the IRS now requires that the trust document specifically provide that I.C. §30-2-14-31(e) will not apply.

Rather, the Ruling requires that Joan must have the power to compel the trustee to withdraw from the IRA and pay to her a "reasonable" allocation of income, even if it is greater than the MRD. Let's say that in the first year of the QTIP trust, the $1 million IRA earned $20,000 in interest and dividends. However, if the trustee considers the total return on the IRA, including appreciation and capital gains, the trustee might conclude that a fair allocation to income is $50,000. Under §30-2-14-15, the trustee can use the power to adjust income to the $50,000 amount. In Rev. Rul. 2006-26, the trust must provide that the surviving spouse can compel (but does not have to compel) a withdrawal of this reasonable IRA income from the trust each year. In the above example, where the MRD is $58,824 and the reasonable IRA income is, say,

(continued on page 32)

$50,000, Joan can compel a distribution of the $50,000. The excess of $8,824 ($58,824 - $50,000) remains in the trust.

Step 4: What about non-IRA QTIP assets?

Rev. Rul. 2006-26 also requires that if the QTIP trust holds other assets in addition to the IRA, the trustee must go through the same allocation process separately for the other assets to determine trust income for each calendar year, and the spouse must receive distributions of those amounts.

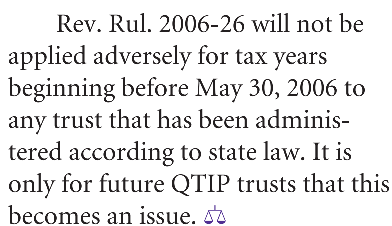
The bottom line

When drafting a QTIP trust that will receive IRA benefits, that trust now must include special additional language to qualify for the marital deduction. Rev. Rul. 2006-26 requires a QTIP trust to address "income." Consider including the following language:

> The trustee shall determine the income of the IRA each year, under Indiana's Uniform Principal & Income Act (UPIA), and distribute that income to the spouse, upon request. In no event shall the 10 percent rule of I.C. §30-2-14-31(e) apply in determining income with respect to an IRA distribution to the trust. Also, each year the trustee must determine the income from other assets held in the trust, under Indiana's UPIA, and distribute the income to the spouse.

An interested trustee (one who also is either an income or a remainder beneficiary) is not permitted to adjust trust income.[22] So, it is wise to make sure to name a disinterested party as trustee of a QTIP trust.

Rev. Rul. 2006-26 will not be applied adversely for tax years beginning before May 30, 2006 to any trust that has been administered according to state law. It is only for future QTIP trusts that this becomes an issue. ⚖



1. Rev. Rul. 2006-26, 2006-22 I.R.B. 1.
2. Reg. §1.401(a)(9)-4, A-1 and A-2.
3. §1.401(a)(9)-4, A-5.
4. Reg. §1.401(a)(9)-9.
5. §1.401(a)(9)-4, A-5 and A-6.
6. Reg. §1.401(a)(9)-4, A-6(b). A copy of the trust or a verified listing of all beneficiaries and conditions of taking must be given to the IRA trustee by Oct. 31 of the year following the year of death of the IRA owner.
7. Reg. §1.401(a)(9)-4, A-3. This is so even though the IRA may pass from the estate to an identifiable individual. PLR 2003-43030.
8. Reg. §1.401(a)(9)-4, A-3; Reg. §1.401(a)(9)-8, A-11.
9. Reg. §1.401(a)(9)-4, A-4(a).
10. *See* PLR 200432027 to 200432029, where the IRS ruled a beneficiary trust qualifies as a "see through" trust even though trust distributions paid expenses prior to the 9/30 date.
11. IRC §2056(a).
12. IRC §2056(b)(1).
13. IRC §2056(b)(7).
14. IRC §2056(b)(7)(B)(ii)(I).
15. IRC §2056(b)(7)(B)(ii)(II).
16. IRC §2056(b)(7)(B)(v).
17. IRC §2044.
18. I.C. §30-2-14-35.
19. Rev. Rul. 2002-2, 2000-1 C.B. 305; Rev. Rul. 2006-26, 2006-22 I.R.B. 1.
20. Rev. Rul. 2002-2, 2000-1 C.B. 305.
21. I.C. §30-2-14-31(d) will not work to qualify the QTIP for the marital deduction because it neither requires all IRA income to be distributed to the spouse nor addresses the allocation of income where the MRD exceeds the IRA income. In fact, this section functions like section (g), which the Ruling rejected. Also, the new Pension Protection Act (Aug. 17, 2006) permits beneficiaries to create inherited IRAs from qualified plans, which arrangements may not be contemplated by section (d).
22. I.C. §30-2-14-15(c)(7).

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