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Memorandum

To: ABA RPTE Council and ACTEC Executive Committee

From: Steven B. Gorin

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Date: April 29, 2008

Re: Distributions from IRAs and Other Retirement Plans to Marital Trusts: Proposed Changes to the Uniform Principal & Income Act

Below is what I sent to Cathy Hughes:

As we discussed, Revenue Ruling 2006-26 (the “Ruling”) criticized Section 409 of the Uniform Principal & Income Act (“UPIA”). Even before the Ruling, the Internal Revenue Service’s safe harbor for marital deductions for retirement plans payable to trusts required special language in those trusts, even if those trusts themselves are drafted in a manner that ordinarily qualified for the marital deduction.

I am working on proposed changes to UPIA § 409 that are to be submitted to the American Bar Association’s Real Property, Trust & Estate Law Section (RPTE) and the American College of Trust & Estate Counsel (ACTEC) for their recommendation that the Uniform Law Commission (ULC) adopt these changes. These changes attempt to satisfy not only the Ruling’s literal terms but also the policy behind the Ruling’s position that might be applied to other situations.

My understanding is that the Internal Revenue Service (the “Service”) and the Department of Treasury (“Treasury”) will not rule on such changes before they are adopted by the ULC. This makes it difficult for us to fashion changes to model laws to address the Service’s and Treasury’s concerns. To help us come as close as we can to satisfying these concerns without obtaining a formal ruling, I would appreciate informal indications that these changes address the concerns of Rev. Rul. 2006-26, with the full understanding that such informal indications would not commit the Service or Treasury to any particular course of action and could not be relied upon by taxpayers for any purpose.

I have already talked with Mary Berman, who is the Ruling’s author, and George Masnik, her Branch Chief. They indicated that any informal indications they might give would provide no assurance with respect to issues not addressed in the Ruling. These issues include the treatment of defined benefit plans payable to marital deduction trusts and whether certain types of retirement plan benefits might not be suitable for being held by a marital deduction trust.

Thus, my goal is limited to obtaining informal indications that the proposed changes satisfy the situations that the Ruling addressed. You will see that the proposed changes also address other scenarios that concern those with whom I have discussed these issues.

If and to the extent that you are willing to provide informal feedback on other scenarios, your suggestions about those other issues would also be appreciated.

For your convenience, I have attached the text of Rev. Rul. 2006-26 and UPIA § 409 as an Appendix.

She unofficially suggested some clarification, the essence of which has been integrated into the language below.

The following language would be proposed as changes to UPIA § 409:

(a) In this section:

(1) "payment" means a payment that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments; however, for the purposes of subsections (d), (e) and (f), the term also includes any payment from a separate fund, whether or not received because of services rendered or property transferred to the payer. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer;

(2) "separate fund" includes a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

.....

(d) Subsections (e) and (f) and not subsections (b) and (c) shall apply in determining the allocation of a payment made from a separate fund to:

(1) a trust to which an election to qualify for a marital deduction under section 2056(b)(7) of the Internal Revenue Code of 1986 [, as amended,] has been made; or

(2) a trust that qualifies for the marital deduction under section 2056(b)(5) of the Internal Revenue Code of 1986 [, as amended];

except that this subsection (d) and subsections (e) and (f) shall not apply if and to the extent that the series of payments would, without the application of this subsection (d), qualify for the marital deduction under section 2056(b)(7)(C) of the Internal Revenue Code of 1986 [, as amended,].

(e) The trustee shall determine the internal income of the separate fund for the accounting period as if the separate fund were a trust subject to this Act. Upon request of the surviving spouse, the trustee shall demand of the person administering the separate fund that this internal income be distributed to the trust. The trustee shall allocate a payment from the separate fund to income to the extent of the internal income of the separate fund (and distribute that amount to the surviving spouse), and the balance to principal. Upon request of the surviving spouse, the trustee shall allocate principal to

income to the extent the internal income of the separate fund exceeds payments made to the trust during the accounting period from the separate fund.

