

KNOW WHEN TO HOLD 'EM AND KNOW WHEN TO FOLD 'EM: PROBATE LITIGATION AND SETTLEMENTS INVOLVING IRAS

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Biography

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- Obtained favorable jury verdict in a guardianship case involving an elderly ward.
- Successfully defeated claim that Will was executed without testamentary capacity on summary judgment.
- Routinely obtains temporary injunctions and temporary guardianships to halt rogue agents from abusing their powers of attorney.
- Obtained partial summary judgment against Trustee for breach of fiduciary duty involving the failure to account.
- Represents guardians, executors, and administrators in all phases of guardianship and estate administration.
- Routinely serves as attorney ad litem and guardian ad litem in guardianship cases.
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- Successfully obtained ancillary estate administration in California to collect and administer

- assets and claims due and owing to Texas estate.
- Successfully transferred guardianships to and from California.

Public Speaking & Publications

- Co-Author/Speaker: State Bar of Texas: Changing IRA Beneficiary Designations After Death by Court Order or Agreement – Intermediate Estate Planning and Probate (2019)
- Co-Author/Speaker: National College of Probate Judges: “A Road Increasingly Traveled: Multistate Probate Issues” – (2019).
- Co-Author: “You Settled It, Right? Family Settlement Agreements in Probate, Trust and Guardianship Disputes” – North Texas Probate Bench Bar (2019).
- Co-Author/Speaker: “Choosing Your Own Adventure and Navigating Self-Dealing Transactions Under the New Power of Attorney Act” – 29th Annual Estate Planning & Probate Drafting (2018).
- Co-Author/Speaker: “A Road Increasingly Traveled: Multistate Probate Issues” – The Estate Planning, Trust and Probate Law Section of the San Diego County Bar Association (2017).
- Co-Author: “Ensure Powers of Attorney Fulfill Intended Purposes” – Estate Planning, Thompson Reuters Checkpoint, (January 2018).
- Co-Author: National College of Probate Judges: “Constitutional Considerations When Restricting Access to the Proposed Ward in Contested Guardianship Proceedings” – Spring Journal (2017).
- Co-Author/Speaker: State Bar of Texas: State Bar of Texas: “Litigation Involving Powers of Attorney & Bank Accounts” – Advanced Estate Planning & Probate (2017).
- Co-Author/Speaker: State Bar of Texas: “What’s New in Guardianship” – Advanced Guardianship Law Course (2017).
- Co-Author/Speaker: State Bar of Texas: “The Shortest Route to Victory: Summary Judgment Practice in Probate and Trust Litigation” – 40th Annual Advanced Estate Planning and Probate Course (2016).
- Co-Author/Speaker: Dallas County Bar Association, Probate, Trust and Estates Section: “Trends in Litigating and Administering Guardianships” (2016).
- Author/Speaker: State Bar of Texas: “Injunctive Relief–The Lethal Preemptive Strike in Probate, Trust and Guardianship Litigation” – 39th Annual Advanced Estate Planning and Probate Course (2015).
- Co-Author/Speaker: State Bar of Texas: “Elder Exploitation” – Advanced Guardianship Law (2015).
- Co-Author/Speaker: Travis County Bar Association: “Winning the Battle & the War: A Remedies–Centered Approach to Litigation Involving Durable Powers of Attorney” (2015).
- Co-Author: “Properly Performing Annual Accounts in Guardianships and Management Trusts Where One or Both Spouses are Incompetent” – Real Estate, Probate, & Trust Law Reporter, Volume 52, No. 4 (2014).
- Served as Moderator for the Guardianship and Ad litem Attorney Certification Course, sponsored by the Dallas Bar Association Probate, Trusts & Estate Section, Dallas County Probate Courts and the Dallas Volunteer Attorney Program to train lawyers in the representation of guardians of indigent wards, and the role and responsibilities of the attorney ad litem (2014).

- Co-Author: "Winning the Battle and the War; A Remedies—Centered Approach to Litigation Involving Durable Powers of Attorney"— 64 Bay. L. Rev. 435 (Spring 2012).
- Author/Speaker: "An Introduction to Guardianships" – Texas Department of Assistive & Rehabilitative Services (DARS), Dallas, Texas (Fall 2010; Spring 2011).
- Co-Author/Speaker: "Proof of Facts and Common Evidentiary Problems Encountered in Contested Probate Proceedings," at the Seventh Probate Litigation Seminar, sponsored by the Tarrant County Probate Bar Association (September 2010).
- Author, A Good Deed Repaid: "Awarding Attorney's Fees in Contested Guardianship Proceedings" – 51 S. Tex. L. Rev. 439 (Winter 2009).

Community and Bar Association Involvement

- State Bar of Texas; Real Estate, Probate and Trust Law Section, Guardianship Committee; Member (2015-2018)
- Dallas Bar Association; Probate and Trust Section Member; Trial Skills Section Member
- Dallas Bar Association; Probate and Trust Section; Council Member (2015-2016)
- Dallas Association of Young Lawyers; Elder Law Section Member
- Member, St. Thomas More Society
- Dallas Bar Mentor Program; Participated as Mentee; Mentor, Edward V. Smith III
- Board of Directors and Vice President, City of Sachse Economic Development Corporation (2010-2014)
- Member, Charter Review Commission, City of Sachse, Texas (2012-2013)
- Organized and leads an ongoing monthly probate study group featuring prominent guest speakers and court staff

Certifications, Awards and Recognition

- Board Certified Estate Planning and Probate Law – Texas Board of Legal Specialization
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Education

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Christian S. Kelso**Partner**

Christian S. Kelso practices in the areas of estate planning, wealth preservation and transfer, probate, tax and transactional corporate law. His primary focus is finding practical, cost-effective solutions for families and businesses to avoid costly, and often heartbreaking disputes in both the courtroom and the living room. Mr. Kelso is a counselor who is dedicated to making the law work for his clients and helping them understand how best to address the legal issues they face.

Mr. Kelso's estate planning and wealth preservation practice involves estates of varying sizes and is premised on the notion that each client deserves bespoke planning and attention to detail because no two families are the same. Whether the situation merely calls for a simple Will to care for minor children or complex trusts to mitigate tax liability, Mr. Kelso works closely with his clients and their other professionals to craft solutions that best achieve the client's goals, both legal and personal.

Where probate of an estate is required, Mr. Kelso provides assistance and advice which is focused on minimizing litigation and intra-family disputes. When proper planning is in place and other circumstances allow, this process can be straightforward and simple, particularly for clients who have the right counselor by their side to guide them through the legal formalities. Other situations, however, can be more complicated. The death of a loved one can often set an entire family at odds as emotions and forgotten tensions well up. In situations like this, Mr. Kelso is able to draw on both his personal and professional experience to ease family tensions and deploy appropriate legal strategies so that clients can move on with their lives.

Mr. Kelso's transactional corporate practice is focused on avoiding legal problems before they materialize. He helps businesses develop solutions that mitigate risk, both in the form of legal exposure and tax. Employing a full-time, in-house attorney can be expensive, but every business faces situations which are best addressed with the counsel of a trusted advisor. Mr. Kelso fills this roll by acting as general counsel on an as-needed basis and assisting with all manner of issues.

Biography

Christian S. Kelso is a native Dallasite, having attended St. Mark's School of Texas for twelve years before moving on to the University of Texas at Austin. Mr. Kelso came back to Dallas for both his J.D. and LL.M. (Taxation), which he received at Southern Methodist University. Mr. Kelso is an active member of the community in North Texas, both legal and otherwise, and sits on charitable boards and other governing bodies. He speaks German fluently and lives in Dallas with his wife and two children.

TABLE OF CONTENTS

I. INTRODUCTION	4
II. DISCLAIMER & PRACTICAL CONSIDERATIONS	5
III. IRA BASICS	5
A. Qualified Plans vs. NonQualified Plans, and Roth IRAs	5
B. IRA Overview	6
C. Key Definitions and Concepts.....	6
(1). Owner/Participant; Beneficiary Distinguished.....	6
(2). Required Beginning Date	7
(3). Required Minimum Distributions	7
(4). The 5-Year Rule	7
(5). The 10-Year Rule	8
(6). Designated Beneficiary	8
(7). Eligible Designated Beneficiary.....	9
D. Deadline to Determine DBs and EDBs	9
E. RMD Rules After Death.....	10
IV. FUNDAMENTAL TAX CONCEPTS APPLICABLE TO IRA BENEFICIARY DESIGNATION DISPUTES.....	10
A. Legal Authority with Respect to Taxation	10
B. Gift and Income Tax Consequences of Settlements Generally	11
C. Binding Effect of Settlement Agreements and State Court Judgments as to Tax Consequences	12
D. Disclaimers	14
V. FUNDAMENTAL LEGAL CONCEPTS APPLICABLE TO IRA BENEFICIARY DESIGNATION DISPUTES.....	15
A. State Law with Respect to the Validity of the IRA Designation.....	15

(1). Generally	15
B. An IRA Beneficiary Designation Will Generally Supersede the Terms of a Will.....	16
(1). It's in the Fine Print: <i>Smith v. Marez</i>	16
(2). Interpretation: Franklin Templeton Bank & Tr. v. Tigert	17
C. Community Property Issues	18
(1). Pre-Decree Designation of Ex-Spouse as Beneficiary in Retirement Benefits and Other Financial Plans	18
VI. CASE STUDIES.....	19
A. The IRA Has <i>Already</i> Been Distributed or Rolled over Before Settlement.....	19
(1). PLR 2016-23001 (Fraud on the Community)	19
B. The IRA Has <i>Not Already</i> Been Distributed or Rolled Over Before Settlement	20
(1). PLR 2007-07158 (Undue Influence).....	20
(2). PLR 2001-27027 (Rollover to Surviving Spouse)	21
(3). <i>Ozimkoski v. Comm'r of Internal Revenue</i> (A Warning to Lawyers).....	21
C. Failure to Update Beneficiary Designation Form	22
(1). PLR 2007-42026	22
(2). PLR 2016-28004	23
VII. STRATEGIES TO CHANGE THE DESIGNATED BENEFICIARY AFTER DEATH.....	24
A. Invalidate the Beneficiary Designation if the IRA Plan Provides A Favorable Alternative Disposition.....	24
B. Reform Beneficiary Designation Form	24
C. Disclaimer.....	24
D. Remove a beneficiary	24
VIII. PRACTICAL TIPS AND CONCLUDING THOUGHTS	25
A. Send Asset Discovery Early to Identify the Existence of an IRA	25
B. Obtain, Review, and Analyze the IRA Beneficiary Designation and Plan Documents ..	25

C.	Advise the Client of the Potential Tax Challenges in Settling IRA Beneficiary Designation Disputes.....	25
D.	Consider Informing Opposing Counsel of the Potential Tax Challenges in Settling IRA Beneficiary Designation Disputes	25
E.	Consider Settling Claims to IRA assets with Other Assets	25

I. INTRODUCTION

As Professor John H. Langbein predicted more than three decades ago, we are in the midst of “a non-probate revolution.”¹ As more wealth is passed from one generation to the next in the form of non-probate assets, estate disputes are increasingly focused on non-probate assets as opposed to traditional Will contests. According to one study, individuals hold close to 9 trillion dollars in employee sponsored defined contribution plans and IRAs.² At the forefront of these disputes are the validity (or non-validity) of beneficiary designations on such non-probate assets as life insurance, annuities, pensions, retirement accounts, and joint bank accounts. These disputes are commonly founded on one or more of the following legal theories: (1) the account owner lacked capacity to complete the IRA beneficiary designation; (2) the account owner was unduly influenced to complete the IRA beneficiary designation; and/or (3) there is some technical defect in the beneficiary designation form.

Texas jurisprudence has long favored the settlement and distribution of property of trusts and estates pursuant to settlement agreements.³ As the Texas Supreme Court announced, such an agreement “is an alternative method of administration in Texas that is a favorite of the law.”⁴ The beneficiaries of such a trust or estate “are free to arrange among themselves for the distribution of the estate and for the payment of expenses from that estate.”⁵ The family settlement doctrine is generally utilized when there is a disagreement on the distribution of an estate, and the beneficiaries enter into an agreement to resolve the controversy.⁶

If, however, the parties are trying to divide and distribute the decedent’s assets and those assets include an IRA (or 401(k) or 403(b) or similar plan), extreme caution must be exercised to the extent the parties agree to distribute such assets in a manner different from the beneficiary designation relating to the plan as it exists at the time of the plan participant’s death.

The structure of statutory and common law rules and regulations surrounding IRAs in the context of litigation is complex, mystifying, and often frustrating. Results turn on seemingly insignificant minutia, and can be catastrophic when they go against a taxpayer. When you boil it all down, what emerges is a set of gambits available to taxpayer litigants (and their counsel), each to be played at just the right time and under just the right circumstances. Did the decedent die before his or her required beginning date? Is one of the litigants a surviving spouse? How long has it been since the decedent died? The trick, of course, is knowing when, and under which circumstance, each gambit may be played to affect the best result, net of taxes, for your client. Perhaps these gambits, and their use, is best summarized in the refrain of Kenny Rogers’s famous

¹ John H. Langbein, *The Nonprobate Revolution and the Future of the Law of Succession*, 97 Harv. L. Rev. 1108, 1116, 1119 (1984).

² Inv. Co. Inst., *The U.S. Retirement Market*, Fourth Quarter 2011 (Apr. 2012).

³ *Stringfellow v. Early*, 40 S.W. 871 (Tex. Civ. App. 1897, no writ) (heirs/legatees can agree not to probate will and to distribute property pursuant to laws of intestacy); *Everett v. Everett*, 309 S.W.2d 893, 896 (Tex. Civ. App.—Waco 1958, writ ref’d n.r.e.) (same).

⁴ *Shepherd v. Ledford*, 962 S.W. 2d 28, 32 (Tex. 1998).

⁵ *Shepherd*, 962 S.W. 2d at 32; *In the Matter of the Estate of Hodges*, 725 S.W. 2d 265, 267 (Tex. App.—Amarillo 1986, writ ref’d n.r.e.); *Salmon v. Salmon*, 395 S.W.2d 29, 32 (Tex. 1965); *Estate of Morris*, 577 S.W.2d 748, 755-56 (Tex. Civ. App.—Amarillo 1979, writ ref’d n.r.e.).

⁶ *In re Estate of Halbert*, 172 S.W.3d 194, 200 (Tex. App.—Texarkana 2005, pet. denied); see also *Estate of Hodges*, 725 S.W.2d at 267.

song: “You gotta know when to hold 'em, know when to fold 'em, know when to walk away, and know when to run!”

II. DISCLAIMER & PRACTICAL CONSIDERATIONS

This paper is presented for educational purposes only and is not intended as legal advice. It is also not intended to be an exhaustive treatise on IRAs, the MRD rules, etc. It is merely intended to familiarize the practitioner to some of the most very basic rules regarding IRAs and the most common issues that may arise when disputing the beneficiary designation on an IRA. Tax professionals should be involved early in a case to analyze any proposed settlement so that any unintended or “surprise” tax consequences can be avoided to the maximum extent possible.

The original version of this paper was prepared for presentation at the State Bar of Texas Intermediate Estate Planning Seminar in the summer of 2019. On December 20, 2019, president Trump signed the Setting Every Community up for Retirement Enhancement Act (the “**SECURE**”). Effective with regard to IRAs owned by persons dying on or after January 1, 2020, SECURE implemented some drastic and sweeping changes to the rules discussed in the original paper. As of this writing in January of 2020, precious little has been written or discussed about how the new rules will play out. Nor do we have any new case law or regulations to work with. The authors have done their best to revise this paper to account for SECURE’s impact, but the reader is advised that their interpretations of the new law can be little more than best guesses at this early point.

Additionally, the authors recognize that litigation over the next several years may well involve decedents who died prior to 2020. In these cases, the old rules will continue to apply, by and large. In modifying this paper to accommodate SECURE, we have therefore attempted to provide both old and new rules.

III. IRA BASICS

A. Qualified Plans vs. NonQualified Plans, and Roth IRAs

While retirement plans may take many different forms, there are two basic types: qualified plans and nonqualified plans.⁷ IRAs are nonqualified plans. Qualified plans include 401(k) plans, profit-sharing plans, 403(b) plans, ESOPs, Keoghs, and SEPs, to name a few. Like IRAs, qualified plans receive favorable tax treatment because they meet certain legal requirements as set forth in the Employee Retirement Income Security Act of 1974 (ERISA), the Internal Revenue Code of 1986, as amended (the “**IRC**”) and its regulations.⁸ Although many of these plans share rules that are similar to those applicable to IRAs, they are not always exactly the same. This paper focuses on IRAs, so practitioners dealing with a qualified plan should be sure to verify the specific rules applicable to the type of plan at issue.

⁷ Michael J. Feinfeld, *Planning an Estate*, § 13.5 (4th Ed. 2017-2018)

⁸ *Id.*

Similarly, Roth IRAs, which are funded with after-tax dollars and therefore do not incur income tax upon distribution, are also outside the scope of this paper. Therefore, references herein to IRAs are intended to mean traditional, rather than Roth IRAs.