(f) If the trustee cannot determine the internal income of the separate fund but can determine the value of the separate fund, then the internal income of the separate fund shall be deemed to equal [insert number between 3% and 5%] of the fund's value, according to the most recent statement of value preceding the beginning of the accounting period. If the trustee can determine neither the internal income of the separate fund nor the fund's value, the internal income of the fund shall be deemed to equal the product of the interest rate and the present value of the expected future payments, as determined under Section 7520 of the Internal Revenue Code of 1986 [, as amended,] for the month preceding the accounting period for which the computation is made.

[former subsection (e) redesignated as subsection (g)]

The Comment to UPIA section 409 entitled “Marital deduction requirements” would be deleted and replaced with the following:

Marital deduction requirements. When an IRA or other retirement arrangement (a “plan”) is payable to a marital deduction trust, the IRS treats the plan as a separate property interest that itself must qualify for the marital deduction. IRS Revenue Ruling 2006-26 said that, as written, Section 409 does not cause a trust to qualify for the IRS’ safe harbors. Revenue Ruling 2006-26 was limited in scope to certain situations involving IRAs and defined contribution retirement plans. Without necessarily agreeing with the IRS’ position in that ruling, the revision to this section is designed to satisfy the IRS’ safe harbor and to address concerns that might be raised for similar assets. No IRS pronouncements have addressed the scope of Code § 2056(b)(7)(C).

Subsection (e) requires the trustee to demand certain distributions if the surviving spouse so requests. The safe harbor of Revenue Ruling 2006-26 requires that the surviving spouse be separately entitled to demand the fund’s income (without regard to the income from the trust’s other assets) and the income from the other assets (without regard to the fund’s income). In any event, the surviving spouse is not required to demand that the trustee distribute all of the fund’s income from the fund or from other trust assets. Treas. Reg. § 20.2056(b)-5(f)(8).

Subsection (e) also recognizes that the trustee might not control the payments that the trustee receives and provides a remedy to the surviving spouse if the distributions under subsection (d)(1) are insufficient.

Subsection (f) addresses situations where, due to lack of information provided by the fund’s administrator, the trustee is unable to determine the fund’s actual income. The bracketed language is the range approved for unitrust payments by Treas. Reg. § 1.643(b)-1. In determining the value for purposes of applying the unitrust percentage, the trustee would seek to obtain the value of the assets as of the most recent statement of value immediately preceding the beginning of the year. For example, suppose a trust’s accounting period is January 1 through December 31. If a retirement plan administrator

furnishes information annually each September 30 and declines to provide information as of December 31, then the trustee may rely on the September 30 value to determine the distribution for the following year. For funds whose values are not readily available, subsection (f) relies on Code section 7520 valuation methods because many funds described in Section 409 are annuities, and one consistent set of valuation principles should apply whether or not the fund is, in fact, an annuity.

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Issue

If a marital trust described in *Situations 1, 2, or 3* is the named beneficiary of a decedent's individual retirement account (IRA) or other qualified retirement plan described in section 4974(c) that is a defined contribution plan, under what circumstances is the surviving spouse considered to have a qualifying income interest for life in the IRA (or qualified retirement plan) and in the trust for purposes of an election to treat both the IRA and the trust as qualified terminable interest property (QTIP) under § 2056(b)(7) of the Internal Revenue Code?

Facts

A dies in 2004, at age 68, survived by spouse, B. Prior to death, A established an IRA described in § 408(a). A's will creates a testamentary marital trust (Trust) that is funded with assets in A's probate estate. As of A's death, Trust is irrevocable and is valid under applicable local law. Prior to death, A named Trust as the beneficiary of all amounts payable from the IRA after A's death. The IRA is properly included in A's gross estate for federal estate tax purposes. The IRA is currently invested in productive assets and B has the right (directly or through the trustee of Trust) to compel the investment of the IRA in assets productive of a reasonable income. The IRA document does not prohibit the withdrawal from the IRA of amounts in excess of the annual required minimum distribution amount under § 408(a)(6). The executor of A's estate elects under § 2056(b)(7) to treat both the IRA and Trust as QTIP.