B. IRA Overview

An IRA, or individual retirement account, is basically a tax-advantaged savings account for retirement. It is a creature of so-called 'legislative grace,' so special statutory rules apply to its management and taxation, and those rules are applied strictly. That is, IRAs are considered to be a gift from congress, so the courts (and in particular, the IRS) give little leeway when applicable rules are not followed strictly.

The benefit of an IRA is that its assets are not subject to income tax while they remain in the plan,⁹ so they are allowed to (hopefully) grow much more rapidly than they would under normal circumstances.¹⁰ The idea is that this will encourage more taxpayers to save for retirement so that they are more self-sustaining in later life.

The trade-off for this benefit is that each distribution from an IRA is generally taxed as ordinary income in the taxable year in which the distribution is received.¹¹ For this reason, an IRA owner will generally want the distributions from the IRA to be deferred as long as possible to achieve the greatest tax-deferred growth of the assets held in the IRA.

As Professor Johanson points out, “[w]hat is to prevent an [IRA owner] from leaving the benefits in the plan, taking small distributions, or no distributions at all, so as to build up a sizeable inheritance for his or her heirs?”¹² The answer is that rules are applied to require the distribution of IRA assets over a prescribed period. These rules “reflect Congressional policy that benefits under qualified plans [and IRAs] are primarily for the purpose of providing for retirement, and not for building an estate through tax-deferred accumulations.”¹³ Under these rules, the IRA owner must take certain required minimum distributions out of the IRA every year or face harsh penalties.

C. Key Definitions and Concepts

The world of IRAs is laced with defined terms. Some are defined and used in the IRC, some are used but not defined in the IRC, and some are only found in the literature. Below are some of the most important terms that will come up in this paper and a short explanation of each.

(1). Owner/Participant; Beneficiary Distinguished

The term “**IRA owner**” refers to the person who initially established the IRA. Some resources also refer to the IRA owner as the “**participant**.” An IRA owner is distinguished from a

⁹ IRC § 501(a)

¹⁰ Michael J. Feinfeld, *Planning an Estate*, § 13.17 (4th Ed. 2017-2018)

¹¹ IRC § 408(d)(1); Treas. Reg. 1.408-4(a)

¹² Stanley Johanson, *Estate Planning for Qualified Plan Benefits and IRAs*, 6, Annual Course on Estate Planning-The Center for American and International Law (2015).

¹³ *Id.*

“beneficiary,” who inherits the IRA. Note, however, that a surviving spouse may sometimes inherit IRA assets which are then rolled over into an IRA of which he or she is the owner.

(2). Required Beginning Date

The required beginning date (“RBD”) is the date by which an IRA owner must begin taking distributions from their IRA.¹⁴ Before SECURE, the RBD for a traditional IRA was generally April 1 of the year following the year in which the participant reached age 70 ½, regardless of whether he or she is retired.¹⁵ Under SECURE, however, the RBD is extended to April 1 of the calendar year following the latter of (i) the year in which the participant reaches age 72 or (ii) the year in which the participant retires.¹⁶

(3). Required Minimum Distributions

Once the RBD is determined, the owner must take required minimum distributions (“RMDs”) for the first year and every subsequent year.¹⁷ IRC § 401(a)(9) sets forth the applicable minimum distribution rules. The minimum distribution rules impose a tax penalty to on IRA owners who skip benefits in order to pass wealth to future generation. Should an IRA owner fail to receive the required minimum distributions, a steep excise tax equal to 50% of the shortfall between the actual amount distributed and the required minimum distribution.¹⁸ Although some leeway is given the first year, RMDs generally must be made by December 31 of each year to avoid the tax penalty.¹⁹

(4). The 5-Year Rule

The “5-Year Rule” is the default rule that applies to inherited IRAs. Under this rule, all benefits must be distributed (and tax thereon paid) no later than December 31 of the year that contains the fifth anniversary of the Participant's death.²⁰ For obvious reasons, this can be rather tax inefficient, particularly where a beneficiary will be thrust into a higher tax bracket, for example because the IRA is large or the beneficiary is experiencing prime earning years. Therefore, taxpayers (and their professionals) have historically gone to great lengths to avoid the 5-Year Rule in many instances.

It is worth stating that, contrary to popular opinion among planners, the 5-Year Rule is not a particularly bad deal to many taxpayers. A joke in the estate planning community says that, when a surviving parent dies, his or her children will call the bank on the ride to the funeral if they're broke and graciously wait until the ride back from the funeral if they're not. That is to say, many beneficiaries intend to drain an inherited IRA long before five years have run. It is therefore incumbent on probate lawyers and other professionals to counsel clients on the impact this might have.

¹⁴ IRC § 401(a)(9) and Treas. Reg. § 1.401(a)(9)-2, Q&A-2(a).

¹⁵ IRC §§ 408(a)(6), 401(a)(9)(C)(i)(I), (ii)(II); Natalie B. Choate, *Life and Death Planning for Retirement Benefits*, § 1.4.02 (7th ed. 2011).

¹⁶ IRC § 401(a)(9)(C)(i)

¹⁷ Treas. Reg. § 1.401(a)(9)-5, Q&A-1.

¹⁸ § 4974(a).

¹⁹ Treas. Reg. § 1.401(a)(9)-2, Q&As-1 through 4.

²⁰ Reg. § 1.401(a)(9)-3.

(5). The 10-Year Rule

The “**10-Year Rule**” is a creature of SECURE. Similar to the 5-Year Rule, the 10-Year Rule requires that the assets of an inherited IRA be distributed (and tax thereon paid) within ten years of the participant’s death.²¹ Although the statute requires full distribution “within [10] years of the participant’s death,” it does so by referencing the statute that provides the 5-Year Rule. Regulations under the 5-Year Rule clarify that the final distributions must be made by December 31 of the year containing such anniversary, not exactly 5 years from the date of the participant’s death (unless the participant happens to die on December 31).

As with the 5-Year Rule, taxpayers (and their professionals) will go to great lengths to avoid the 10-Year Rule in many instances. Under SECURE, however, many, if not most, beneficiaries will not qualify to avoid the 10-Year Rule.

Note that SECURE did not replace the 5-Year Rule with the 10-Year Rule. The 5-Year Rule continues to exist under SECURE for beneficiaries who do not qualify as DBs. Thus (and quite confusingly) the 10-Year Rule applies to DBs that are not EDBs (both defined below) and the 5-Year Rule continues to apply to beneficiaries who are not DBs.

(6). Designated Beneficiary

A designated beneficiary (“**DB**”) is narrowly defined, and not every beneficiary is a DB. Generally, a DB is an *individual* who is designated as a beneficiary, either by the terms of the plan or, if the plan so provides, by an affirmative election by the IRA owner.²² A DB need not be specified by name, so long as the individual who is to be the beneficiary is identifiable under the plan.²³ The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible to identify the class member with the shortest life expectancy.²⁴ Generally, a trust is not an “individual,” however special rules allow for some trusts to be “seen through” so as to treat individual trust beneficiaries as if the IRA owner had named them directly.²⁵

As the name implies, DBs are generally designated on a beneficiary designation form, making a participant’s Will irrelevant to a given beneficiary’s designation...usually. IRA inheritance may happen through a Will in certain, limited circumstances, such as when the participant’s estate is selected as the beneficiary on a beneficiary designation form or where the default terms of an IRA plan apply, as might be the case where all other named beneficiaries predecease the participant or where a beneficiary designation form was filled out improperly, or not at all. Generally, a beneficiary who inherits an IRA (or some portion thereof) through an estate will not qualify as a DB under the rules.

The benefit to DB status is that the beneficiary is allowed to take smaller RMDs over a longer period of time, thereby preserving the IRA assets and reaping the tax advantages for a longer period of time. Such a “**stretch-out**” can produce significant tax advantages.

²¹ IRC § 401(a)(9)(B)(ii), as modified by new IRC § 401(a)(9)(H)(i)(I)

²² Treas. Reg. § 1.401(a)(9)-4.

²³ *Id.*

²⁴ *Id.*

²⁵ Choate, § 1.7.03 (7th ed. 2011); See also Reg. § 1.401(a)(9)-4, Q&A-5; PLR 201633025.

Prior to SECURE, many DBs enjoyed far greater tax treatment than they do now, particularly where the DB was young (i.e. grandchildren and further descendants), and/or where the IRA was large. Under SECURE, most DB's will be subject to the 10-Year Rule. While this is better than the 5-Year Rule, it is not as advantageous as a stretch-out over the lifetime of the beneficiary, as had been possible for many more beneficiaries prior to SECURE.

Note that, under SECURE, the distinction of DB has not been repealed or changed. Rather, an additional layer of complexity has been added over what was an already complex system.

(7). Eligible Designated Beneficiary

The eligible designated beneficiary (“**EDB**”) is another creature of SECURE. EDBs are the only DBs that are entitled to avoid the 10-Year Rule under SECURE. ALL EDBs are DBs but not all DB's are EDBs. There are five categories of EDBs: (i) spouses; (ii) minor children of the participant; (iii) disabled individuals; (iv) chronically ill individuals; and (v) beneficiaries who are less than ten years younger than the participant.²⁶ Quite a bit of nuisance is involved with EDBs. For example, where a minor child is a beneficiary, a stretch-out will apply, but only until the child reached the age of majority, at which time the 10-Year Rule begins to apply.²⁷ Additionally, EDB status does not apply to grandchildren or other relatives of a plan participant.

D. Deadline to Determine DBs and EDBs

DB and EDB status are determined at the time of the participant's death.²⁸ Where a trust is involved, however, it may be important to determine which of several beneficiaries are “counted” for RMD purposes. If just one “bad apple” beneficiary is not a DB, the 5-Year Rule will apply such that the trust must withdraw (and pay tax on) all of the IRA assets within the 5-year period. A special rule for DBs, however, allows for the counting of only those beneficiaries who remain as of September 30 of the calendar year following the IRA owner's death (the “**Beneficiary Finalization Date**”).²⁹ Under this rule, if all non-qualifying beneficiaries can somehow be excised from the pool of trust beneficiaries in time, the trust will reap the benefits of DB status.

There are a couple ways to excise non-qualifying beneficiaries from a trust. One option may be to split a single trust into multiple trusts such that one or more of the resultant trusts has only DBs. Another option may be to buy a non-qualifying beneficiary out of their interest. Similarly, if a person effectively disclaims their right to an IRA by the Beneficiary Finalization Date (thereby allowing other beneficiaries to receive the benefit in lieu of that person), the disclaimant is not taken into account in determining the owner's DBs.³⁰ Qualified disclaimers are discussed in more detail below.

Presumably, the regulation providing for the Beneficiary Finalization Date with regard to DB's is likewise applicable to EDBs, but it is too soon to know for sure.

²⁶ IRC § 401(a)(9)(E)(ii).

²⁷ IRC § 401(a)(9)(E)(iii).

²⁸ Treas. Reg. § 1.401(a)(9)-4 and IRC § 401(a)(9)(E)(ii).

²⁹ Treas. Reg. § 1.401(a)(9)-4.

³⁰ *Id.*

E. RMD Rules After Death

RMDs for IRA beneficiaries depend not only on the identification of the beneficiaries, but also on whether the participant survived his or her RBD. This rule exists because the participant's RBD is necessarily close (at least in theory) to the end of his or her life and it can lead to a great deal of confusion. The RMD rules before SECURE were complex, and the new law has made them even more so. Given this complexity, details of the RMD rules are beyond the scope of this paper. Suffice to say, however, that SECURE has taken what was a two-tiered regime and added another layer. Before SECURE, the options were generally as follows:

- 1) Beneficiaries who were not DBs got stuck with the 5-Year Rule or were required to take distributions based on the life expectancy of the participant.³¹
- 2) Beneficiaries who qualified as DBs got a stretch-out based on their life expectancy, or in the case of certain trusts or classes of beneficiaries, on the life expectancy of the oldest beneficiary.

After SECURE, the options are as follows:

- 1) Beneficiaries who are not DBs are subject to the same rules as before, so they get stuck with the 5-Year Rule or are required to take distributions based on the life expectancy of the participant.
- 2) Beneficiaries who are DBs (but not EDBs) are subject to the 10-Year Rule.
- 3) DBs who are also EDBs get a stretch-out, but the length of the stretch-out depends on which of the five categories of EDB the beneficiary falls into.

IV. FUNDAMENTAL TAX CONCEPTS APPLICABLE TO IRA BENEFICIARY DESIGNATION DISPUTES

A. Legal Authority with Respect to Taxation

Legal authority with respect to taxation in the US is rather more dynamic than most practitioners in other fields may be used to. The starting point is generally the IRC and the regulations promulgated thereunder. Although not technically binding, the regulations are generally considered authoritative.

Case law relating to federal taxation is also more bifurcated than in other areas. The Supreme Court and circuit courts of appeals operate as with other legal subcategories. But lower court decisions can come primarily from three places: the district courts, the Tax Court, and the Court of Federal Claims. District court decisions are not binding, not even on other district court judges within the same district, and are merely persuasive.³² On the other hand, “[The Tax Court] was

³¹ Even though the participant was necessarily deceased, the calculation could still be made based on actuarial tables as if he or she were still alive.

³² 28 U.S.C. § 132.

established by Congress to interpret and apply the Internal Revenue Code in disputes between taxpayers and the Government.”³³ The Tax Court is composed of 19 members who are presidentially appointed,³⁴ as well as special trial judges, who are appointed by a chief judge,³⁵ and senior judges.³⁶ All of the judges have expertise in the tax laws. The Tax Court can issue four types of opinions—reviewed opinions, division opinions (also known as unreviewed regular opinions), memorandum opinions, and summary opinions—each of which has different authoritative weight. In addition, when there is a reviewed opinion, there might be concurring and dissenting opinions that accompany it, and they too may have their own authoritative value. Further, because of the Tax Court’s expertise on tax matters, courts have on occasion suggested that its decisions may be accorded greater authoritative value than other trial court decisions.³⁷ Finally, the Court of Federal Claims consists of 16 judges nominated by the President and confirmed by the Senate for a term of 15 years. Approximately one-quarter of the cases before the Court of Federal Claims involve tax refund suits, an area in which the court exercises concurrent jurisdiction with U.S. district courts.³⁸ Decisions of the Court of Federal Claims are not binding, not even on the Court of Federal Claims itself.³⁹ They may, however, be persuasive and are sometimes cited by the Tax Court.

The IRS and the Treasury Department in general issue a number of pronouncements taking various forms and bearing varying degrees of authoritative weight. These include the treasury regulations, which come in three flavors: proposed, temporary, or final. Revenue Rulings are another form of pronouncement. They provide official IRS interpretation of the IRC and can be both relied upon and cited as authority. Revenue Procedures are official IRS interpretation on how to comply with the tax law. They may also be relied upon and cited as authority. Private Letter Rulings (“**PLRs**”, Determination Letters, Technical Advice Memoranda, and Chief Counsel Advice provide guidance on a specific taxpayer’s situation and cannot be relied upon or cited by taxpayers other than those specifically at issue (i.e. those requesting a given ruling).⁴⁰ These can, however, provide insight on the IRS’s position on certain issues and may lead to a primary source that may not have been previously considered. Many private letter rulings are cited in this paper.

B. Gift and Income Tax Consequences of Settlements Generally

Tax treatment is an often overlooked aspect of any litigation. Parties to an estate settlement should not assume the property they receive in satisfaction of their claims will not be subject to income and/or gift tax. The IRS will not respect a settlement agreement unless the parties’ claims were bona fide and are satisfied, to the extent feasible, on an economically fair basis.⁴¹ Transfers which do not relate to a bona fide dispute will generally subject parties to income and/or gift taxes.

³³ *Freytag v. Commissioner*, 501 U.S. 868, 891 (1991).

³⁴ IRC § 7443(a).

³⁵ IRC § 7443A.

³⁶ IRC § 7447(c).

³⁷ See *Estate of Schnack v. Commissioner*, 848 F.2d 933, 935 (9th Cir. 1988); *Guy F. Atkinson Co. v. Commissioner*, 814 F.2d 1388, 1391 (9th Cir. 1987); *Aeroquip-Vickers, Inc. v. Commissioner*, 347 F.3d 173, 184 (6th Cir. 2003) (Clay, J., dissenting); and *Temple v. United States*, 423 F. Supp. 2d 605, 620 (E.D. Tx. 2006).

³⁸ 28 U.S.C. § 271.

³⁹ 28 U.S.C. § 174.

⁴⁰ IRC § 6110(k)(3).

⁴¹ PLR 8902045.

Even in the context of a bona fide dispute, however, the exchange of property in settlement of a dispute will often trigger tax.

The portion of an estate an heir receives in settlement of a Will contest is generally exempt from federal income tax.⁴² There are a number of exceptions to this general rule, however.⁴³ Similarly, a transfer of property by an individual for full and adequate consideration is not a gift for federal gift tax purposes.⁴⁴

C. Binding Effect of Settlement Agreements and State Court Judgments as to Tax Consequences

Deciphering just when and how state law, and in particular, state court judgments are binding on the IRS can be difficult, to say the least. As one court put it, “[s]tate law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed.”⁴⁵ Put another way, “[i]t is virtually hornbook law that state law determines the legal interests and rights created by a trust instrument, while federal law determines the federal tax consequences of those interests and rights.”⁴⁶

Consider, for example, a prototypical scenario where the children of a deceased IRA owner are in a dispute with their step-mother (the owner's much younger spouse at death). The children claim, *inter alia*, that the spouse exerted undue influence over their father, thereby inducing him to change the beneficiary designation of his IRA. At mediation, the spouse agrees to the modification of the beneficiary designation such that the children become beneficiaries of the IRA. Suppose further that a state court blesses this plan in an order that is binding upon all the parties and the IRA is transferred to the children. For argument's sake, presume that the beneficiaries are individually named in the “new” beneficiary designation, that the IRA Owner died in 2019, prior to his RBD, and everything is done by September 30 in the year following the owner's death. What result?