Under Trust's terms, all income is payable annually to B for B's life, and no person has the power to appoint any part of the Trust principal to any person other than B during B's lifetime. B has the right to compel the trustee to invest the Trust principal in assets productive of a reasonable income. On B's death, the Trust principal is to be distributed to A's children, who are younger than B. Under the trust instrument, no person other than B and A's children has a beneficial interest in Trust (including any contingent beneficial interest). Further, as in Rev. Rul. 2000-2, 2000-1 C.B. 305, under Trust's terms, B has the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all the income of the IRA for the year and to distribute that income to B. If B exercises this power, the trustee is obligated under Trust's terms to withdraw the greater of all of the income of the IRA or the annual required minimum distribution amount under § 408(a)(6), and distribute currently to B at least the income of the IRA. The Trust instrument provides that any excess of the required minimum distribution amount over the income of the IRA for that year is to be added to Trust's principal. If B does not exercise the power to compel a withdrawal from the IRA for a particular year, the trustee must withdraw from the IRA only the required minimum distribution amount under § 408(a)(6) for that year.

The trustee of Trust provides to the IRA trustee a copy of A's will (Trust's governing instrument) before October 31, 2005, in accordance with A-6(b) of § 1.401(a)(9)-4 of the Income Tax

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regulations. Because the requirements of A-4 and A-5 of § 1.401(a)(9)-4 of the Income Tax regulations are satisfied and there are no beneficiaries or potential beneficiaries that are not individuals, the beneficiaries of the trust may be treated as designated beneficiaries of the IRA. In accordance with § 408(a)(6) and the terms of the IRA instrument, the trustee of Trust elects to receive annual required minimum distributions using the exception to the five year rule in § 401(a)(9)(B)(iii) for distributions over a distribution period equal to a designated beneficiary's life expectancy. Because amounts may be accumulated in Trust for the benefit of A's children, B is not treated as the sole beneficiary and, thus, the special rule for a surviving spouse in § 401(a)(9)(B)(iv) is not applicable. Accordingly, the trustee of Trust elects to have the annual required minimum distributions from the IRA to Trust begin in 2005, the year immediately following the year of A's death. The amount of the annual required minimum distribution from the IRA for each year is calculated by dividing the account balance of the IRA as of December 31 of the immediately preceding year by the remaining distribution period. Because B's life expectancy is the shortest of all of the potential beneficiaries of Trust's interest in the IRA (including remainder beneficiaries), the distribution period for purposes of § 401(a)(9)(B)(iii) is B's life expectancy, based on the Single Life Table in A-1 of § 1.401(a)(9)-9, using B's age as of B's birthday in 2005, reduced by one for each calendar year that elapses after 2005. On B's death, the required minimum distributions with respect to any undistributed balance of the IRA will continue to be calculated in the same manner and be distributed to Trust over the remaining distribution period.

Situation 1—Authorized Adjustments Between Income and Principal. The facts and the terms of Trust are as described above. Trust is governed by the laws of State X. State X has adopted a version of the Uniform Principal and Income Act (UPIA) including a provision similar to section 104(a) of the UPIA providing that, in certain circumstances, the trustee is authorized to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries. More specifically, State X has adopted a provision providing that adjustments between income and principal may be made, as under section 104(a) of the UPIA, when trust assets are invested under State X's prudent investor standard, the amount to be distributed to a beneficiary is described by reference to the trust's income, and the trust cannot be administered impartially after applying State X's statutory rules regarding the allocation of receipts and disbursements to income and principal. In addition, State X's statute incorporates a provision similar to section 409(c) of the UPIA providing that, when a payment is made from an IRA to a trust: (i) if no part of the payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be distributed currently to the beneficiary, the trustee must allocate 10 percent of the required payment to income and the balance to principal; and (ii) if no part of the payment made is required to be distributed from the trust or if the payment received by the trust is the entire amount to which the trustee is contractually entitled, the trustee must allocate the entire payment to principal. State X's statute further provides that, similar to section 409(d) of the UPIA, if in order to obtain an estate tax marital deduction for a trust a trustee must allocate more of a payment to income, the trustee is required to allocate to income the additional amount necessary to obtain the marital deduction.