In this hypothetical scenario, there are at least three possible results and each has a different tax consequence. If the IRS is not bound by the order, it could take the position that the IRA assets were fully distributed by the step-mother to herself (incurring income tax), then gifted to the children (possibly incurring gift tax), and then improperly transferred to the children's new IRA accounts (incurring penalties, and the loss of tax benefits). Needless to say, this result would be extremely undesirable for all of the parties. In contrast, if the IRS is fully bound by the order, then

⁴² See *Lyeth v. Hoey*, 305 U.S. 188, 197, 59 S. Ct. 155, 160, 83 L. Ed. 119 (1938) (addressing the issue of whether property received by an individual from the estate of a decedent in compromise of his claim as an heir is taxable as income).

⁴³ See Mickey R. Davis and Melissa J. Willms, *Knowing the Ropes and Binding the IRS When Fiduciaries are Involved in Settlements and Modifications: Income and Transfer Tax Issues Every Fiduciary Should Know*, 41st Advanced Estate Planning & Probate Course (2017) (pg. 12-16; discussing exceptions for distributable net income, bequest of income, and bequest for services rendered).

⁴⁴ See *Righter v. United States*, 258 F. Supp. 763, 768 (W.D. Mo. 1966), rev'd and remanded on other grounds, 400 F.2d 344 (8th Cir. 1968).

⁴⁵ *Morgan v. Comm'r of Internal Revenue*, 309 U.S. 78, 80, 60 S. Ct. 424, 426, 84 L. Ed. 585 (1940).

⁴⁶ *Estate of Vissering v. C. I. R.*, 96 T.C. 749, 755–56 (1991), rev'd, 990 F.2d 578 (10th Cir. 1993); see also *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967) (Judgments) and *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981) (Settlements).

the children are DBs and get to enjoy a stretch-out on their inherited IRAs with RMDs payable over their respective lifetimes. This is a much better result for everyone. Finally, if the IRS is only partially bound by the court order, it might treat the “new” beneficiary designation as valid, but disallow DB status for the children, thereby subjecting them to the 5-Year Rule.

Unfortunately, determining what should happen in the above scenario is very difficult. It appears, however, that the “partially bound” result is correct under the law as it applied before SECURE. After SECURE, there does not appear to be any difference in the analysis, however, it is too soon to have any confirmation of this.

At one point, the IRS seemed willing to allow DB status where an individual took under a judicially modified beneficiary designation, at least where the initial failure was caused by a scrivener's error.⁴⁷ Later, however, the IRS seemed to change its stance and began disallowing DB status in this scenario.⁴⁸ In one rather extreme instance, the IRS even refused to acknowledge that a state slayer rule change the beneficiary designation of an IRA.⁴⁹

There are a number of instances where the IRS has denied DB status following judicial reformation of a beneficiary designation.⁵⁰ According to one private letter ruling, “in order to be a designated beneficiary, an individual must be a beneficiary as of the date of the employee's death.”⁵¹ The IRS appears to be afraid that taxpayers might use the judicial system merely to reap tax benefits. As stated in one private letter ruling, if the IRS were bound by such court orders, “there would exist considerable opportunity for “collusive” state court actions having the sole purpose of reducing federal tax liabilities.”⁵²

On the other hand, the IRS seems to be more lenient in other cases. For example, in PLR 2017-06004, a surviving spouse was granted an IRA pursuant to a court order. Although she wasn't allowed DB status, she was allowed to roll her inherited account over (which is an even better result).⁵³ Indeed, there are several instances where a surviving spouse has been treated mercifully for DB purposes.⁵⁴ In PLR 2000-27061, a surviving spouse was treated as having received IRA asset directly from the IRA (and not from the IRA owner's estate) where the owner named his estate on his IRA beneficiary designation form, but under applicable state law, the surviving spouse opted for an elective share of his assets.

The IRS recently confirmed its willingness to be lenient to surviving spouses. In two PLRs with similar fact patterns, surviving spouses were able to posthumously modify beneficiary designations by judicial action.⁵⁵ In both instances, the IRS allowed the spouses to roll over their spouses' IRA assets into their own accounts without penalty.⁵⁶

⁴⁷ PLR 2006-16039.

⁴⁸ PLR 2007-42026.

⁴⁹ PLR 2010-08049.

⁵⁰ See PLR 2007-42026. See also PLRs 2010-21038 and 2017-06004.

⁵¹ PLR 2016-28005.

⁵² PLR 2010-21038.

⁵³ PLR 2017-06004.

⁵⁴ See PLRs 2004-40035, 2000-27061, PLR 9006050, and 2003-04038.

⁵⁵ PLRs 201935005 and 201935006.

⁵⁶ *Id.*

As to the issue of IRA distribution and subsequent gifting by the party relinquishing an IRA, the IRS has also been generous.⁵⁷ In PLR 2007-42026, a beneficiary designation was modified by state court order. The change was allowed without any income or gift tax consequences, but the post-order beneficiaries were not granted DB status.⁵⁸ Similarly, in PLR 2007-07158 (which is discussed in more detail below), a beneficiary was able to transfer IRA assets to another litigant, pursuant to a settlement agreement and related order, without being treated as if he had made a taxable distribution to himself.

On the other hand, there is at least one PLR which indicates that the income and gift taxes should be triggered. In PLR 2016-23001 (which is discussed in more detail below), a state court ordered a beneficiary (the IRA owner's child), to assign IRA funds to the IRA owner's surviving spouse pursuant to a settlement agreement between the child and the surviving spouse. The ruling states that the order cannot be accomplished under state law in part because doing so would be treated as a taxable distribution to the child.⁵⁹

D. Disclaimers

Disclaimers are often useful in “fixing” unwanted problems after someone has died. In the context of settlements, however, their usefulness is greatly reduced.

A disclaimer is a party's refusal to accept property by gift or inheritance. The theory behind disclaimers is that you cannot force a person to accept property they do not want. When a disclaimer is made, the disclaimant is, for all intents and purposes, treated as having predeceased the given decedent. As such, the disclaimant has no control over where the disclaimed property will eventually go.

A question arises as to whether a disclaimer constitutes a taxable gift from the disclaimant. Fortunately, IRC § 2518 makes it clear that a disclaimer, by itself, is not a gift for gift tax purposes, so long as it meets certain requirements (a “**qualified disclaimer**”). A qualified disclaimer also avoids triggering income tax (i.e. under a theory that IRA property should be treated as having been distributed to the disclaimant).⁶⁰ Where IRA assets are disclaimed, the person who received the benefits of the disclaimer, and not the disclaimant, is taxed on the IRA under the otherwise applicable rules.⁶¹ Presumably, this rule hasn't been changed by SECURE, but yet again, we cannot be sure at this time.

One requirement of a qualified disclaimer is that it must be made before the disclaimant receives any benefit from the disclaimed property. Often, an RMD must come out of an IRA before a disclaimer can be made, which begs the question: Does receipt of the RMD constitute receipt of a benefit of the IRA assets? Fortunately, the IRS has stated in a safe-harbor ruling that a taxpayer can receive and keep an RMD in the year of the IRA owner's death and still be eligible

⁵⁷ PLR 2003-24059. See also PLRs 2011-28036 and 2007-742026.

⁵⁸ *Id.* See also PLR 2016-28005.

⁵⁹ *Id.*

⁶⁰ GCM 39858

⁶¹ *Id.*

for a qualified disclaimer.⁶² Of course, the taxpayer will be liable for the tax associated with the RMD.

In the context of settlements, however, disclaimers are less useful. As stated above, a disclaimant cannot accept any benefit from disclaimed property prior to making a qualified disclaimer thereof. Unfortunately, Reg. § 25.2518 states that “acceptance of any consideration in return for making the disclaimer” is treated as acceptance of the property. Thus, a litigant generally cannot agree to disclaim an IRA as part of a settlement agreement because he or she will be doing so only in consideration of the other terms of the settlement.

V. FUNDAMENTAL LEGAL CONCEPTS APPLICABLE TO IRA BENEFICIARY DESIGNATION DISPUTES

A. State Law with Respect to the Validity of the IRA Designation

(1). Generally

With respect to Texas state law, Chapter 111 of the Texas Estates Code (“TEC”) governs non-probate assets in general (including IRAs). When Chapter 111 uses the term “individual retirement account” it is defined as a trust, custodial arrangement, or annuity under Section 408(a) or (b), Internal Revenue Code of 1954 (26 U.S.C. Section 408 (1986)).⁶³ The definition of “[r]etirement account” includes an “individual retirement account.”⁶⁴

TEC § 111.052, entitled “Validity of Certain Nontestamentary Instruments and Provisions,” further states in relevant part:

(a) This code does not invalidate:

(1) any provision in a . . . retirement account . . . or any other written instrument effective as a contract, gift, conveyance, or trust, stating that:

(A) money or other benefits under the instrument due to or controlled or owned by a decedent shall be paid after the decedent's death, or property that is the subject of the instrument shall pass, to a person designated by the decedent in the instrument or in a separate writing, including a Will, executed at the same time as the instrument or subsequently; or

(B) money due or to become due under the instrument shall cease to be payable if the promisee or promisor dies before payment or demand; or

(2) an instrument described by Subdivision (1).

⁶² Rev. Rul. 2005-36.

⁶³ TEC § 111.051(3).

⁶⁴ TEC § 111.051(4) states that “[r]etirement account” means a retirement-annuity contract, an individual retirement account, a simplified employee pension, or any other retirement savings arrangement.

(b) A provision described by Subsection (a)(1) is considered nontestamentary.

TEC § 111.054(b) states that “Notwithstanding a choice of law or other contractual provision in an agreement prepared or provided by a contracting third party, Texas law applies to determine: (1) whether a nontestamentary transfer of assets or interests described by Subsection (a) has occurred; and (2) the ownership of the assets or interests following a possible nontestamentary transfer.” That section applies “if more than 50 percent of the: (1) assets in an account at a financial institution, in a retirement account, or in another similar arrangement are owned, immediately before a possible nontestamentary transfer of the assets, by one or more persons domiciled in this state; or (2) interests under an insurance contract, annuity contract, beneficiary designation, or other similar arrangement are owned, immediately before a possible nontestamentary transfer of the interests, by one or more persons domiciled in this state.”⁶⁵

TEC § 111.054(c) creates a foothold for an interested person to enforce their rights in an IRA by stating “[n]otwithstanding a choice of law or other contractual provision in an agreement prepared or provided by a contracting third party, any person, including a personal representative, who is asserting an ownership interest in assets or interests described by Subsection (a) subject to a possible nontestamentary transfer shall have access to the courts of this state for a judicial determination of: (1) whether a nontestamentary transfer of the assets or interests has occurred; or (2) the ownership of the assets or interests following a possible nontestamentary transfer.”

However, Texas law does not apply (and neither do subsections (a), (b), and (c)) to an obligation: (1) owed by a party to the contracting third party; or (2) owed by the contracting third party to a party.”⁶⁶

B. An IRA Beneficiary Designation Will Generally Supersede the Terms of a Will

(1). It’s in the Fine Print: *Smith v. Marez*

In *Smith v. Marez*,⁶⁷ a decedent's surviving spouse (his wife), individually and as executrix under decedent's Will, brought declaratory judgment action against three of decedent's children to determine rights and obligations of the parties with respect to decedent's two IRAs. The decedent's wife claimed the two IRAs belonged to her, and his children counterclaimed that the decedent intended for the two IRA accounts to go to them in the percentages set forth in his “Last Will and Testament” or in the alternative, if the changes to his beneficiary forms were not effective, the distribution of the IRA accounts should be pursuant to earlier designation forms, which gave them specific percentages of the IRA accounts.⁶⁸ The trial court granted summary judgment in favor of the wife, declaring she was the owner of the two IRA accounts. On appeal, the appellate court affirmed.

The court rejected the children’s arguments that the decedent’s intent governed the dispute as reflected by his handwritten edits to the IRA forms directing the funds to be distributed under the

⁶⁵ TEC § 111.054(a).

⁶⁶ TEC § 111.054(d).

⁶⁷ 217 N.C. App. 267, 719 S.E.2d 226 (2011).

⁶⁸ *Id.* at 228.

Will. Relying on New York law, the appellate court reasoned that any changes to the beneficiary designation had to be made in accordance with the rules of the IRA policies and there was no indication that the IRA custodian had waived strict compliance with the terms of the IRA agreements.⁶⁹ Thus, the children's arguments regarding the decedent's intent as indicated by the provisions of his Will were irrelevant, so the court was only left to consider only "whether the decedent strictly complied with the requirements of the IRA agreement as to the change of beneficiary form."⁷⁰ Moreover, because the decedent expressly revoked "all prior beneficiary designations" the IRA custodian could not distribute the proceeds pursuant to the prior designations.⁷¹

The appellate court's analysis in *Marez* provides a helpful warning for anyone considering changing the beneficiary designation on their IRA. IRA owners should make sure to correctly fill out the beneficiary designations and be forewarned that, even if the forms are not correctly filled out, they *may have the effect of revoking a previous valid beneficiary designation*.

(2). Interpretation: *Franklin Templeton Bank & Tr. v. Tigert*

Texas courts have interpreted the effect of imprecise language used in a beneficiary designation form for an IRA. In *Franklin Templeton Bank & Tr. v. Tigert*,⁷² the children from the decedent's first marriage, as independent executors, sued the decedent's second wife for declaratory judgment that three retirement accounts, a SEP IRA, an IRA that had been rolled over from the decedent's first spouse (the "**Rollover IRA**"), and Money Purchase Pension Plan (the "**MPP Plan**"), belonged to the decedent's estate. The trial court declared the estate as the beneficiary of the accounts. On appeal, the Dallas Court of Appeals held that the trial court erred as a matter of law in its construction of the retirement account contracts and reversed the trial court's judgment and rendered judgment in favor of the surviving spouse.⁷³

The opinion provides an excellent summary of contractual interpretation rules. Essentially, the decedent's children argued that, with respect to the SEP IRA and the Rollover IRA, the decedent, by describing his first wife as his "spouse" on the SEP IRA application, intended "to give the proceeds [of the retirement accounts] specifically to [his first wife] and if that spouse did not survive, to his estate."⁷⁴ Thus, "the effect of him describing his first wife as 'spouse,' was to define her as 'the' spouse for the purpose of interpreting the terms of all the [custodian's] account provisions."⁷⁵ The children further argued that the first wife was likewise defined as "spouse" for the Rollover IRA, despite the fact that the decedent left the beneficiary designation blank on his Rollover IRA application.⁷⁶

The Dallas Court of Appeals rejected the children's contention that the decedent's definition of his first wife as "spouse" imposed a meaning that must be included in construing the language

⁶⁹ *Id.* at 272-274.

⁷⁰ *Id.* at 274.

⁷¹ *Id.* at 276.

⁷² 2011 WL 2507834 (Tex. App.—Dallas June 24, 2011, no pet.).

⁷³ *Id.* at 1.

⁷⁴ *Id.* at 6.

⁷⁵ *Id.*

⁷⁶ *Id.* at 6.

of the custodial agreement. Rather, the court concluded that the entry of the word “spouse” in the blank space provided for “Relationship” was purely informational.⁷⁷ Consequently, the court held that, since under the terms of the custodial agreement, none of the decedent’s identified beneficiaries survived him, as a matter of law, his surviving spouse was the beneficiary of the SEP IRA and Rollover IRA.⁷⁸

With respect to the MPP Plan, the plan required the decedent to designate his spouse as his beneficiary unless she consented otherwise.⁷⁹ Because there was no evidence of such consent, the beneficiary language included in the MPP Plan made it clear that the surviving spouse was the beneficiary.⁸⁰

C. Community Property Issues

In *Allard v. French*,⁸¹ a decedent’s surviving husband filed suit challenging the marital characterization of a retirement account of which he (the surviving husband) was the owner. The trial court rendered judgment characterizing the retirement benefits as community property and awarded the estate one-half of the retirement benefits. The court of appeals affirmed the trial court, holding that the proceeds from the husband’s retirement plan were properly characterized as community property. The Texas Supreme Court affirmed.

The issue on appeal was the proper method to be utilized in dealing with retirement benefits when the marriage is terminated by the death of the non-employee spouse.⁸² The husband contended that his wife’s one-half interest in his retirement benefits should not be allowed to continue after her death and pass under her Will to the couple’s adult child and grandchildren.