For each calendar year, the trustee determines the total return of the assets held directly in Trust, exclusive of the IRA, and then determines the respective portion of the total return that is to be allocated to principal and to income under State X's version of section 104(a) of the UPIA in a

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manner that fulfills the trustee's duty of impartiality between the income and remainder beneficiaries. The amount allocated to income is distributed to *B* as income beneficiary of Trust, in accordance with the terms of the Trust instrument. Similarly, for each calendar year the trustee of Trust determines the total return of the assets held in the IRA and then determines the respective portion of the total return that would be allocated to principal and to income under State *X*'s version of section 104(a) of the UPIA in a manner that fulfills a fiduciary's duty of impartiality. This allocation is made without regard to, and independent of, the trustee's determination with respect to Trust income and principal. If *B* exercises the withdrawal power, Trustee withdraws from the IRA the amount allocated to income (or the required minimum distribution amount under § 408(a)(6), if greater), and distributes to *B* the amount allocated to income of the IRA.

Situation 2—Unitrust Income Determination. The facts, and the terms of Trust, are as described above. Trust is governed by the laws of State *Y*. Under State *Y* law, if the trust instrument specifically provides or the interested parties consent, the income of the trust means a unitrust amount of 4 percent of the fair market value of the trust assets valued annually. In accordance with procedures prescribed by the State *Y* statute, all interested parties authorize the trustee to administer Trust and to determine withdrawals from the IRA in accordance with this provision. The trustee determines an amount equal to 4 percent of the fair market value of the IRA assets and an amount equal to 4 percent of the fair market value of Trust's assets, exclusive of the IRA, as of the appropriate valuation date. In accordance with the terms of Trust, trustee distributes the amount equal to 4 percent of the Trust assets, exclusive of the IRA, to *B*, annually. In addition, if *B* exercises the withdrawal power, Trustee withdraws from the IRA the greater of the required minimum distribution amount under § 408(a)(6) or the amount equal to 4 percent of the value of the IRA assets, and distributes to *B* at least the amount equal to 4 percent of the value of the IRA assets.

Situation 3—"Traditional" Definition of Income. The facts, and the terms of Trust, are as described above. Trust is governed by the laws of State *Z*. State *Z* has not enacted the UPIA, and therefore does not have provisions comparable to sections 104(a) and 409(c) and (d) of the UPIA. Thus, in determining the amount of IRA income *B* can compel the trustee to withdraw from the IRA, the trustee applies the law of State *Z* regarding the allocation of receipts and disbursements to income and principal, with no power to allocate between income and principal. As in *Situations 1* and *2*, the income of Trust is determined without regard to the IRA, and the income of the IRA is separately determined based on the assets of the IRA.

Law And Analysis

Section 2056(a) provides that the value of the taxable estate is, except as limited by § 2056(b), determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes from the decedent to the surviving spouse, to the extent that interest is included in the value of decedent's gross estate.

Under § 2056(b)(1), if an interest passing to the surviving spouse will terminate or fail, no deduction is allowed with respect to the interest if an interest in the property passes or has passed

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from the decedent to any person other than the surviving spouse (or the estate of the spouse), that may be possessed or enjoyed by such other person after termination of the spouse's interest.

Section 2056(b)(7) provides that QTIP, for purposes of § 2056(a), is treated as passing to the surviving spouse and no part of the property is treated as passing to any person other than the surviving spouse. Section 2056(b)(7)(B)(i) defines QTIP as property that passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and to which an election under § 2056(b)(7) applies. Under § 2056(b)(7)(B)(ii), the surviving spouse has a qualifying income interest for life if, *inter alia*, the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals.

Section 20.2056(b)-7(d)(2) provides that the principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the property, apply in determining whether the surviving spouse is entitled for life to all of the income from the property for purposes of § 2056(b)(7).

Section 20.2056(b)-5(f)(1) provides that, if an interest is transferred in trust, the surviving spouse is entitled for life to all of the income from the entire interest if the effect of the trust is to give the surviving spouse substantially that degree of beneficial enjoyment of the trust property during the surviving spouse's life that the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. In addition, the surviving spouse is entitled for life to all of the income from the property if the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)-1.

Section 20.2056(b)-5(f)(8) provides that the terms “entitled for life” and “payable annually or at more frequent intervals” require that under the terms of the trust the income referred to must be currently (at least annually) distributable to the spouse or that the spouse must have such command over the income that it is virtually the spouse's. Thus, the surviving spouse will be entitled for life to all of the income from the trust, payable annually, if, under the terms of the trust instrument, the spouse has the right exercisable annually (or at more frequent intervals) to require distribution to the spouse of the trust income and, to the extent that right is not exercised, the trust income is to be accumulated and added to principal.

Generally, § 1.643(b)-1 provides that, for purposes of various provisions of the Code relating to the income taxation of estates and trusts, the term “income” means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Under § 1.643(b)-1, trust provisions that depart fundamentally from traditional principles of income and principal generally will not be recognized. Under these traditional principles, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.

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However, under § 1.643(b)-1, the allocation of an amount between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3 percent and no more than 5 percent of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, under § 1.643(b)-1, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust.

Rev. Rul. 2000-2, 2000-1 C.B. 305, concludes that a surviving spouse has a qualifying income interest for life under § 2056(b)(7)(B)(ii) in an IRA and in a marital trust named as the beneficiary of that IRA if the spouse has the power, exercisable annually, to compel the trustee to withdraw the income earned on the IRA assets and to distribute that income (along with the income earned on the trust assets other than the IRA) to the spouse. Therefore, assuming all other requirements of § 2056(b)(7) are satisfied, and provided the executor makes the election for both the IRA and the trust, the IRA and the trust will qualify for the marital deduction under § 2056(b)(7). The revenue ruling also concludes that the result would be the same if the terms of the trust require the trustee to withdraw an amount equal to the income earned on the IRA assets and to distribute that amount (along with the income earned on the trust assets other than the IRA) to the spouse.

In *Situation 1*, under section 104(a) of the UPIA as enacted by State X, the trustee of Trust allocates the total return of the assets held directly in Trust (*i.e.*, assets other than those held in the IRA) between income and principal in a manner that fulfills the trustee's duty of impartiality between the income and remainder beneficiaries. The trustee of Trust makes a similar allocation with respect to the IRA. The allocation of the total return of the IRA and the total return of Trust in this manner constitutes a reasonable apportionment of the total return of the IRA and Trust between the income and remainder beneficiaries under § 20.2056(b)-5(f)(1) and § 1.643(b)-1. Under the terms of Trust, the income of the IRA so determined is subject to *B*'s withdrawal power, and the income of Trust, so determined, is payable to *B* annually. Accordingly, the IRA and Trust meet the requirements of § 20.2056(b)(7)(B)(ii) and therefore *B* has a qualifying income interest for life in both the IRA and Trust because *B* has the power to unilaterally access all of the IRA income, and the income of Trust is payable to *B* annually.

Depending upon the terms of Trust, the impact of State X's version of sections 409(c) and (d) of the UPIA may have to be considered. State X's version of section 409(c) of the UPIA provides in effect that a required minimum distribution from the IRA under Code section 408(a)(6) is to be allocated 10 percent to income and 90 percent to principal. This 10 percent allocation to income, standing alone, does not satisfy the requirements of §§ 20.2056(b)-5(f)(1) and 1.643(b)-1, because the amount of the required minimum distribution is not based on the total return of the IRA (and therefore the amount allocated to income does not reflect a reasonable apportionment of the total return between the income and remainder beneficiaries). The 10 percent allocation to income also does not represent the income of the IRA under applicable state law without regard to a power to adjust between principal and income. State X's version of section 409(d) of the