The Texas Supreme Court noted there was no beneficiary designation on the retirement account. Therefore, since there was no indication that the deceased spouse agreed to the disposition of the retirement benefits, there was no valid reason to deny the spouse the opportunity to dispose of her community interest in the retirement plan. The Texas Supreme Court held that, since a spouse has a community property interest in that portion of the retirement benefits of the opposite spouse earned during their marriage, the retirement benefits in this case were properly characterized as community property, and thus, one-half of such benefits was properly included in the wife’s estate.⁸³

(1). Pre-Decree Designation of Ex-Spouse as Beneficiary in Retirement Benefits and Other Financial Plans

Texas Family Code § 9.302 applies if a decree of divorce or annulment is rendered after a person has designated the former spouse as a beneficiary under an individual retirement account. That section states, in relevant part: “If a decree of divorce or annulment is rendered after a spouse,

⁷⁷ *Id.* at 7.

⁷⁸ *Id.* at 7.

⁷⁹ *Id.* at 7.

⁸⁰ *Id.*

⁸¹ 754 S.W.2d 111, 112–13 (Tex. 1988).

⁸² *Id.* at 113.

⁸³ *Id.* at 114.

acting in the capacity of a participant, annuitant, or account holder, has designated the other spouse as a beneficiary under an individual retirement account, employee stock option plan, stock option, or other form of savings, bonus, profit-sharing, or other employer plan or financial plan of an employee or a participant in force at the time of rendition, the designating provision in the plan in favor of the other former spouse is not effective.” There are three exceptions to this general rule: (1) the decree designates the other former spouse as the beneficiary; (2) the designating former spouse redesignates the former spouse as the beneficiary after rendition of the decree; or (3) the former spouse is designated to receive the proceeds or benefits in trust for, on behalf of, or for the benefit of a child or dependent of either former spouse.

TEC § 123.052(c) affirms the above referenced Family Code scheme as it states that “[s]ections 9.301 and 9.302, Family Code, govern the designation of a former spouse as a beneficiary of certain life insurance policies or as a beneficiary under certain retirement benefit plans or other financial plans.”

VI. CASE STUDIES

A. The IRA Has *Already* Been Distributed or Rolled over Before Settlement

(1). PLR 2016-23001 (Fraud on the Community)

In PLR 2016-23001, the decedent, who lived in a community property state, was survived by a surviving spouse and their child. The decedent named the child as the sole beneficiary on three IRAs. After the decedent’s death, the surviving spouse sued the decedent’s estate to recover the surviving spouse’s one-half community property interest in their marital estate. The surviving spouse and the Estate reached a settlement where they agreed on the value of the surviving spouse’s community interest in the IRAs. A state court approved the settlement and ordered the custodian of the IRAs to assign the IRAs as provided in the settlement agreement, specifically directing that the amount assigned to the surviving spouse be treated as a spousal rollover.⁸⁴

In its ruling, the IRS noted that the child was named as the beneficiary of the IRA and that it had been retitled as an inherited IRA for the child per standard procedure when a child inherits an IRA. IRC § 408(g) provides that it “shall be applied without regard to any community property laws.” Consequently, because the child was the named beneficiary and because any community property interest must be disregarded, the surviving spouse could not be treated as the payee of the child’s inherited IRA.⁸⁵ Additionally, the surviving spouse could not rollover amounts from the child’s inherited IRA.⁸⁶ Importantly, since the child was the named beneficiary of the IRA and because the surviving spouse’s community property interest had to be disregarded for purposes of IRC § 408(g), any assignment of an interest in the inherited IRA to the surviving spouse would be treated as a taxable distribution to the child. Therefore, said the ruling, “the order of the state court cannot be accomplished under federal tax law.”⁸⁷

⁸⁴ PLR 2016-23001.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

B. The IRA Has *Not Already* Been Distributed or Rolled Over Before Settlement

(1). PLR 2007-07158 (Undue Influence)

PLR 2007-07158 involved the very common fact pattern where one party claims an IRA beneficiary designation is invalid as a result of lack of capacity and undue influence and then a settlement is reached that attempts, with a court order, to reform the designation retroactively. The Ruling may provide a good example of how to structure settlements involving IRA beneficiary designations to minimize adverse and unintended tax consequences.

In PLR 2007-07158, the decedent left his estate to two cousins. Allegations were made that, prior to the decedent's death, one of the cousins ("**Taxpayer B**"), who was the decedent's agent under a power of attorney, had mismanaged the decedent's assets and improperly directed non-probate assets to himself and his children.⁸⁸

After the decedent's death (and before any settlement), the IRA was transferred to three separate sub-accounts for the benefit of Taxpayer B's three children (who were the named beneficiaries on the IRA) and they started taking their RMDs and reporting the distributions as income. A settlement was eventually reached and subsequently approved by a state court which entered a judgment, among other things, retroactively naming the other cousin ("**Taxpayer C**") as the beneficiary of the IRA, effective the day before the decedent died. The settlement required Taxpayer B's children to transfer their interests in the IRA account to an IRA set up and maintained in the name of the decedent for benefit of Taxpayer C. Pursuant to the settlement, Taxpayer B's children were not required to refund the RMDs they received (which they already reported as income).⁸⁹

One of Taxpayer B's children ("**Taxpayer D**") sought the following Revenue rulings:

1. That he would not be subject to the gift tax under IRC § 2501 if he enters into the settlement agreement;
2. That the remaining assets of the IRA would not be includible in his (Taxpayer D's) gross estate under IRC § 2033; and
3. That future distributions from the IRA would not be taxable to him (Taxpayer D) under IRC § 408(d)(1).⁹⁰

With respect to the first two questions, the IRS concluded there was a bona fide controversy and the outcome of the settlement was consistent with the decedent's Will and reflective of the rights of the parties under state law. Thus, the IRS ruled that: (1) entering into the settlement would not result in Taxpayer D being deemed to have made a taxable gift under IRC § 2501; and (2) Taxpayer D would not be deemed to be the owner of the IRA at his death under IRC § 2033. The Service concluded that the minimum distributions previously received from the IRA, however,

⁸⁸ PLR 2007-07158.

⁸⁹ *Id.*

⁹⁰ *Id.*

would be included in Taxpayer D's gross estate under IRC § 2033 unless these assets were exhausted prior to Taxpayer D's death.⁹¹ Finally, with respect to the third request, the IRS concluded that distributions from the IRA set up and maintained in the name of the decedent for the benefit of Taxpayer C, would not be taxable to Taxpayer D under IRC § 408(d)(1).

(2). PLR 2001-27027 (Rollover to Surviving Spouse)

In PLR 2001-27027, a daughter, who was disinherited from the estate of her father (the decedent), filed a Will contest. The litigation was resolved by a settlement whereby the parties agreed to divide the estate and six IRAs in stated percentages. The settlement was approved by a state court which included that it reflected the decedent's intent. Among the rulings requested by the surviving spouse, was whether she could roll her share of the IRA assets to her own IRA under IRC §§ 402(c)(2) and 408(d)(3).⁹²

The IRS concluded that the surviving spouse was eligible to roll over her percentage share of the IRAs into an IRA set up and maintained for her.⁹³ The ruling noted that, under § 401(a)(9)(B)(i), if a surviving spouse remains the beneficiary of an interest in a decedent's IRAs, she is bound to continue to receive the balance in the IRAs at least as rapidly as the method that the decedent was using.⁹⁴

(3). *Ozimoski v. Comm'r of Internal Revenue* (A Warning to Lawyers)

Ozimoski v. Comm'r of Internal Revenue,⁹⁵ provides an ominous warning to the probate practitioner. That court noted in its opinion that it was "clear from the record before the Court is that petitioner's probate attorney failed to counsel her on the full tax ramifications of paying [the settling party] \$110,000 from her own IRA."⁹⁶

In *Ozimoski*, a surviving spouse petitioned the IRS to redetermine her alleged tax deficiency arising from certain payments made from an IRA to the decedent's son to settle a contested state court probate proceeding. The surviving spouse failed to report the IRA distributions used to fund the settlement payment on her personal income tax return.⁹⁷ The surviving spouse received a notice of deficiency and filed an appeal. The issue on appeal was whether the IRA distributions used to fund the settlement were taxable income to the surviving spouse.

The Tax Court concluded that the distributions the surviving spouse received from her own IRA were taxable income to her under the normal rules.⁹⁸ The Tax Court began its analysis by zeroing in on several key facts: "On July 2, 2008, after Wachovia unfroze the IRA assets, it transferred \$235,495.46 from [the decedent's] IRA to [the surviving spouse's] traditional IRA, which was also with Wachovia. The [surviving spouse] then received distributions from her IRA

⁹¹ *Id.*

⁹² PLR 2001-27027.

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ 112 T.C.M. (CCH) 666 (T.C. 2016).

⁹⁶ *Id.* at 13.

⁹⁷ *Id.* at 3.