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UPIA, requiring an additional allocation to income if necessary to qualify for the marital deduction, may not qualify the arrangement under § 2056. Cf. Rev. Rul. 75-440, 1975-2 C.B. 372, using a savings clause to determine testator's intent in a situation where the will is ambiguous, but citing Rev. Rul. 65-144, 1965-1 C.B. 422, for the position that savings clauses are ineffective to reform an instrument for federal transfer tax purposes. Based on the facts in *Situation 1*, if *B* exercises the withdrawal power, the trustee is obligated under Trust's terms to withdraw the greater of all of the income of the IRA or the annual required minimum distribution amount under § 408(a)(6), and to distribute at least the income of the IRA to *B*. Thus, in this case, State *X*'s version of section 409(c) or (d) of UPIA would only operate to determine the portion of the required minimum distribution amount that is allocated to Trust income, and (because Trust income is determined without regard to the IRA or distributions from the IRA) would not affect the determination of the amount distributable to *B*. Accordingly, in *Situation 1*, the requirements of § 2056(b)(7)(B)(ii) are satisfied. However, if the terms of a trust do not require the distribution to *B* of at least the income of the IRA in the event that *B* exercises the right to direct the withdrawal from the IRA, then the requirements of § 2056(b)(7)(B)(ii) may not be satisfied unless the Trust's terms provide that State *X*'s version of section 409(c) of the UPIA is not to apply.

In *Situation 2*, the trustee determines the income of Trust (excluding the IRA) and the income of the IRA under a statutory unitrust regime pursuant to which "income" is defined as a unitrust amount of 4 percent of the fair market value of the assets determined annually. The determination of what constitutes Trust income and the income of the IRA in this manner satisfies the requirements of § 20.2056(b)-5(f)(1) and § 1.643(b)-1. The Trustee distributes the income of Trust, determined in this manner, to *B* annually, and *B* has the power to compel the trustee annually to withdraw and distribute to *B* the income of the IRA, determined in this manner. Accordingly, in *Situation 2*, because *B* has the power to unilaterally access all income of the IRA, and the income of Trust is payable to *B* annually, the IRA and Trust meet the requirements of § 20.2056(b)(7)(B)(ii). The result would be the same if State *Y* had enacted both the statutory unitrust regime and a version of section 104(a) of the UPIA and the income of Trust is determined under section 104(a) of the UPIA as enacted by State *Y*, and the income of the IRA is determined under the statutory unitrust regime (or *vice versa*). Under these circumstances, Trust income and IRA income are each determined under state statutory provisions applicable to Trust that satisfy the requirements of § 20.2056(b)-5(f)(1) and § 1.643(b)-1, and therefore *B* has a qualifying income interest for life in both the IRA and Trust.

In *Situation 3*, *B* has the power to compel the trustee to withdraw the income of the IRA as determined under the law (whether common or statutory) of a jurisdiction that has not enacted section 104(a) of UPIA. Under the terms of Trust, if *B* exercises this power, the trustee must withdraw the greater of the required minimum distribution amount or the income of the IRA, and at least the income of the IRA must be distributed to *B*. Accordingly, in *Situation 3*, the IRA and Trust meet the requirements of § 2056(b)(7)(B)(ii), and therefore *B* has a qualifying income interest for life in both the IRA and Trust, because *B* receives the income of Trust (excluding the IRA) at least annually and *B* has the power to unilaterally access all of the IRA income determined in accordance with § 20.2056(b)-5(f)(1). The result would be the same if State *Z* had enacted section 104(a) of the UPIA, but the trustee decided to make no adjustments pursuant to that provision.

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In *Situations 1, 2, and 3*, the income of the IRA and the income of Trust (excluding the IRA) are determined separately and without taking into account that the IRA distribution is made to Trust. In order to avoid any duplication in determining the total income to be paid to *B*, the portion of the IRA distribution to Trust that is allocated to trust income is disregarded in determining the amount of trust income that must be distributed to *B* under § 2056(b)(7).

The result in *Situations 1, 2, and 3* would be the same if the terms of Trust directed the trustee annually to withdraw all of the income from the IRA and to distribute to *B* at least the income of the IRA (instead of granting *B* the power, exercisable annually, to compel the trustee to do so). Furthermore, if, instead of Trust being the named beneficiary of a decedent's interest in the IRA, Trust is the named beneficiary of a decedent's interest in some other qualified retirement plan described in section 4974(c) that is a defined contribution plan, the same principles would apply regarding whether *B* is considered to have a qualifying income interest for life in the qualified retirement plan.