⁹⁸ *Id.* 13.

totaling \$174,597.17 in 2008.”⁹⁹ The only problem was the surviving spouse was **not named** as a beneficiary of the Decedent’s IRA. From examining the record, the Tax Court concluded there was an improper rollover of the Decedent’s IRA to the surviving spouse, stating:

Wachovia incorrectly rolled over the entirety of [the decedent’s] IRA to [the surviving spouse’s] IRA. An IRA beneficiary designation cannot be reformed after the IRA owner dies. Sec. 1.401(a)(9)–4, A–4(a), Income Tax Regs. (“In order to be a designated beneficiary, an individual must be a beneficiary as of the date of death.”). The Court finds that [the surviving spouse] was not a named beneficiary of [the decedent’s] IRA on the date of his death and therefore cannot be named a designated beneficiary after his death.¹⁰⁰

The Court noted there was nothing it could do to unwind the erroneous rollover. The surviving spouse argued that the distributions should not be included in her income because she and the son had agreed, through the settlement, that the son was entitled to \$110,000 of the decedent’s IRA. The court, however, stated it was “sympathetic to [the surviving spouse’s] argument” but remained focused on the fact that the distributions she received were from her own IRA and therefore are considered taxable income to her.¹⁰¹

C. Failure to Update Beneficiary Designation Form

(1). PLR 2007-42026

In PLR 2007-42026, the IRS declined to give effect to a state court order designating the decedent’s daughter (his sole surviving heir) as beneficiary of the IRA which was issued nearly two years after the decedent’s death for purposes of allowing a retroactive beneficiary designation.

In that instance, a decedent had named his wife the primary beneficiary on an updated beneficiary designation form but failed to add his daughter as the secondary beneficiary. After the wife’s death, the IRA custodian allegedly mailed another beneficiary designation form to the decedent so that he could name his daughter as the beneficiary of his IRA, but the participant died prior to signing the form. As a result, his estate became the beneficiary of his IRA pursuant to applicable plan rules.¹⁰²

To conform to the presumed intent of the decedent, a state court issued an order amending the beneficiary designation such that the daughter was named as the beneficiary of the IRA. The order indicated that the daughter was to be treated as if the decedent had named her as his IRA beneficiary prior to his death. Prior to the court order, the daughter transferred, by means of a trustee-to-trustee transfer, the decedent’s IRA to a new IRA, which was established and was maintained in the name of the decedent for the benefit of the daughter.¹⁰³

⁹⁹ *Id.* at 10.

¹⁰⁰ *Id.* at 11.

¹⁰¹ *Id.* at 14.

¹⁰² PLR 2007-42026

¹⁰³ *Id.*

The IRS denied the daughter's request to be treated as a DB of the IRA. It noted that the applicable beneficiary form contained no DB at the decedent's death, and as a result, the estate was the beneficiary of the IRA. The IRS declined to give retroactive effect to the state court order designating the daughter as beneficiary of the IRA which was issued nearly two years after the decedent's death.¹⁰⁴

The IRS noted in that ruling that "the statute and applicable regulations clearly describe the method to determine the designated beneficiary and provide a specific mechanism to achieve a post-required beginning date payout period longer than the IRA owner's remaining life expectancy - the IRA owner merely has to ensure that at least one individual is designated as beneficiary under the IRA as of his date of death."¹⁰⁵ Because "no living person was named, as either primary or contingent beneficiary, on that date, the decedent must be treated as having no designated beneficiary as of his death under section 401(a)(9) and the timing of distributions under the IRA must reflect this and be paid out over a period not longer than Taxpayer A's remaining life expectancy."¹⁰⁶

(2). PLR 2016-28004

PLR 2016-28004 involved another attempt to retroactively "fix" an improper beneficiary designation, which was rejected by the IRS.

In that instance, the decedent maintained two IRAs with financial advisors who changed firms. After his advisors moved, the decedent sought to transfer of his IRA assets to the new financial firm. As part of the move, a new beneficiary designation form was prepared, but it erroneously named the decedent's estate as the sole beneficiary rather than certain trusts which had been named in his previous designations. Nonetheless, the decedent signed that form and, after the decedent's death, the trustees of the trusts obtained a state court judgment modifying the beneficiary designation to carry out the original estate plan. The order was retroactively effective as if such designation were properly made.¹⁰⁷

Unfortunately, the IRS refused to honor the state court judgment.¹⁰⁸ Because the decedent's estate was named as the beneficiary of the IRA at the time of his death, and an estate cannot qualify as a DB, the IRS concluded that the IRA did not have a DB and no stretch-out was allowed.¹⁰⁹

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

VII. STRATEGIES TO CHANGE THE DESIGNATED BENEFICIARY AFTER DEATH

A. Invalidate the Beneficiary Designation if the IRA Plan Provides A Favorable Alternative Disposition

Where the facts and circumstances permit, invalidating the beneficiary designation may be an effective way to resolve a dispute. This is often done on standard theories of undue influence or lack of capacity. This strategy may be most effective where a surviving spouse is the default taker under a given plan, assuming, of course, that is the desired (or agreed) result.

B. Reform Beneficiary Designation Form

Another option is to reform the beneficiary designation form. This seems to be effective from an absolute perspective, but not with regard to DBs. That is, the IRS generally respects such changes, but does not afford beneficiaries an ideal tax status. The primary exception to this seems to be where the recipient (after the reformation) is a surviving spouse. Also, under SECURE, it is unclear whether a reformation can result in the application of the 10-Year Rule. Presumably, because DB status is generally not allowed, there is no way to get out of the 5-Year Rule. But until the case law and other sources have had time to develop, it is hard to say for sure.

C. Disclaimer

Disclaimers can be effective in the right circumstances. The disclaimant will have no dispositive control over any disclaimed property, but where IRA assets would end up in the “right” hands if the disclaimant failed to survive the participant, it may be a viable option. Remember that, in order to be most effective, a disclaimer must be made by the Beneficiary Finalization Date. Also, a qualified disclaimer cannot be made in exchange for any consideration, so it may not work in the context of a settlement.

D. Remove a beneficiary

Additionally, beneficiaries may be removed before the Beneficiary Finalization Date by simply distributing all of their share of the IRA to them. According to the regulations, “any person who was a beneficiary as of the date of the employee's death, but is not a beneficiary as of that September 30 (e.g., because the person receives the entire benefit to which the person is entitled before that September 30) is not taken into account in determining the employee's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the employee's death.”¹¹⁰ Depending on the facts and circumstances, this can be an effective tool for improving the tax result for one or more beneficiaries. For example, where a charitable beneficiary prevents a trust from qualifying as a DB (because in order to qualify, all of a trust's individuals must be identifiable individuals), it may be possible to simply distribute the charitable beneficiary's share to it. This should not cause an adverse tax result for the charity because it should not have to pay income tax on the distribution.

¹¹⁰ Treas. Reg. § 1.401(a)(9)-4, Q and A-4(a).

VIII. PRACTICAL TIPS AND CONCLUDING THOUGHTS

A. Send Asset Discovery Early to Identify the Existence of an IRA

Needless to say, litigating (or uncovering) an “IRA beneficiary designation issue” raises a series of complex issues that must be carefully considered in order to identify potential resolution strategies. Consequently, the earlier an IRA issue (and its DB or default beneficiary) can be identified, the better. Therefore, discovery should be sent early on to avoid missing an important deadline.

B. Obtain, Review, and Analyze the IRA Beneficiary Designation and Plan Documents

Because the IRA plan documents might provide for unanticipated default beneficiaries in the event an IRA beneficiary designation is challenged, it is critical to request, through discovery, copies of all beneficiary designation forms and the plan documents. Whether a previous beneficiary designation is resurrected when a subsequent designation is invalidated must also be analyzed.

C. Advise the Client of the Potential Tax Challenges in Settling IRA Beneficiary Designation Disputes

This goes without saying. Many litigators simply ignore the tax consequences of their work. They may do this through affirmative waivers in their representation agreements or by some other method, but query whether such provisions should really stand up on policy grounds. The tax implications of probate disputes can be huge, especially where large IRAs are involved. As professional counselors, it is incumbent upon us to provide at least some modicum of assistance to clients in this regard, lest they fall into a devastating trap. At the very least, attorneys should seek tax co-counsel to review and advise on settlements.

D. Consider Informing Opposing Counsel of the Potential Tax Challenges in Settling IRA Beneficiary Designation Disputes

Because of the timing issues, getting in front of any IRA beneficiary designation disputes can be critical, so it often makes sense for practitioners to make opposing counsel aware of the potential problems sooner rather than later. The tax savings to be had can be very valuable and might sufficiently induce parties to come to the negotiating table more quickly.

E. Consider Settling Claims to IRA assets with Other Assets

Where something has gone awry with an IRA, the easiest solution may simply be to leave the IRA wherever it is and offset its loss with other assets. Although this may not be possible in all situations, it will be in others, so it should always be considered.