Holding

If a marital trust is the named beneficiary of a decedent's IRA (or other qualified retirement plan described in section 4974(c) that is a defined contribution plan), the surviving spouse, under the circumstances described in *Situations 1, 2, and 3* in this revenue ruling, will be considered to have a qualifying income interest for life in the IRA (or qualified retirement plan) and in the trust for purposes of an election to treat both the IRA (or qualified retirement plan) and the trust as QTIP under § 2056(b)(7). If the marital deduction is sought, the QTIP election must be made for both the IRA and the trust.

Taxpayers should be aware, however, that in situations such as those described in this revenue ruling in which a portion of any distribution from the IRA to Trust may be held in Trust for future distribution rather than being distributed to *B* currently, *B* is not the sole designated beneficiary of *A*'s IRA. As a result, both *B* and the remainder beneficiaries must be taken into account as designated beneficiaries in order to determine the shortest life expectancy and whether only individuals are designated beneficiaries. See A-7(c) of § 1.401(a)(9)-5.

Prospective Application

Under the authority provided by § 7805, the principles illustrated in *Situations 1* and *2* of this revenue ruling will not be applied adversely to taxpayers for taxable years beginning prior to May 30, 2006, in which the trust was administered pursuant to a state statute described in §§ 1.643(b)-1, 20.2056(b)-5(f)(1), and 20.2056(b)-7(d)(1) granting the trustee a power to adjust between income and principal or authorizing a unitrust payment in satisfaction of the income interest of the surviving spouse.

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Effect On Other Revenue Rulings

Rev. Rul. 2000-2, 2000-1 C.B. 305, is modified, and as modified, is superseded.

Drafting Information

The principal author of this revenue ruling is Mary Berman of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mary Berman on (202) 622-3090 (not a toll-free call).

Appendix B: Existing UPIA § 409

SECTION 409. DEFERRED COMPENSATION, ANNUITIES, AND SIMILAR PAYMENTS.

(a) In this section, “payment” means a payment that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer’s general assets or from a separate fund created by the payer, including a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

(b) To the extent that a payment is characterized as interest or a dividend or a payment made in lieu of interest or a dividend, a trustee shall allocate it to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.

(c) If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not “required to be made” to the extent that it is made because the trustee exercises a right of withdrawal.

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(d) If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.

(e) This section does not apply to payments to which Section 410 applies.

Comment

Scope. Section 409 applies to amounts received under contractual arrangements that provide for payments to a third party beneficiary as a result of services rendered or property transferred to the payer. While the right to receive such payments is a liquidating asset of the kind described in Section 410 (i.e., “an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration”), these payment rights are covered separately in Section 409 because of their special characteristics.

Section 409 applies to receipts from all forms of annuities and deferred compensation arrangements, whether the payment will be received by the trust in a lump sum or in installments over a period of years. It applies to bonuses that may be received over two or three years and payments that may last for much longer periods, including payments from an individual retirement account (IRA), deferred compensation plan (whether qualified or not qualified for special federal income tax treatment), and insurance renewal commissions. It applies to a retirement plan to which the settlor has made contributions, just as it applies to an annuity policy that the settlor may have purchased individually, and it applies to variable annuities, deferred annuities, annuities issued by commercial insurance companies, and “private annuities” arising from the sale of property to another individual or entity in exchange for payments that are to be made for the life of one or more individuals. The section applies whether the payments begin when the payment right becomes subject to the trust or are deferred until a future date, and it applies whether payments are made in cash or in kind, such as employer stock (in-kind payments usually will be made in a single distribution that will be allocated to principal under the second sentence of subsection (c)).

The 1962 Act. Under Section 12 of the 1962 Act, receipts from “rights to receive payments on a contract for deferred compensation” are allocated to income each year in an amount “not in excess of 5% per year” of the property’s inventory value. While “not in excess of 5%” suggests that the annual allocation may range from zero to 5% of the inventory value, in practice the rule is usually treated as prescribing a 5% allocation. The inventory value is usually the present value of all the future payments, and since the inventory value is determined as of the date on which the payment right becomes subject to the trust, the inventory value, and thus the amount of the annual income allocation, depends significantly on the applicable interest rate on the decedent’s date of death. That rate may be much higher or lower than the average long-term interest rate. The amount determined under the 5% formula tends to become fixed and remain unchanged even though the amount received by the trust increases or decreases.

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Allocations Under Section 409(b). Section 409(b) applies to plans whose terms characterize payments made under the plan as dividends, interest, or payments in lieu of dividends or interest. For example, some deferred compensation plans that hold debt obligations or stock of the plan's sponsor in an account for future delivery to the person rendering the services provide for the annual payment to that person of dividends received on the stock or interest received on the debt obligations. Other plans provide that the account of the person rendering the services shall be credited with "phantom" shares of stock and require an annual payment that is equivalent to the dividends that would be received on that number of shares if they were actually issued; or a plan may entitle the person rendering the services to receive a fixed dollar amount in the future and provide for the annual payment of interest on the deferred amount during the period prior to its payment. Under Section 409(b), payments of dividends, interest or payments in lieu of dividends or interest under plans of this type are allocated to income; all other payments received under these plans are allocated to principal.

Section 409(b) does not apply to an IRA or an arrangement with payment provisions similar to an IRA. IRAs and similar arrangements are subject to the provisions in Section 409(c).

Allocations Under Section 409(c). The focus of Section 409, for purposes of allocating payments received by a trust to or between principal and income, is on the payment right rather than on assets that may be held in a fund from which the payments are made. Thus, if an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest is not taken into account in determining the principal and income allocation except to the extent that the Internal Revenue Service may require them to be taken into account when the payment is received by a trust that qualifies for the estate tax marital deduction (a situation that is provided for in Section 409(d)). An IRA is subject to federal income tax rules that require payments to begin by a particular date and be made over a specific number of years or a period measured by the lives of one or more persons. The payment right of a trust that is named as a beneficiary of an IRA is not a right to receive particular items that are paid to the IRA, but is instead the right to receive an amount determined by dividing the value of the IRA by the remaining number of years in the payment period. This payment right is similar to the right to receive a unitrust amount, which is normally expressed as an amount equal to a percentage of the value of the unitrust assets without regard to dividends or interest that may be received by the unitrust.

An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under Section 409(c), which differentiates between payments that are required to be made and all other payments. To the extent that a payment is required to be made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), 10% of the amount received is allocated to income and the balance is allocated to principal. All other payments are allocated to principal because they represent a change in the form of a principal asset; Section 409 follows the rule in Section 404(2), which provides that money or property received from a change in the form of a principal asset be allocated to principal.

Section 409(c) produces an allocation to income that is similar to the allocation under the 1962 Act formula if the annual payments are the same throughout the payment period, and it is

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simpler to administer. The amount allocated to income under Section 409 is not dependent upon the interest rate that is used for valuation purposes when the decedent dies, and if the payments received by the trust increase or decrease from year to year because the fund from which the payment is made increases or decreases in value, the amount allocated to income will also increase or decrease.

Marital deduction requirements. When an IRA is payable to a QTIP marital deduction trust, the IRS treats the IRA as separate terminable interest property and requires that a QTIP election be made for it. In order to qualify for QTIP treatment, an IRS ruling states that all of the IRA's income must be distributed annually to the QTIP marital deduction trust and then must be allocated to trust income for distribution to the spouse. Rev. Rul. 89-89, 1989-2 C.B. 231. If an allocation to income under this Act of 10% of the required distribution from the IRA does not meet the requirement that all of the IRA's income be distributed from the trust to the spouse, the provision in subsection (d) requires the trustee to make a larger allocation to income to the extent necessary to qualify for the marital deduction. The requirement of Rev. Rul. 89-89 should also be satisfied if the IRA beneficiary designation permits the spouse to require the trustee to withdraw the necessary amount from the IRA and distribute it to her, even though the spouse never actually requires the trustee to do so. If such a provision is in the beneficiary designation, a distribution under subsection (d) should not be necessary.

Application of Section 104. Section 104(a) of this Act gives a trustee who is acting under the prudent investor rule the power to adjust from principal to income if, considering the portfolio as a whole and not just receipts from deferred compensation, the trustee determines that an adjustment is necessary. See Example (5) in the Comment following Section 104.